CPAs & BUSINESS ADVISORS

OBSERVATIONS FROM THE FIELD

Agriculture Lending Update

LOAN REVIEW CONSULTING PRACTICE

Eide Bailly LLP Des Moines Office

Greg Clausen, CPA, Partner
Randy Friederich, Senior Manager

- 29 loan review consulting engagements completed in 2018.
- Banks ranging in size from $75 million to $4.5 billion.
- 85% percent of the banks we performed loan reviews in were concentrated in agricultural lending through the State of Iowa.

OBSERVATIONS FROM THE RUN UP

- Farmers operated in generally favorable economic environment beginning in 2007/2008 when commodity prices were increasing above historical averages.

- By 2012, the average corn price for the marketing year was $6.92/bushel and the average soybean price was $14.40/bushel and there were several opportunities to make sales above these averages.

- There was a high level of disposable income in family farms, the majority of which was not saved.

- Equipment lines were updated; new homes were constructed on the home farm and operations expanded either by purchasing land at historically high prices or by renting additional acres.

OBSERVATIONS FROM THE RUN UP

- Competition for rented acres was fierce, driving up rental rates.
- New opportunities presented themselves for the next generation to come back to the farm.
- Off-farm employment was reduced.
- Family living costs ramped up (new pickup trucks, vacations, etc.).
- Previously classified ag borrowers suddenly looked a lot better even though they didn't change how they operated or how they marketed their grain.
- Working capital was plentiful and profitability was strong as land rental rate increases and input costs lagged for a period of time.

OBSERVATIONS FROM THE DOWNTURN

- Grain prices began to fall. For the 2014 marketing year, corn fell to $3.71/bushel (46 percent decrease from 2012) and soybeans to $9.96/bushel (31 percent decrease from 2012).

- The classified borrowers that looked much better a couple of years prior, who didn't change how they operated, now were showing stress again.

- Land rental rates remained high due to continued competition for acres and because land owners had previously delayed increases.

- The higher rental rates were paid and were paid willingly.

OBSERVATIONS FROM THE DOWNTURN

- In 2014, there were few that believed that the down cycle would be this prolonged.
- Input prices, which had lagged the run up, were now increasing and would not be stabilizing any time soon.
- Farm families were not rushing to get back to their off-farm employment.
- Family living costs were slow to adjust early in the downturn.

OBSERVATIONS FROM THE DOWNTURN

- Cash flows began to tighten due to lower revenue levels and because there were machinery & equipment and land payments to pay.
- Suddenly there was less than $5/bushel corn that was used to make more than $5/bushel loan payments.
- High intermediate, equipment, debt level operations were showing stress.
- Significant rented land base operations were showing stress.
- Farm operations lacking diversity in revenue sources were at risk.

OBSERVATIONS FROM LAST 5 YEARS IN THE DOWN CYCLE

- In our loan review consulting and bank audit work - It was after the 2013 crop year when we first saw issues developing in the agriculture sector, which were largely associated with operations having high land rental rates on a large number of acres, grain concentrated operations and high machinery & equipment payments.

- It was at this point when we started seeing restructuring of ag borrowers and it's been happening ever since given the continued low level of grain prices.

OBSERVATIONS FROM LAST 5 YEARS IN THE DOWN CYCLE

- Restructuring. How was it handled? At first, it was a kick the can down the road mentality whereby carryover debt was left alone hoping it could be repaid with the next year's crop. No one thought the low level of grain prices would last, right? When that didn't materialize, banks began moving debt down the balance sheet. Carryover debt was refinanced against the equity in machinery & equipment and amortized over 5 years. Then when that wasn't sustainable, the intermediate indebtedness was refinanced against the equity in real estate and amortized over 20 to 25 years, or even to 30 years.

- We have seen many borrowers that have been restructured more than once because of the need to restore working capital and find a way to make the cash flow work.

OBSERVATIONS FROM LAST 5 YEARS IN THE DOWN CYCLE

- Early on after a restructuring, there was a lack of assessing pro forma post-restructuring cash flow and if could it work under the sustained current conditions with the added restructured debt. Again, the kick the can down the road mentality.

- Many borrowers have found themselves burning equity the last few years. Those lacking equity and/or adequate cash flow to service additional loan payments because of restructuring have needed to liquidate assets such as unneeded equipment, land or financial assets such as IRAs. Many have had to let previously rented acres go due to the inability to renegotiate rental rates.

- Some operations need off-farm income to survive, but what about family living expenses? Have they been cut back in reality or only in what the borrower is telling us for the projected cash flows?

