# Credit Risk 2020 & Beyond: Answers to Critical Questions


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**Macro Clinic Video Blog**: www.compeer.com/education
**Road Warrior of Agriculture**: www.cornandsoybeandigest.com
**Ag Globe Trotter**: www.northwestfcs.com
**Dave's GPS & Dashboard Indicators:** www.farmermac.com

# Low Margin Era

- technology- supply exceeds demand
- worldwide- new resources in production
- weather and climate changes
- base hits vs. home run profits & cash flow
- managing expectations
- focus on fiduciary fundamentals

# *Volatility of Profits/Cash Flow*

- trade negotiations and expectations
- weather/African swine flu
- political uncertainty
- consumer demand shifts
- structural changes in industry

# Generational Financial Performance Comparisons Super Cycle & Post Super Cycle

| | 2012 | | 2018 | |
|---|---|---|---|---|
| **Financial Metric** | **Super Cycle Median 10 to 40 Years** | **Under 10 years** | **Post Super Cycle Median 10 to 40 years** | **Under 10 years** |
| Number of Farms | 2,881 | 744 | 2,451 | 836 |
| Net Farm Income | $197,828 | $90,865 | $30,752 | $26,855 |
| ROA | 10.6% | 14.4% | 1.4% | 3.6% |
| OPM | 30.5% | 30.0% | 6.8% | 11.6% |
| ATO | 45.3 | 55.3 | 21.5 | 35.9 |
| Working Capital/Revenue | 39.9% | 27.6% | 19.0% | 19.8% |
| Term Debt Coverage | 3.37 | 3.18 | 0.94 | 1.63 |
| Debt/Asset Ratio | 35% | 54% | 38% | 58% |
| NFI | $13,162 | $17,891 | $16,013 | $28,728 |
| Family Living | $53,536 | $36,959 | $49,987 | $32,996 |
| Capital Expenditures | $126,770 | $69,333 | $49,000 | $28,705 |
| Machinery/Equip. Invest Per Acre | $558 | $290 | $670 | $231 |
| Term Debt/EBITDA | 1.10:1.0 | 1.11:1.0 | 2.59:1.0 | 1.63:1.0 |

