FARMER MAC

DAVE'S GPS

Q&A with Dr. Kohl
By Dr. David M. Kohl

During the late fall and winter I received many questions from attendees at various ag lending conferences across the country. This article focuses on some of the more common questions asked.

Does the ag balance sheet have good equity?

Mark, a banker at a conference, overheard me indicating that equity in the agriculture industry is strong and he did not believe my statement. First, Mark did not hear me clearly, which often occurs because I speak quite fast! Yes, the debt to asset ratio industry-wide is the lowest ever at 10 percent. However, that does not mean it is good equity on the balance sheet. The marketplace has a way of dissolving equity, specifically appreciated or paper wealth, to which I believe Mark was alluding. What one has to observe on the balance sheet is earned net worth, equity from profit or earnings of the business or income generators.

American agriculture is in a classic "phase one" of asset correction. Negative margins and cash flow will result in an inability to service debt and meet expenses, or a margin crunch. "Phase two" is the classic liquidity trap which will deplete working capital reserves and result in inability to repay operating loans or garner additional operating loans. "Phase three" is characterized by asset devaluation, specifically because of negative income and working capital reduction, eventually resulting in reduction of the paper wealth on the balance sheet. This is due to inactivity in the marketplace, that being more sellers than qualified buyers. The extent of the decline will generally be seen on local or regional levels depending on economics, quality of assets, and local dynamics that support land prices. Yes, land is overinflated in a classic asset bubble. The lack of cash flow, liquidity and marketplace psychology could result in a revaluation.

How liquid should producers be?

This is a great question because revenue and cost volatility and size of loans places a premium on this factor in credit analysis. How much liquidity is enough? Farm record systems generally find working capital to revenue ratios of 40 percent or greater in the top echelon of businesses and 10 percent to 15 percent working capital to revenue on marginal operations. Not all liquidity is equal. For example, those producers who maintain cash to meet one year's debt service or 2 to 3 months of average expenses

are in better shape than those with prepaid assets that will not generate income for another 9 to 15 months. Crops growing in the field without insurance or grain in the bin without a marketing and risk management plan are vulnerable as well. Thus, as one examines liquidity, match income flows from the sale of current assets to obligations over the next 12 months. This will be a feature of an upcoming article as many of you examine the top half of the balance sheet.

How can producers control family living expenses?

Family living expenses have skyrocketed along with farm income over the past decade. How can producers and lenders gain control? The biggest competitor for free cash flow in a business is family living expense. Historically, one could plug an average number, but currently family living cost is all over the board. High maintenance individuals are in the $125,000 to $150,000 range and modest to frugal expenditures fall in the $40,000 to $70,000 range, with the difference equating to approximately $80,000 that could impact free cash flow.

Recently, I have been working with three stressed financial situations. In these situations, the first step was to require individuals to develop a personal family living budget modeled after the farm and ranch record systems of Nebraska. Co-mingling living expenses with business expenses is a business killer! Separation was critical in all three instances. These producers pay themselves a monthly draw and live within the amount. As lenders, be careful to monitor credit card balances and be sure operating lines of credit are not being drawn for family living expenses. Beware of the balance sheet bully, which occurs when a producer with high paper wealth or equity demands operating money for living costs to maintain an extravagant lifestyle.

What is your single most important advice for ag lenders?

It is the professor's prerogative, and I cannot just give one! First, make sure that you start dialogue with your customers with good financial information. Next, examine a trend analysis because historical trends can help to determine a pattern.

Do not forget the financial issues often start outside the numbers. Signs of issues are often embedded in human behavior, i.e. becoming disinterested, sudden changes in personal habits, going into a shell, giving up, seeking other lenders, or shutdown of communications with suppliers, lenders, the community, and even with the family.

Next, if you embark on a turnaround strategy, a helpful tool is good old-fashioned variance analysis. That is, develop projections and compare actual results to those projections periodically. In some cases this could happen monthly or quarterly, but in all turnarounds it is important to be timely and stay on top of the account.

Celebrate mini-victories if the producer does show some progress, and give them an earned pat on the back. Prioritize the "laundry list" by identifying low hanging fruit and what can be accomplished quickly to build momentum. Surround yourself with positive

people, events, and habits and remember the most loyal customer base is built in a downturn.

Should we throw out accrual net income because it distorts analysis and does not pay back loans?

Ouch! A banker asked this question based upon another speakers' comment at a conference, and indicated that it could damage credit analysis in this environment. While I was not there to hear the speaker's comment, let's examine the point. Accrual adjusted net income is adjusted for changes in current assets and current liabilities between beginning and end of period balance sheets to determine profitability. Accrual adjusted net farm income is more appropriate when measuring profitability than net farm income reported on a cash basis using Schedule F tax statements. Variation of up to 60 percent difference over a five year period was found by Drs. Barnard, Ellinger, and Wilson of Purdue University, University of Illinois, and Kansas State University, respectively.

