FARMER MAC

DAVE'S GPS

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Changes in Credit and Financial Culture

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All signs are pointing towards an agriculture economic cycle similar to the pre-pandemic period from 2013 to 2020. In the down cycle of those years, increasing land values provided a financial shield and, in many cases, contributed to appreciating equity despite economic struggles. What is different this time is that lower prices are now combined with sticky, inflated costs and higher interest rates. This combination brings a sense of urgency to the credit culture of agricultural lenders, and both the financial culture and acumen of the borrower. The recent “mini super cycle" was propped up by government stimulus, which brought a false sense of financial security.

Culture changes and actions

Many agricultural lenders use the debt service coverage ratio to assess risk and repayment capacity. An analysis of state record-keeping systems and the FINBIN database finds that the debt service coverage ratio is rapidly declining for the median and lower segments of producers, as measured by profitability. More reports from lenders, borrowers, and farm management consultants in the mid-year budget assessments are finding negative trends in debt service coverage ratios.

In these cases, it’s likely an operating loss refinancing request will be in store for the fall and winter operating loan renewal seasons. Will the debt restructure be building a financial bridge to overcome the financial shortfalls? If building a financial bridge, what will be the strategies necessary to move the debt service coverage ratio to an acceptable range and maintain it for the long run? Critical questions must be asked concerning the increase in term debt at higher interest rates and what that means for the cost of production.

Instead of building a financial bridge, in some situations a refinancing request may be moving the borrower towards the end of the pier where the water is deeper and the financial obligations are higher. This situation could be difficult to navigate and sustain the business in the future.

Working capital

The secondary backup to the debt service coverage ratio will be monitoring working capital, which can be assessed by dividing working capital by expenses or revenues. Two years ago, operating lines of credit were often at zero balances and working capital positions were healthy and strong on many agricultural producers' balance sheets.

Fast forward to today when operating losses are magnified by the decline of working capital positions. De-valuations of inventory, such as crops in the bin with no marketing plan, result in paper losses for current assets. For example, in some cases \$5- to \$6-per-bushel corn is now in the \$3.50- to \$4-per-bushel range. Thus, current liabilities are up and current asset values are down, which can create potential financial liquidity traps.

As with the debt service coverage ratio, the refinancing plan to replenish working capital has to stand the test of time and the bridge versus pier concept. What will be the changes in the borrower's financial culture to ensure that working capital is preserved? On the other hand, if no changes are made, what is the burn rate on working capital? How does this impact the financial sustainability of the business? How do we avoid a situation where the borrower gets to the end of the pier with no options as a result of higher long-term debt obligations?

Monitoring

As with the other down cycles in agriculture, intense financial monitoring will be a two-way street by both the lender and borrower. Once-per-year assessments for loan renewals or for tax management is a trap that many have fallen into during strong economic cycles. Complacent habits are often developed during good economic times.

Next, the numbers will decline in an accelerated manner with larger customers—this is where changes in price and costs can result in large swings on the bottom line. This situation can give any analyst or internal reviewer high blood pressure!

Trust and verify! Inspections of crops in the bin and cattle in the pasture or feedlot are not optional. What is lurking out there in the form of accounts payable that are not reported? Has credit card debt built up to cover some of the business and personal obligations?

Watch out for the producer seeking a new lender as a last resort or in desperation. If they do seek you as a new lender, do they have a written plan that has been tested with different scenarios? If they are in an adverse financial situation, what caused the debt and how can it be rectified? Remember, it takes four times the amount of time, money, and effort to handle a nonperforming or adverse credit versus a performing situation.

Radar screen

The proactive radar screen is going to require the best of the science and the art of agricultural lending and borrower financial management. Be aware of fraudulent activities such as missing inventories, machinery, equipment, and livestock. Watch out for the producers who are attempting to hit the jackpot or the home run to bail out poor decision-making. Desperation often brings out the extremes in individuals.

Be prepared for machinery and equipment values to decline by 30% to 50%, reducing paper equity. Will the hot cattle sector with record prices cool off like a Canadian polar vortex in the winter? Watch for uncollectible accounts receivable such as custom work, grain, and inventory. What happens if a major integrator or agribusiness firm runs into financial adversity? What is the third-party counterparty risk?