**Source:** FINBIN, https://finbin.umn.edu/

# Super Cycle & Post Super Cycle Game Critique – Youth Vs. Experience

### Younger Farmers/Ranchers

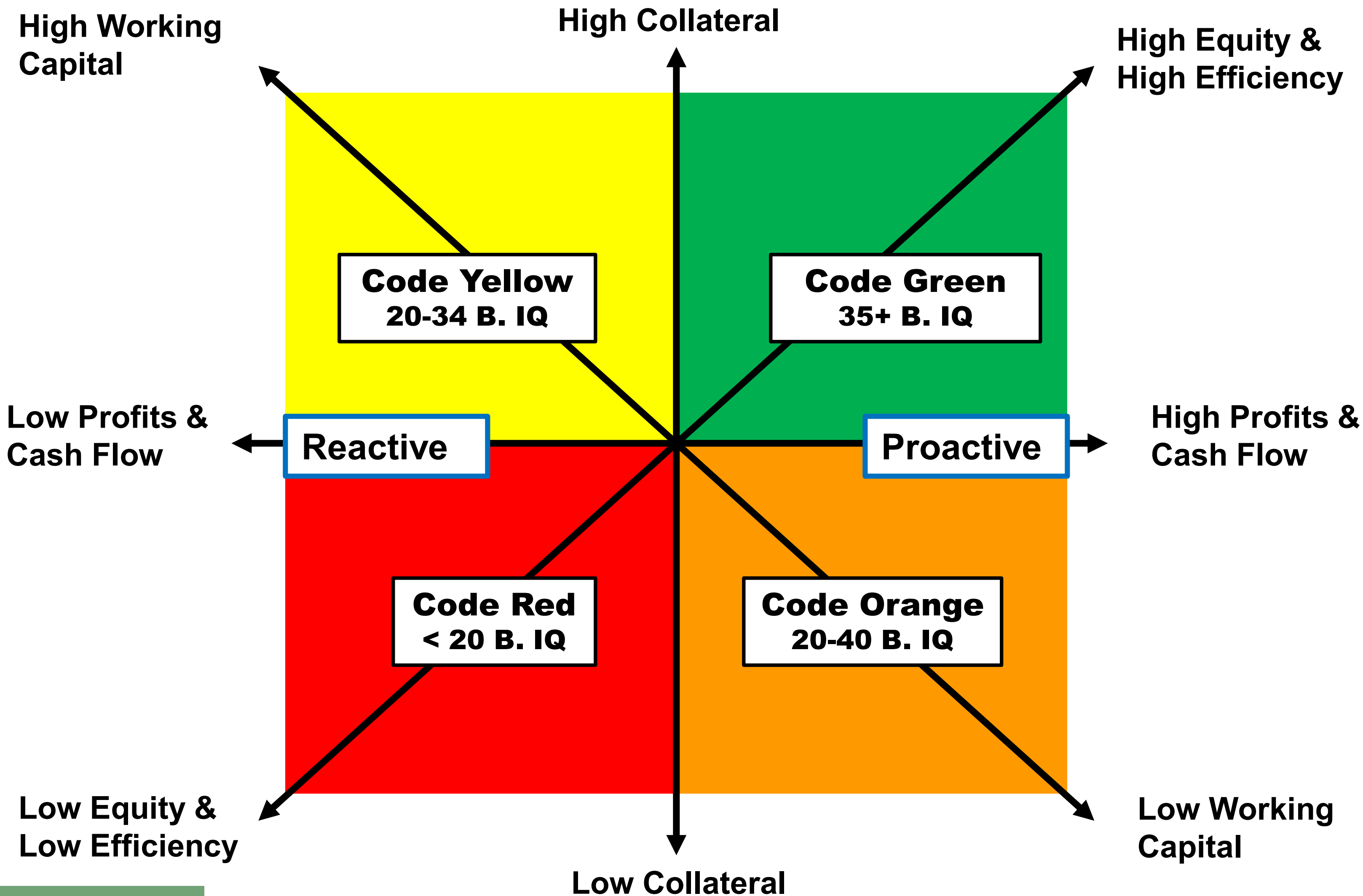
- maintain operating margins
- have stronger asset turnover ratios
- preserve working capital
- have much stronger term debt coverage ratio post super cycle
  - more off farm income
  - less family living withdrawals
- have half as much machinery investment per acre

VS.

### Experienced Farmers/Ranchers

- term debt to EBITDA increased dramatically
  - refinance losses and term debt decrease EBITDA
- have much stronger equity position, debt to asset ratio, under 40% represents resiliency
- capital expenditures strong, good times
- have twice as much machinery investment per acre

# *Business IQ:*
# *Spectrum of Performance Possibilities*






B. IQ= Business IQ

# Paddling - Upper Right Quad.
## Code Green - Disciplined Growth

- strong business IQ score of 35+
- proactive manager
- > 60% equity
- term debt to EBITDA <2.5:1
- operating expense/revenue ratio (excluding interest and depreciation) <75%
- working capital to expenses >30%

# Treading Water- Upper Left Quad. Code Yellow - Limited Growth

- moderate business IQ score of 20-34
- 70% equity
- working capital to expenses >20%
- operating expenses/revenue ratio (excluding interest and depreciation) >80%
- competitive issues in industry

# *Paddling or Bailing Water – Lower Rt.*
# *Code Orange - Excessive Growth*

Paddling towards Green

- business IQ score >38
- ROA averages 6%
- <50% equity
- modest family living expenses
- dimensional revenue streams
- earns and turns