Granted, accrual net income does not pay back loans; however, analyzing the time it takes to turn those accrual income assets to cash, and alignment of cash flow with debt servicing obligations is the next important step. Doing a cash flow and liquid asset analysis and determining its impact on short and long-term credit analysis is critical. I would by no means throw out accrual analysis, but supplement it with cash flow and liquidity analysis to determine the impact on cash available for debt service.

Lender Tip: Educational Opportunities

There are many good state and national ag lending schools and conferences for education in the summer, so get signed up. More ag lenders are presenting educational conferences in which both producers and lenders attend the same meeting. Please invite your regulator to attend various conferences. While many of you cringe at the thought, an educated and informed regulator will be necessary in a challenging environment.

Global Economics

The European region is now carrying out its version of quantitative easing, similar to the U.S. The result has been an increase in equity markets in that region and a slight pickup of growth. It will be interesting to see if the European economies can sustain after 21 months of quantitative easing are over. As a side note, I was recently with an Irish and German dairyman and they said all quotas have been lifted as Europe goes toward a free market. The Irish dairyman indicated that the government has mandated a 50 percent increase in milk production by 2020. This increased global competition may impact the U.S. dairy sector, which is currently flush with milk and experiencing lower prices.

Asia is still experiencing a slowdown along with other emerging nations. China's economic engine has observed a slower export market as global growth softens. As an importer of agriculture products, it will be interesting to observe what happens if economic growth rates slip back toward 5 percent.

The bottom line is that global growth is slowing, but quantitative easing in Europe, Japan, and even in China may create economic change that will be difficult to comprehend for the agriculture, rural, and energy sectors.

Domestic Economics
The Leading Economic Index (LEI) and purchasing manager index (PMI) are still predicting a growing economy four to six months into the future. The LEI diffusion is 60 percent, indicating 60 percent of the indicators that make up this index are positive, and the recent index was up 0.2 for the month. The PMI is still above 50, indicative of a growing economy, but it has slipped two points since January, from 53.5 to 51.5. However, the advance estimate of GDP growth for the first quarter of 2015 came out at a low 0.2 percent rate.

King dollar, or the strong U.S. dollar, is still in process with the dollars per euro in March being 1.07. Similar strength is being shown against the yen and other major currencies in the world. King dollar's duration will be a variable that we need to closely monitor for regional economies such as Midwest agriculture and rural areas that export a considerable amount of products. The beneficiaries are the U.S. coastal economies that benefit from cheaper imports. If you are investing in the stock market, watch for profit declines in multinational companies marketing abroad where a strong dollar is hindering market forces.

Oil prices in the $40 to low $50 per barrel range are benefiting consumers and some agriculture segments. Deflationary effects on all commodities including oil bears watching.

Unemployment is still in the 5.5 percent range which bodes well for interest rate increase possibly later in the year. However, recent job numbers suggest the economy is not as strong and wage inflation is basically non-existent.

Factory utilization has declined by a slight amount but it still demonstrates strength in the high 70s. As the year progresses, it will be interesting to determine whether inventory buildups on oil and the strong dollar will result in factory cutbacks later in the year.

Housing starts increased slightly in March to 926,000. With the millennials purchasing fewer homes and tougher regulatory standards, it appears to be difficult to reach the ideal metric of 1.5 million annual housing starts.

Core and headline inflation are benign coming in at 1.8 and -0.1% respectively. Disinflation or deflation factors led by oil prices may prevent the Federal Reserve from raising interest rates despite solid employment figures.

Lender and Business Dashboard Economic Indicators (for the month of March)

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	121.4	✓		
LEI Diffusion Index	60%		✓	
Purchasing Manager Index - PMI	51.5	✓		
Housing Starts (millions)	0.926			✓
Factory Capacity Utilization	78.4		✓	
Unemployment Rate	5.5%	✓		
Core Inflation	1.8	✓		
Headline Inflation	-0.1			✓
Oil Price ($/barrel)	$51.45		✓	
Yield Curve	1.91	✓		

Lender and Business Dashboard Economic Indicator Benchmarks

Indicator	Green	Yellow	Red
The Conference Board Leading Economic Index® - LEI	Increasing	Flat to Decline	Decline 0.3% for 3 consecutive months AND >1% over the period
LEI Diffusion[1]	>60%	40%-60%	<40%
Purchasing Manager Index - PMI	>50	41.7-50	<41.7
Housing Starts (millions)	>1.5	1.0-1.5	<1.0
Factory Capacity Utilization	>80%	70%-80%	<70%
Unemployment Rate	5%-6%	6%-8%	>8% or <5%
Core Inflation	0%-2%	2%-4%	>4% or <0%
Headline Inflation[2]	0%-4%	4%-5%	>5% or <0%
Oil Price[3] ($/barrel)	<$50	$50-$100	>$100
Yield Curve[4]	Steep	Flattening	Inverted

[1]Ten indicators make up the LEI - measures % that are increasing; [2]Includes food & energy; [3]Consumer's perspective; [4]3-Month Treasury Bill rate to 10-Year Bond rate