Financing The Large Farm Operator in Tomorrow's Environment

Mid America Cooperative Council

Credit Conference

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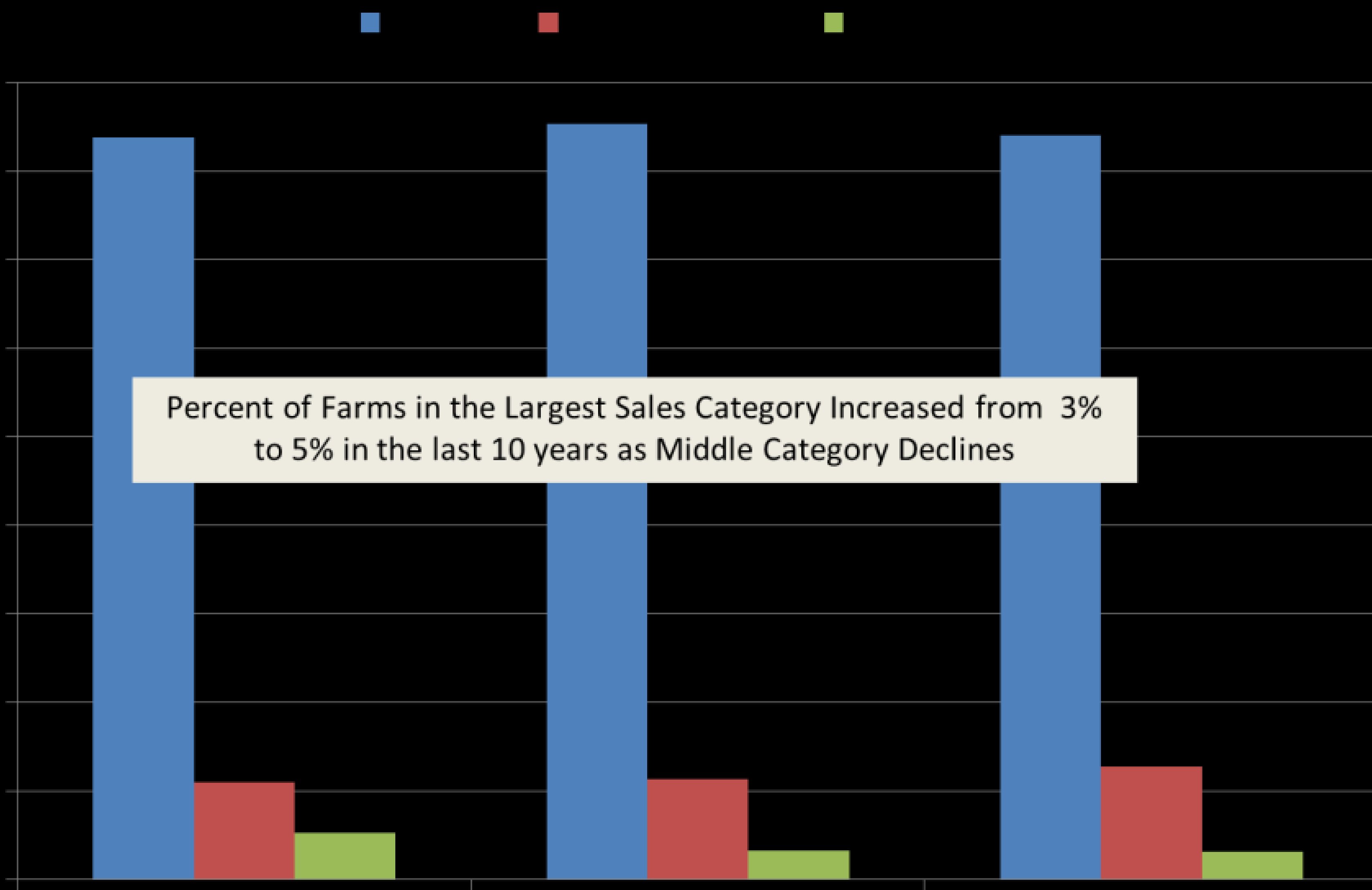
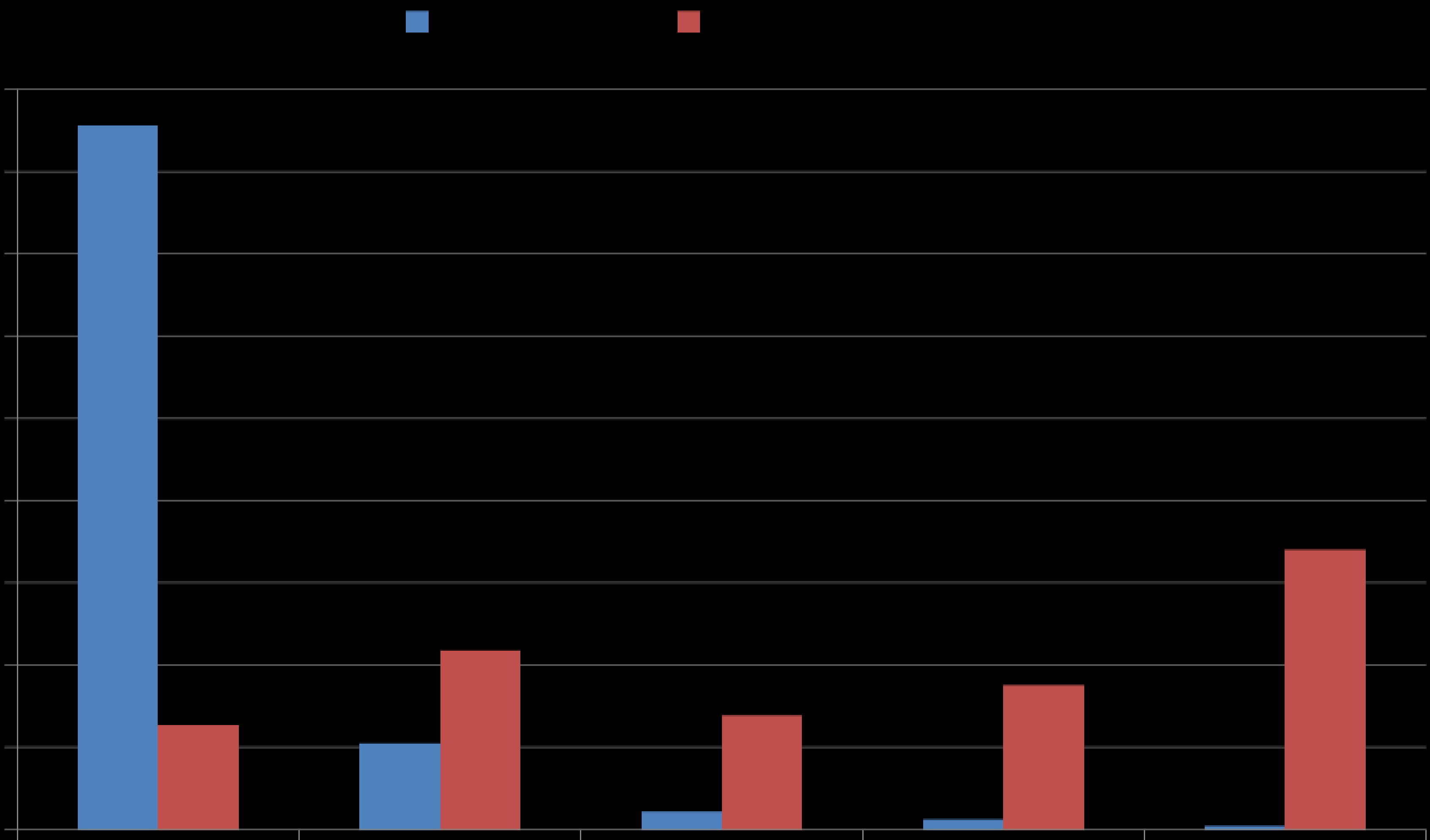
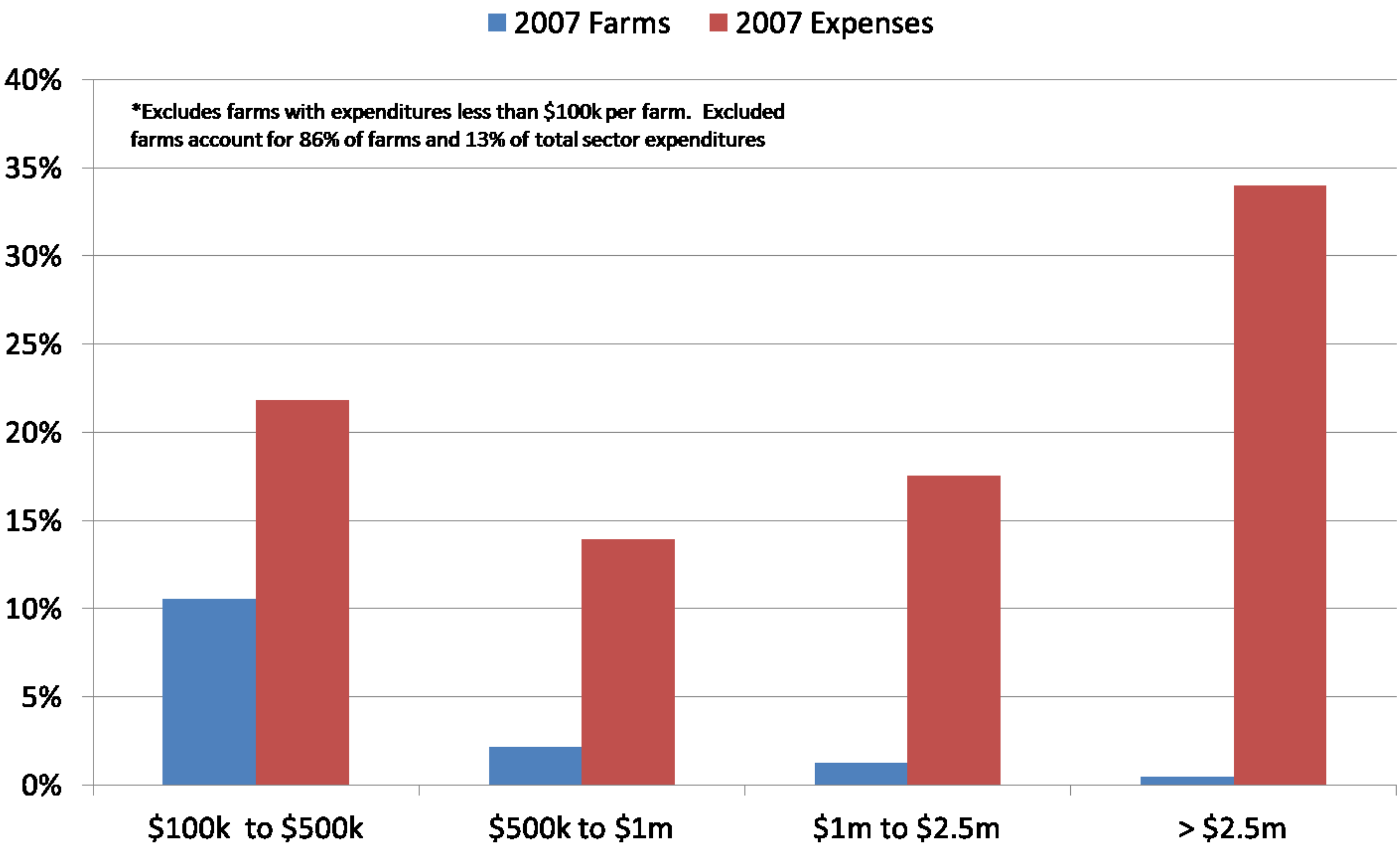
The Customer Base Continues to Change