Bailing towards Red

- business IQ score of <28
- profit issues- ROA averages 1%
- <50% equity
- high living costs
- specialized revenue streams
- lack earns & turns

# Bailing Water -Lower Left Quad.
## Code Red- Partial or Total Liquidation

- poor business IQ score of <20
- reactive manager
- <40% equity
- working capital is negative
- operating expense to revenue over 90%
- excessive family living expenses
- victims & “know-it-alls”

# *Financial Trip Points*

- split lines of credit
  - > 10 lines
- term debt/EBITDA 6 to 1 or more
  - 3 to 5 years earnings on average
- burn rate on core equity <2.0 years
- operating expense/revenue ratio excluding interest & depreciation above 95% (three year average) with no non-farm income
- victim, know it all attitude concerning business improvement

# Business IQ: Management Factors
## *Critical Questions for Crucial Conversations*

| Customer Checklist | Green (3-4 points*) | Yellow (2 points) | Red (1 point) |
|---|---|---|---|
| 1. Knows cost of production | Written | In head | No idea |
| 2. Knows cost of production by enterprise | Written | In head | No idea |
| 3. Goals- business, family & personal | Written | In head | No idea |
| 4. Record keeping system | Accrual | Schedule F (one & done) | No idea |
| 5. Projected cash flow | Written | In head | No idea |
| 6. Financial sensitivity analysis | Written | In head | No idea |
| 7. Understand financial ratios, break evens | Written | In head | No idea |
| 8. Work with advisory team and lender | Yes | Sometimes | Never |
| 9. Marketing plan written and executed | Yes | Sometimes | Never |
| 10. Risk management plan executed | Yes | Sometimes | Never |
| 11. Modest lifestyle habits, family living budget | Yes | Sometimes | Non existent |
| 12. Written plan for improvement executed & strong people management | Yes | Sometimes | Non existent |
| 13. Transition plan/Business Owner plan | Yes | Working on plan | Non existent/controversy |
| 14. Educational seminars/courses | Yes | Sometimes | Never attend |
| 15. Attitude | Proactive | Reactive | Indifferent |

*Extra Points:
- **Progressive Business** may receive 4 points for #2,6,7,8,14
- **Struggling Business attempting turnaround** may receive 4 points for #3,5,8,11,12

| Score | Overall Analysis |
|---|---|
| 35-50 | Strong management rating & viability |
| 20-34 | Moderate risk & viability; will most likely show previous refinancing |
| <20 | High risk & lack of long term viability |

# Recent Business IQ Scores

| Group | Score |
|---|---|
| TEPAP | 38.5 |
| Crop Insurance | 29.5 |
| Farm Credit Associations | 36.5 |
| Median Score | 32 |
| FSA | 22 |
| Bank Sponsored Events | 36 |

# Trouble Shooting Matrix

## Insufficient Repayment Capacity

| | |
|---|---|
| **Cut Business Cost** | Reduce Four Largest Expenses: Crop, Feed, Labor, ?? |
| **Non-Farm Revenue** | Job Stability/Availability, Job Cost<br>Job Earnings, Skills, Time Management |
| **Increase Income** | Sell Capital Assets, Deferred Taxes,<br>Increase Production, Increase Price |
| **Cut Living Withdrawals** | Purchase Financial Software, Small Cost Containment |
| **Restructure Debt** | Longer Term, Interest Only,<br>Principal/Interest Deferred |
| **Capital Infusion** | Equity Capital, Family Capital,<br>Supplemental Cash Flow |
| **Bankruptcy** | Voluntary, Involuntary,<br>Chapter 7, 11, 12, 13 |

