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Managing through a recession: options for farm operators and agriculture lenders

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Managing through a recession: options for farm operators and agriculture lenders

By Bob Jolly, extension economist, 515-294-6267, rjolly@iastate.edu

With financial institutions and businesses collapsing worldwide, rising unemployment, record home foreclosure rates and government deficits, the agricultural sector seems like an island of tranquility. One of the big questions on the minds of farmers, and the lenders and agribusinesses who serve them is when will these conditions start to have a major impact on agriculture and what can be done to avoid or lessen their impacts. The challenge for agricultural managers, however, is that the current financial meltdown is so unprecedented and so widespread that it is difficult to discern a reasonable course of action. After all, if several Nobel prize-winning economists can’t make coherent statements, what is a garden variety farmer or lender to do?

In this article we will attempt to describe what we know about the current financial condition of farmers in Iowa and suggest a few options for managing through some very difficult and uncharted waters. One of the key points we want to emphasize, however, is that the future is extremely uncertain and managers need to think in terms of contingencies – having plans for a number of possible situations that will be revealed to all of us later in the year.

Farm finance at the national and farm level

Looking at the balance sheet of the agricultural sector, there has been a remarkable increase in asset values since the late 1980s. Figure 1 shows this increase has accelerated significantly beginning around 2002. Debt loads have risen over this same period, but at a modest rate. Consequently the net worth of the agriculture sector in today’s dollars is at historically high levels. Stated another way, the debt-to-asset level of the US farm sector is as low as it has been since the 1960s. Net worth is a critical asset during hard or uncertain times. Net worth provides a credit reserve – unused borrowing capacity that can be tapped if adverse conditions occur. And it also means that even with reduced returns to assets, less income is needed to pay for debt service.

On the farm income side, the picture at the national level is a little less rosy. Inflation-adjusted farm income was fairly stagnant from the late 1980s through the next 20 years. Again, beginning in 2002, there was a significant increase in net income – along with an...
increase in volatility. However, farm income leveled off in 2008, decreasing in real or inflation-adjusted terms. Despite the plateau, real U.S. net farm income is significantly above levels that persisted over the 1990s.

Aggregate statistics can hide a great deal of variability in the financial situation of individual farm families. To get a little information on farm-level conditions, we applied a simple credit scoring model to farm financial data obtained from the Iowa Farm Business Association for 2007 – the most recent information available. Farms in this data set are, generally, representative of full time commercial operations. The credit scoring model takes into account the farm’s debt repayment capacity and its debt load and classifies it into one of four categories: strong, stable, weak or severe. Strong and stable farms have significant capacity to survive short term economic downturns because of their earning capacity or their equity position. Farms classified as weak are more vulnerable either because of lower cash flows or net worth. Farms in severe financial condition are unlikely to survive if current (i.e. 2007) economic conditions persist.

The results of this credit scoring analysis are presented in Table 1. Most farms – more than 90 percent, were classified as strong or stable. Only 9 percent were classified as financially stressed. For the record, this compares to nearly a third of farms in weak or severe conditions during the Farm Crisis of the 1980s. The balance sheet and income information summarized in Table 1 also demonstrates the financial strength and potential resilience of the farms included in this analysis. High grain prices in 2007 and 2008 should have allowed crop producers to improve their financial situation even more. Some livestock producers, on the other hand, would likely show a weakening in their financial position.

Informal lender survey

In December, 2008, we conducted an informal survey of agricultural bankers in Iowa. This is a very small sample analysis, but it does provide some information on bankers’ expectations for the credit review period currently underway.

In a nutshell, lenders responding to the survey report:

A sizable majority of their borrowers will show positive cash flows for 2009.

Of those with negative cash flow projections, most have either strong or adequate balance sheets – reflecting their equity and working capital positions.

Less than 5 percent of borrowers will require some type of restructuring or debt roll over.

A significant number of their borrowers will be attempting to judiciously reduce input costs, delay capital purchases and renegotiate rental arrangements and rates.

Very few banks reported that they would be discontinuing any borrowers in the year to come for failing to meet credit standards.

In addition, a majority of banks responding to the survey stated they had a very adequate or adequate supply of loanable funds – credit worthy farmers will be able to obtain the financing that they need.

