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RED FLAGS FOR HIGH RISK BORROWERS

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Production Agriculture – A Competitive Environment

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"The function of a competitive market is to drive the economic return to the average producer to breakeven through supply and demand in both input and output markets. *In equilibrium, the top end are profitable and growing, the average are hanging in there, and the bottom end are losing money and exiting the industry.* Business success and survival depend on continuous improvement at a pace necessary to stay in the front half of the pack." ---**Professor Danny Klinefelter, Texas A & M University**

Business Success Factors:

1. Marketing
2. Production

Margin Management

3. Surviving Industry Cycles
4. Capitalizing on Opportunities

Solvency & Liquidity

Red Flags for High Risk Borrowers

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Farm Credit Services of America identifies a handful of red flags that should alert both producers and their lenders to potential risky outcomes, including:

1. Excessive expansion rates, particularly outside of the normal areas of expertise
2. Inadequate financial records
3. High cost of production
4. Exotic risk management strategies

The Discussion Approach:

1. Identify and explain the risk in the red flag
2. Review common observations
3. Outline practices to prevent, mitigate, or manage the risk

Expansion Decisions & Risks

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- Compound Annual Growth rates that are not sustainable (10%, 20%, 20+%)
- Stretching working capital too thin is most common mistake (@ $250/acre it takes $250,000 for each 1,000 acre expansion increment)
- Logistics of the expansion—moving M&E, labor, management
- What is the return potential for this expansion (RDA)

Expansion Decisions & Risks

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- What does expansion do to the breakeven (or COP) for the whole business
- Does this expansion retain, enhance or dilute the competitive advantage of this business?
- Leaving the balance sheet (business) too vulnerable to volatility of the next industry cycle

Quality of Financial Records

<u>Accounting Systems and Financial Records that lack basic requirements consisting of:</u>

- Comprehensive – All the significant entities, all the assets, all the liabilities, contingent liabilities, derivatives, and off balance sheet items, consistent valuation basis
- Timely – Frequency, match fiscal year-end, accurate inventory reporting and adjustments
- Accrual basis – Least understood and rarely presented but we have to get there

Quality of Financial Records

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Observations:

- Spin off entities often well intended (estate planning, legal liability, minority owners)
- Multiple entities, however, add complexity and sometimes misleading conclusions to producers and lenders
- Multiple entities add to the cost of accounting and the cycle time in generating financial reports for internal use or external presentation
- Not having the whole picture is the greatest risk---can lead to incorrect conclusion and decisions in both directions!!

Quality of Financial Records

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Considerations for Future:

- Third party verification- CPA Review or compilation format/consistency
- Benchmarking database access and comparative format
- Farm Business Consulting Service-public and private options exist

Increased Costs of Production (COP)

- No one has completely escaped increased COP
- Farmland purchases (and other CAPEX) can raise COP significantly – we analyze this on every deal
- Cash rent prices have significantly raised COP – a market lagging factor of production
- Do you account for your COP and use as a major decision-making factor?

Nebraska Farm Business Example

Irrigated Corn (All Tenure Types)				Irrigated Soybeans (All Tenure Types)			
	Bu/Acre	Net Return	Cost of Prod./Bu.		Bu/Acre	Net Return	Cost of Prod./Bu.
2007	181	$134.23	$2.88	2007	60	$122.70	$6.71
2008	191	$123.87	$3.29	2008	59	$96.91	$7.82
2009	207	$60.12	$3.45	2009	65	$94.05	$7.88
2010	190	$218.91	$3.55	2010	63	$151.90	$7.72
2011	192	$346.73	$3.95	2011	61	$123.16	$9.82

Dryland Corn (All Tenure Types)				Dryland Soybeans (All Tenure Types)			
	Bu/Acre	Net Return	Cost of Prod./Bu.		Bu/Acre	Net Return	Cost of Prod./Bu.
2007	120	$93.56	$3.08	2007	49	$167.65	$5.59
2008	134	$53.75	$3.48	2008	41	$39.91	$8.46
2009	153	$58.23	$3.29	2009	52	$129.61	$6.04
2010	140	$217.03	$3.17	2010	47	$163.31	$7.01
2011	139	$227.45	$4.12	2011	52	$151.34	$8.30

Cost of Production

<u>Considerations for Future:</u>

- Enterprise Unit Analysis (Managerial Accounting 102)
  - Requires overhead allocation and an integration of production units (bushels) with the accounting system
  - Production unit, Enterprise x Enterprise, Farm x Farm, Field x Field
  - The Land Holding Company/Operating Company model
  - Who in the farm business is accountable and how often is the information reviewed?
    - Dedicated employee
    - Part time consultant
  - Management information is not all about filing taxes and meeting payroll!!

Risk Management / Marketing Strategies

- Scrambling to support margin calls and crash courses for the Lender on your program are risky practices.
- Production, counter-party risk, exchange traded products, OTC products, option strategy complexity and increased volatility have substantially complicated the process.
- Make sure you understand what your objectives are, stick with them, and then understand the steps you are engaging in to get them.
- Be ready to explain it to your lender, then follow-up and communicate at key checkpoints during the year.

Risk Management / Marketing Strategies

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Future Considerations:

- Develop a margin management concept to begin understanding your forward margin
- Future crop marketing is an acceptable and astute practice
  - Think through the implications of market moves
  - What is and is not locked in on the cost side?
- Illustrate the scenarios and determine the potential capital needs.
- Track and balance all of your positions consistently and concisely.

Recognizing Problems, Exit & Adjustment Options, Execution

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“It is worth noting that many of the businesses we (Koch Industries) have exited were not failures. They were successes, but had simply reached a point in their life cycle where they no longer provided a core capability or platform for growth. As such, they became more valuable to someone else.”------*Charles Koch, CEO, Koch Industries, Inc. from* ***The Science of Success***

- **Utilize data to evaluate performance and cost structure against peer information**
- **Focus on margin management—but must know cost of production, including knowing the fixed cost components and the variable components**
- **Downsizing or exiting decisions (high cost rented land) also require analysis of impact to fixed costs on remaining operation**
- **Landowner relationships and negotiation skills will be important in “making adjustments” in a lower margin environment—consider creative options**
- **What ability, acknowledgement, and desire do producers have to make changes—willingness and the courage to execute on changes?**

Questions & Discussion

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