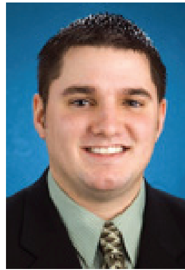
Farm Level Credit Availability



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In a time of a major U.S. recession, world economic crises, banks failures, and real estate collapses, a booming agricultural sector has been one of the few strengths in the U.S. economy. According to the USDA's Economic Research Service, in 2007 and 2008, U.S. net farm income established new nominal records in consecutive years, which after inflationary adjustments equals levels not seen since the early 1970's. Initially, farmers responded through additional debt servicing and investments in land and machinery. However, rapidly increasing input costs quickly diminished surplus cash and farmers became more dependent on operating loans for liquidity. When combined with a highly volatile commodity market and challenging economic climate, the importance of positive lender relationships and access to credit today is second to none for Midwest producers.

Amid the recent records, economists project 2009 net farm income to drop to $71 billion, a decrease of 20 percent. On the surface, this lackluster level of farm earnings may provoke some reason for concern, but in reality these projections remain $6 billion above the previous tenyear average. What is troubling is that this news comes at a time when farm-level input costs are at all time highs. A study by the University of Illinois from 2001 to 2008 shows the average non-land cost for an Illinois farmer to grow an acre of corn is $300. In 2009, that same acre of corn will cost farmers somewhere between $476 and $579 to produce depending on when fertilizer was purchased. Michael Boehlje, an agricultural economist at Purdue University, suggests that these high input costs result in increased financial risk for lenders. "Without a doubt, the increased price volatility combined with significant cost increases have resulted in increased risk in the agricultural sector. This increased risk means that lenders will be more cautious and conservative in their lending or underwriting policies," said Boehlje.

Due to increasing input costs, many operating loans nearly doubled from 2007 to 2008, and some could expect another increase in 2009. In general, individuals expecting increases in operating loans have used excess cash for capital purchases in the form of machinery and land, which lowers cash assets and increases long-term debt on their balance sheet. Such a large volume of new machinery has been purchased over the past two years that agricultural equipment manufacturers have formed waiting lists as long as one year for delivery Meanwhile, industry experts are suggesting that other producers have used the last two years successes as a means to finance the increasing costs of production on their own. "For 2009, operating loans for Midwest farmers could be lower despite increasing costs," reports University of Illinois agricultural economist Gary Schnitkey.

Diminishing commodity prices, the other culprit of reduced net farm income levels in 2009, are currently near breakeven levels. Corn and soybean prices reached a market high last July and since have fallen dramatically. This lower price structure negotiated cash leases, which are becoming more

prevalent than traditional crop-share agreements. During 2007 and 2008, cash lease agreements experienced unprecedented increases due to high commodity prices. Without an improvement in commodity prices this year, Schnitkey believes a widespread decrease of cash leases in 2010 is destined, which in turn may have a negative impact on land prices.

The impact that the current worldwide economic crisis has on U.S. agriculture will be less direct than that of input costs and commodity prices. An expected decrease in export opportunities for U.S. produced agricultural commodities is a result of slow-moving foreign economies and a strengthening U.S. dollar. The ERS estimates that the value of U.S. exports could drop nearly 18 percent this year. And while a decrease in world energy prices does provide savings to farmers at the fuel pump, it simultaneously lowers the demand for biofuels such as ethanol, which in turn puts downward pressure on the price of corn.

Strength of lenders

Recently, the federal government has taken unprecedented actions to rescue several financial institutions. The primary source of losses and financial stress originated in institutions heavily invested in subprime mortgages, which include several investment banks and large national and international commercial banks. These troubled banks, however, are not the institutions lending money to put in crops and purchase land. Purdue's Boehlje states that the flow of credit throughout the agricultural sector has been free of the impediments faced by other firms and industries.

The Farm Credit System, rural commercial banks, the Farm Service Agency, and other midsize banking institutions are the primary sources of agricultural credit. Paul Ellinger, a University of Illinois agricultural economist, finds the Farm Credit System to hold the largest portion of real-estate farm debt at 42 percent, while commercial banks hold the highest percentage of non-realestate farm debt at 53 percent. Ellinger added that the group of lenders who are responsible for most of the credit obtained by farmers have fared relatively well through these times.

This is not to say farm lenders are not taking extra precautions prior to making loans, and in general the increased risk results in increased loan documentation. This added documentation includes more detailed financial statements, production cost estimates, and a risk management strategy. Lender required risk management tools are available in the form of crop insurance, hedging, and the use of options. "At a minimum, producers are going to have to do a better job showing their lender what kind of profitability they've had and what kind of income they're generating," Boehlje said.

A challenge facing seed companies in the future is continuing to convince producers to invest in high quality genetics. Narrowed profit margins have made it necessary to rethink certain input decisions in order to remain profitable. One University of Illinois economist does not think it will result in changes to seed selection. "Farmers are still willing to pay high prices for high quality seed if it increases their chances of a large crop at harvest. They may, however, cut back on certain costs such as fungicides because the commodity prices aren't as attractive as they were a year ago," Schnitkey states.

The high farm income levels of years past have resulted in record prepayments for seed. Due to the uncertainly of banks, farmers found the best use of their money during these years was to take advantage of early payment discounts and lowering their level of taxable income. Meanwhile, agricultural input suppliers should anticipate a lower level of prepayments for 2010 with the anticipated drop in farm income.

Supplier provided financing options are becoming increasingly attractive to some farmers. Designed to provide an alternative means of credit to producers, these programs are in direct competition with banks for business. In order to qualify for financing, interested parties may be required to purchase a certain quantity of seed or combination of seed and chemicals. Incentives that range from deferred payments to zero percent interest make these alternatives hard to overlook.

Although the future holds many uncertainties for agriculture in terms of world demand, input costs, and commodity prices, farm-level access to credit does not appear to be as elusive as some experts predicted. The events that have bottlenecked the flow of credit in large banks are not applicable to the vast majority of lenders holding farm debts. More specifically, losses resulting from investments in subprime mortgage instruments occurred outside of this group of agricultural banks. However, lowered cash reserves, additional operating capital needs, and increased lender scrutiny for those loans requires additional attention be paid to this critical component of the business. Today's borrowers should expect to see tighter regulations and increased documentation for loans, especially those who are highly leveraged. While the outlook for agriculture in 2009 remains strong, the challenge for farmers and seed companies alike is to look upon these times as opportunities rather than threats.

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