OBSERVATIONS FROM LAST 5 YEARS IN THE DOWN CYCLE

- It's not just cash grain operations that have been impacted. The cattle market has been volatile to say the least. 2014 was highly profitable, while 2015 was a disaster for many. Cattle producers have needed to look hard for opportunities ever since and some have exited cattle altogether. The hog and dairy industries are facing volatile marketing challenges as well.

- The US/China trade war is having ramifications on the agricultural economy.

- There are some ag operations that are not sustainable and will have to exit the industry. For the remainder, community banks are here to continue to provide needed funding. Agricultural based community banks are not going to stop making agricultural loans which was prevalent in the 80's.

OBSERVATIONS FROM LAST 5 YEARS IN THE DOWN CYCLE

- There has been more interaction with customers on their financial situation, living cost adjustments and lowering of operational costs.
- Stress testing cash flows.
- Believe it or not, in some banks it was business as usual until recently.
- Restructuring of past operating losses is prevalent.

OBSERVATIONS FROM LAST 5 YEARS IN THE DOWN CYCLE

- There is some complacency with those operations whom have significant land bases and equity.
- Interaction with customers that may not be sustainable under past and current conditions (it is personal to them - family farms).
- Use of conservative inputs on cash flows.
- Properly assess for troubled debt restructurings.
- Parents burning or leveraging equity (retirement) to bail out their children.
- General lack of significant loss exposure industry wide.

REGULATORY ENVIRONMENT

- Obviously regulatory scrutiny has increased regarding agriculture concentrated banks in terms of concentration risk management, carryover debt identification and monitoring, including advancing additional funding for relationships with existing carryover debt.

- Our approach has been to generally not classify carryover debt if it is well secured and the projected cash flow for the upcoming production year is positive. Where we might vary from the aforementioned is if there is prevalent historical carryover indebtedness in the operation, which is indicative of the annual projected cash flow to be flawed.

- The aforementioned has also been the general approach of the FDIC and Iowa Division of Banking.

REGULATORY ENVIRONMENT

- We believe the OCC takes a more critical and aggressive approach in identifying and risk rating carryover indebtedness as well as validating borrower cash flows. We have little exposure to the OCC as many community banks in Iowa have converted to a Federal Reserve or FDIC regulated bank.

- We were in one bank this summer where the Federal Reserve Bank classified all carryover debt present in a line even if it has been restructured with agriculture real estate, with only the carryover portion of the being classified. They also received three MRA's for failure to identify, risk rate and monitor carryover debt. This approach was for all relationships that were well secured and the classified portion being only a small portion of the entire line balance.

REGULATORY ENVIRONMENT

- We expect the level of scrutiny to increase from all regulatory authorities as the down cycle persists.

- It should be noted that classified loan levels of State Chartered banks in Iowa stand at 15.45% as a percent of total risk-based capital compared to 21.30% in 2012 and 14.70% in 2015.

RISK MANAGEMENT PRACTICES

- Assess your lending staff (have they been there).
- For lines on the watch list, assess sustainability of each operation given past, current and expected conditions.
- For operations with continued operating losses, consider partial or total liquidation.
- Review annual projected cash flows with customers in detail.
- Require joint checks for grain and livestock sales proceeds.

RISK MANAGEMENT PRACTICES

- Obtain an assignment of crop insurance.
- Cross-collateralizing operating and intermediate loans with agricultural real estate.
- Assess loan approval authority for individual officers and market locations.
- Increase control and oversight of operating funding for certain borrowers with the use of individual notes.
- Utilize formal loan agreements with the borrower requiring sufficient grain to be marketed by the end of the production year.

RISK MANAGEMENT PRACTICES

- Performing at least annual documented farm inspections for all significant agricultural credit relationships.
- For grain inventory notes perform initial inventory inspection and determine remaining inventory and whether the grain is priced or unpriced. Monitor subsequent grain sales, amounts and update marketing activities.
- Stress testing individual agricultural credit relationships and considering the results in the assignment of a risk rating.
- Obtain FSA guarantees on stressed agriculture credit relationships to mitigate loss exposure as well as the amount subject to adverse classification.
- Monitor land sales in your market (price, CSR, farmer/investor, etc.) Land prices in Iowa are holding firm as the amount of land on the market remains limited.

QUESTIONS?

THANK YOU

Greg Clausen, CPA
Partner
gclausen@eidebailly.com
515.875.7595

Randy Friederich, CPA
Senior Manger
rfriederich@eidebailly.com
515.875.7556

EideBailly®

CPAs & BUSINESS ADVISORS