# The Burn Rate – Working Capital Adversity vs. Opportunity

**Defensive "Adversity Oriented"**

Current Assets: $2,000,000

-Current Liabilities: $1,000,000

= Working Capital: $1,000,000

**Projected Loss: $500,000**

Working Capital = # of years
**Projected Loss**

$1,000,000 = 2 years
$500,000

**Red < 1.0 Year = Vulnerable**

**Yellow 1.0-3.0 Years = Resilient**

**Green >3.0 Years = Agile**

**Offensive "Opportunity Oriented"**

Current Assets: $1,200,000

-Current Liabilities: $ 500,000

= Working Capital: $ 700,000

**Opportunity:** Buy a farm with $300,000 working capital leaves $400,000 working capital.

**Debt Service (Existing & New) Payments: $100,000**

Working Capital = # of years
Total Debt Service Payments

$400,000= 4 Years
$100,000

**Red < 2.5 Years = Vulnerable**

**Yellow 2.5-5.0 Years = Resilient**

**Green >5.0 Years = Agile**

# Burn Rate on Core Equity Adversity vs. Opportunity

(Assume $500,000 Earnings Loss & 20% land value decline)

| Assets- Market Value | Estimated Value | Loan Maximum | Collateral Position | Remaining Principal | Equity Excess Reserves |
|---|---|---|---|---|---|
| 1. Long Term (20% Decline on Land) | $6,000,000<br>$4,800,000 | X 70%<br>X 70% | = $4,200,000<br>= $3,360,000 | - $2,200,000<br>- $2,200,000 | = $2,000,000<br>= $1,160,000 |
| 2. Intermediate | $3,000,000 | X 60% | =$1,800,000 | - $800,000 | = $1,000,000 |
| 3. Current | $1,650,000 | X 80% | =$1,320,000 | - $860,000 | = $460,000 |

**Burn Rate: Land & Long Term Equity Reserves**= Excess Reserves / Earnings Loss[1] = $2,000,000 / $ 500,000 = 4.0 Years

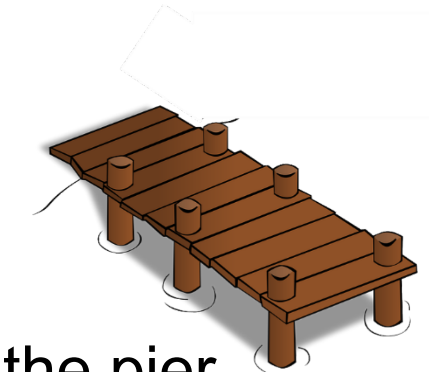
**20% Decline**
**Burn Rate: Land & Long Term Equity Reserves**= Excess Reserves / Earnings Loss[1] = $1,160,000 / $ 500,000 = 2.32 Years

[1] **Assume Earnings Loss of $500,000**

**Red < 4.0 Years = Vulnerable**
**Yellow 4.0-7.0 Years = Resilient**
**Green >7.0 Years = Agile**

# Bridge or Pier Concept

- before: $\frac{\text{Term Debt}}{\text{EBITDA}} = \frac{\$1{,}000{,}000}{\$250{,}000} = 4 \text{ to } 1$
- after: $\frac{\text{Term Debt}}{\text{EBITDA}} = \frac{\$1{,}250{,}000}{\$250{,}000} = 5 \text{ to } 1$
- no improvement in EBITDA
- refinancing using land equity
- debt levels higher
- owner equity loss, more debt service
- water is deeper near the end of pier
- the longer the pier, then the narrower the pier



# *Worst Lending Experiences*

- fraud: missing grain, livestock and/or machinery
- excessive family living based upon good times
- attempting to bash an existing customer
- didn’t follow the plan
- continued refinances, switched lenders
- hidden account payables
- didn’t use line of credit properly
- rumors that were verified
- inherited business debt free/next generation broke

# Best Lending Experiences

- family business, transition old to young- lender transition at the same time
- young producer FSA/bank now 10 years later, million in equity 5-45-50 program
- successfully developed and executed marketing plan
- followed a business plan, very successful advocate for other producers
- used financial benchmarking as a tool to improve the business
- developed a young producer educational program- investment paying off a decade later
- assist a customer work out of the business without losing all the equity