- Traditional farmers
- Industrialized commercial producers
- Integrated production/value-added operators
- Investors/landowners
- Small scale specialty/organic producers
- Recreational/tourism/natural resource
- Dual career farmers
- Ruralpolitans


Percent of Farms in the Largest Sales Category Increased from 3% to 5% in the last 10 years as Middle Category Declines



Distribution of Farms and Total Expenditures by Expenditure Categories Over $100k, 2007*



A Recent Survey Project

- 2013 Large Commercial Producer (LCP) Survey
  – "…understand the strategies of agricultural producers, key issues that producers face, and how input suppliers can best serve agricultural producers."
- Approx. 1,700 total responses to mail, phone, web

Come to our National Conference for Agribusiness
for all the results of this project
November 4-5, 2013, West Lafayette, IN

Farm Size Categories

	Mid	Commerical	Large
Corn/Soybean (acres)	300-1,499	1,500-4,999	5,000+
Wheat/Barley (acres)	700-3,499	3,500-6,999	7,000+
Cotton (acres)	200-1,099	1,100-2,999	3,000+
FNV (acres)	50-249	250-2,349	2,400+
Dairy (head)	40-199	200-1090	1,100+
Finishing Hogs (head)	800-3,999	4,000-27,999	28,000+
Feeder Pigs (head)	3,300-16,499	16,500-41,999	42,000+
Finishing Cattle (head)	150-799	800-6,999	7,000+
Feeder/Stocker Cattle (head)	250-1,249	1,250-6,999	7,000+