The picture that emerges from this admittedly preliminary analysis is that farmers and their lenders are in a relatively strong position to withstand the likely stresses to come in 2009. If economic conditions worsen or continue for several years, however, the capacity of farm businesses to continue without major adjustment will likely decline.

Table 1. Financial Condition of Commercial Farmers in Iowa (2007)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Financial Status Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Strong</td>
</tr>
<tr>
<td>Farms (%)</td>
<td>65</td>
</tr>
<tr>
<td>Assets ($1000)</td>
<td>1405</td>
</tr>
<tr>
<td>Liabilities ($1000)</td>
<td>192</td>
</tr>
<tr>
<td>Equity ($1000)</td>
<td>1213</td>
</tr>
<tr>
<td>Debt-to-Asset Ratio (%)</td>
<td>14</td>
</tr>
<tr>
<td>Value of Farm Production ($1000)</td>
<td>514</td>
</tr>
<tr>
<td>Net Farm Income ($1000)</td>
<td>197</td>
</tr>
<tr>
<td>Acres operated</td>
<td>771</td>
</tr>
<tr>
<td>Labor months</td>
<td>15.9</td>
</tr>
</tbody>
</table>
As we stated earlier, farmers and lenders need to think in terms of contingencies – what should be done if conditions worsen, asset values decline or if rural and agricultural lenders start to experience liquidity problems. For some concrete suggestions that can assist with good management decisions during a very difficult and uncertain period see the next article, “Managing through a recession: options for farm operators,” by William Edwards.

Managing through a recession: options for farm operators
By William Edwards, extension economist, 515-294-6161, wedwards@iastate.edu

After several years of high grain prices and generous margins, crop producers are facing a 2009 that looks less than rosy. Higher inputs costs and selling prices well below the peaks of 2008 will result in fewer dollars left over to pay landlords and put into savings. Livestock producers have had to endure many months of thin or negative margins, as well.

Here is a list of possible financial management practices and strategies that could come in handy this year.

Prepare an accurate set of financial statements. Highly variable inventory prices and increasing land values will make this year’s balance sheet look quite different from last year’s. And for grain farmers, a net income statement for 2008 may be something you to share with your lender. Check out the handy spreadsheets under the Finance section of Ag Decision Maker Web site.

Prepare a detailed cash flow budget. Many crop farmers will have a hard time meeting all their cash commitments from sales in 2009. Higher input costs and rents will increase operating line requirements. Livestock farmers will need to budget feed purchases carefully. More AgDM decision tools are available to make the task easier.

Shop around for inputs. Depending on when suppliers booked fuel, fertilizer, pesticides and other inputs, prices may vary dramatically.

Consider both cost savings and yield effects when applying inputs. For example, cutting back on nitrogen fertilizer when costs are high makes sense, but only up to a point. Use the ISU Nitrogen Calculator to find the right level for current prices.

Know your costs of production. When profitable selling opportunities arise, lock them in. Watch for opportunities to price crop inputs, feed, and feeder livestock, as well.

Document yields for a possible crop insurance or SURE payment. Many crop producers will receive an insurance indemnity payment due to falling prices in 2008 as well as from damage caused by rain or floods. Additional payments may be available under the SURE disaster program in the new farm bill.

Increase crop insurance coverage for 2009. Higher production costs may require higher levels of protection to assure a breakeven level of revenue. Cattle, hog, sheep and dairy producers can set price floors using LGM or LRP insurance programs.

Consider enrolling in ACRE. Under the new farm bill program, Average Crop Revenue Election, crop producers can substitute a gross revenue protection plan for the current price counter cyclical program, with guarantees based on higher price levels and current yields.

Use flexible lease agreements. Tying cash rents to a formula that takes into account both yields and prices will help protect margins. Land owners can share in high profits when they are available with a flexible lease agreement.

Defer capital purchases. When margins are narrower, replacing machinery, putting up new storage bins, or bidding on more land may have to wait. Replacement parts and overhauls are cheaper in the short run.

Defer income taxes. Potential tax bills can be put off until future years through actions such as using expense method and early depreciation, deferring crop insurance payments based on yield losses, prepaying farm expenses, and using income averaging.

Compare financing rates. Federal interest rates are at historic lows. There may be wide differences among agricultural lenders. Marketing loans from the Farm Service Agency are also available for short term financing.

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