On a personal level, divorce, depression, disengagement, desperation, drugs, and dependencies are all natural outcomes of stressful situations for both borrowers and lenders. A good network of people and positive activities are critical in the credit and financial cycle ahead.

On a positive note, relationship lending is a positive outcome that often occurs when difficulty increases. Both the borrower and the lender can come out stronger with many victories along the way to a positive outcome. Transparent financials with open communication, teamwork, and responsiveness to the plan have been the recipe for success in the past for the economic cycle that may be ahead for our industry.

Lender and Business Dashboard Economic Indicator Assessment
August 28, 2024

Global Economy

The global economy, when compared to the U.S. economy, continues to underperform. The health of the global economy is critical to the U.S. agriculture economy, which is very dependent on agriculture exports for profits and maintaining asset values, specifically land.

China, which has been one of the top three agricultural trading partners for the U.S., has had a very sluggish economy growing in the 5% range. Consumers continue slow spending in the retail market. Asset values have declined in both the housing and stock markets and have created a negative wealth effect. When people lose paper wealth, they tend to constrict spending.

China has reduced its consumption of oil and energy which is in the 12% to 15% range of total global consumption of 1 million barrels per day. This reduction has been reflected in the U.S. gasoline and diesel prices, which are moderate to lower when you look year-over-year.

Sanctions, tariffs, and trade uncertainties with the U.S. have placed a damper on agriculture export demand, which is expected to continue through the election cycle in November. China's efforts to stimulate their economy through lower interest rates and loosening monetary policy has yet to boost the economy.

Japan, the third largest economy globally, has observed a massive correction in their stock market after hitting an all-time high above 40,000 points. The market has declined down to 30,000 points, which is an official bear market. Some recovery has been observed in recent weeks.

Europe, which has 5% of the global population, has enjoyed over one-third of the world’s tourism spending. Consumer spending on tourism has been a boost to the Euro sector growth, which was recently reported at just above zero. Keep a close eye on the German economy, the fourth largest economy in the world. Recent growth numbers have been in the negative range.

Domestic Economy

The recent meltdown of the stock market was a quick reminder of how fragile the economy can be teetering on recession.

Watch the job market over the next few months. There is evidence of a tighter job market in manufacturing and particularly in the technology field. Both the U-3 and U-6 (which includes discouraged workers) unemployment rates have increased substantially. Of course, this is reflected in the equity market softness.

The Index of Consumer Sentiment is now back into bear territory, registering in the mid-60s in recent reports. Retail sales at McDonald's, Starbucks, Chipotle, and even my family creamery have been down 6% to 8% year-over-year. If equity markets were to correct more, this would further subdue consumer sentiment as a result of behavioral economics. This, coupled with the spending habits of the ALICE population (asset limited income constrained and employed), could be enough to curtail the service sector, which represents 70% of the U.S. economy.

The Purchasing Manager Index (PMI) is trending downward into the mid-40s range, indicating a slowing economy. The Leading Economic Index (LEI) also points to signs of a slowing economy.

Factory utilization and housing starts are both in neutral territory as an economic barometer.

Both the core and headline inflation rates will remain important for the future direction in interest rates. The Federal Reserve appears increasingly willing to accept a 2.5% core inflation rate versus the 2% guideline before lowering interest rates. Indeed, the Federal Reserve decided on two rate cuts in the September meeting, causing short-term borrowing costs to drop. Two rate cuts may signal the Federal Reserve believes inflation is likely to remain subdued moving forward. However, the number and timing of future rate cuts will be dependent on the direction of the aforementioned economic variables, consumer and business sentiment, and walking the political tightrope.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	100.4		✓	
LEI Diffusion Index	50%		✓	
Purchasing Manager Index - PMI	46.8		✓	
Housing Starts (millions)	1.238		✓	
Factory Capacity Utilization	77.8%		✓	
Unemployment Rate	4.3%	✓		
Core Inflation	3.2%		✓	
Headline Inflation	2.9%	✓		
Oil Price ($/barrel)	$79.58		✓	
Yield Curve	-0.88			✓

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	<6%	6%-8%	>8%
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