Overview of Farm Growth

Number of Producers	1,128
Acres in 2012	1,937,576
Acres 5-Years from Now (2017)	2,385,419
Acre Growth	447,843
% Growth (5-year total)	23.11%
Annualized Growth	4.25%

Data suggest continued growth, but at an annual rate slower than many would probably expect.

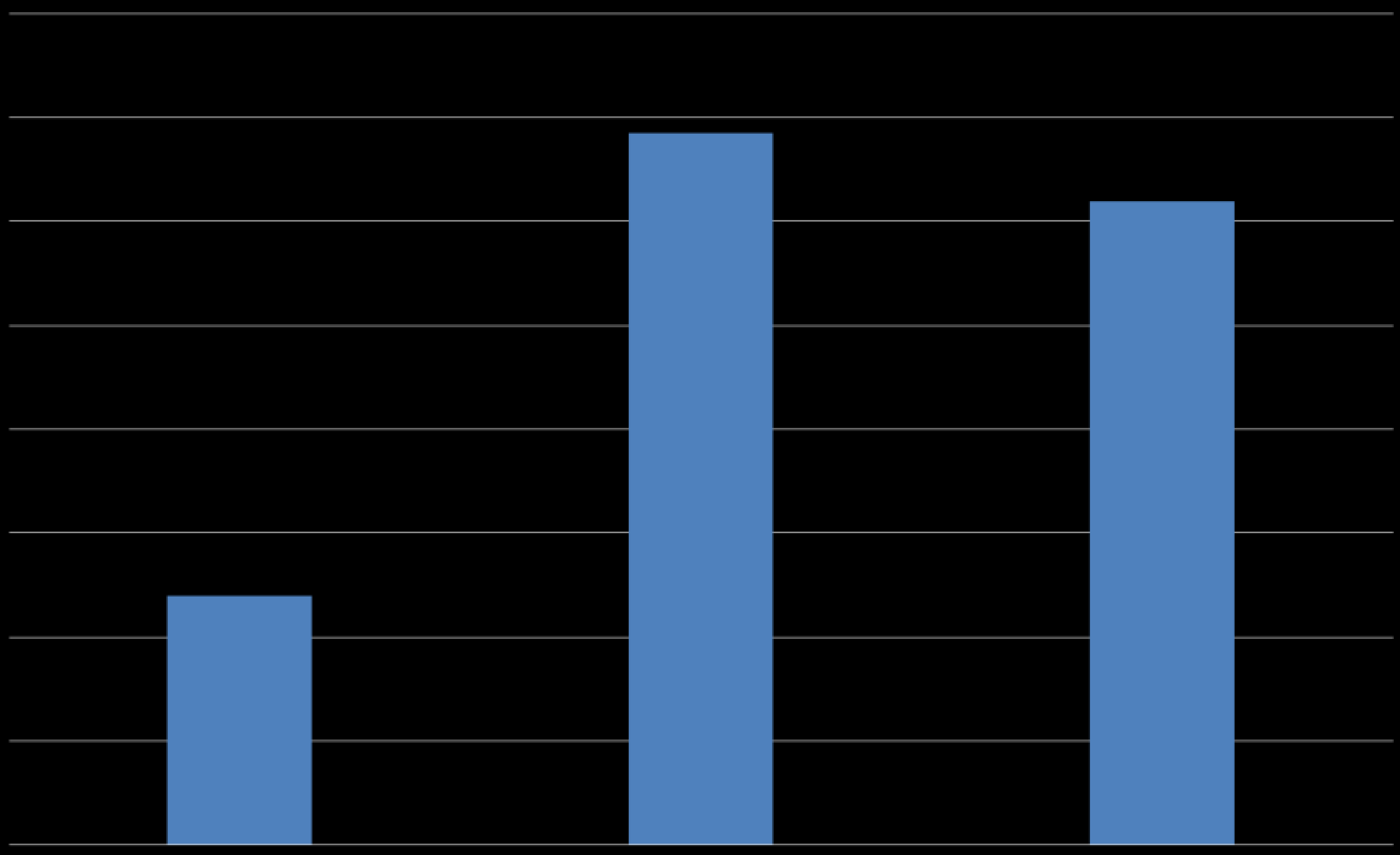
Overview of Farms with No Acre Growth

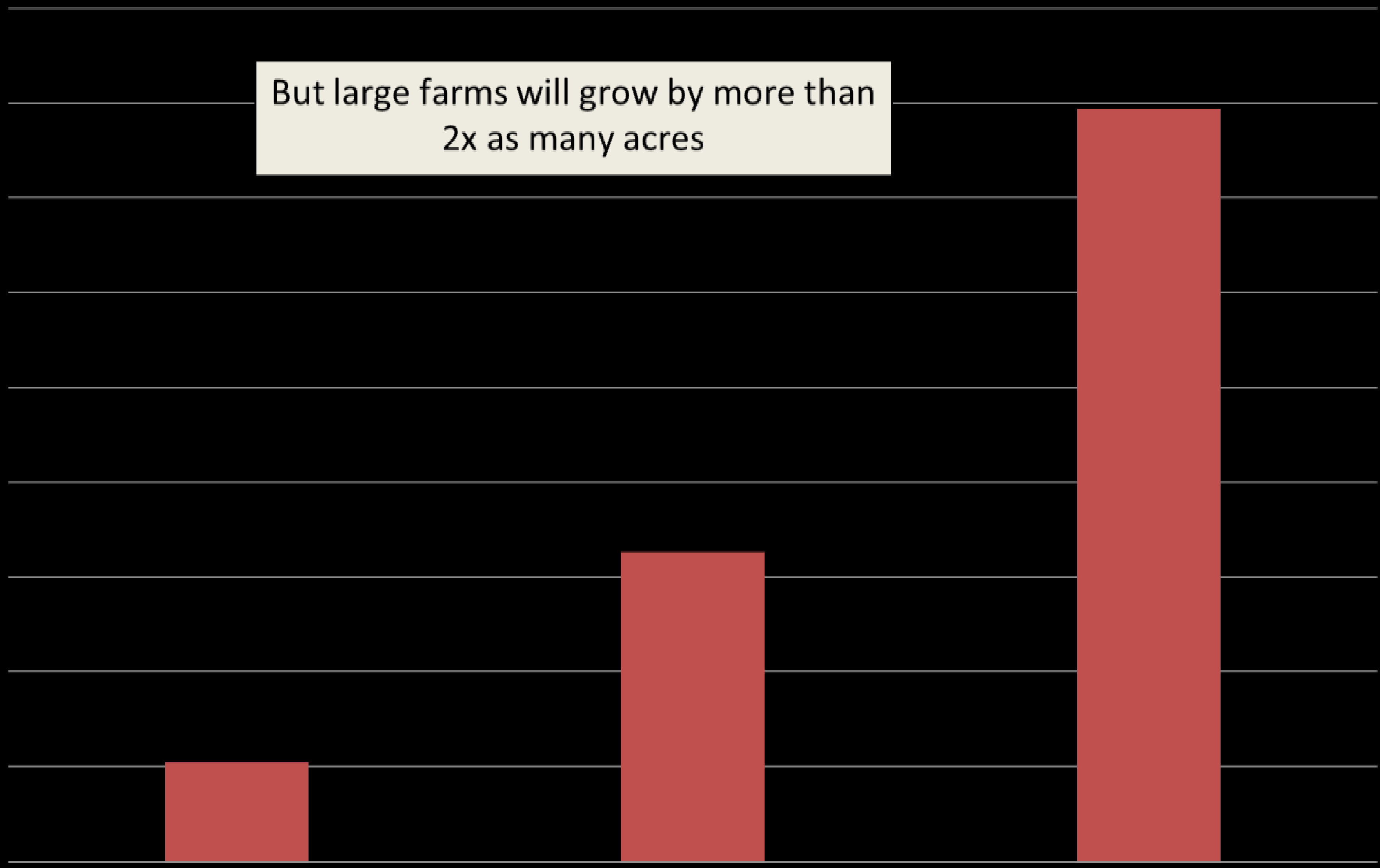
Number of Producers	511
Acres in 2012	701,581
Acres 5-Years from Now (2017)	701,581
Acre Growth	-
% Growth (5-year total)	0.00%
Annualized Growth	0.00%

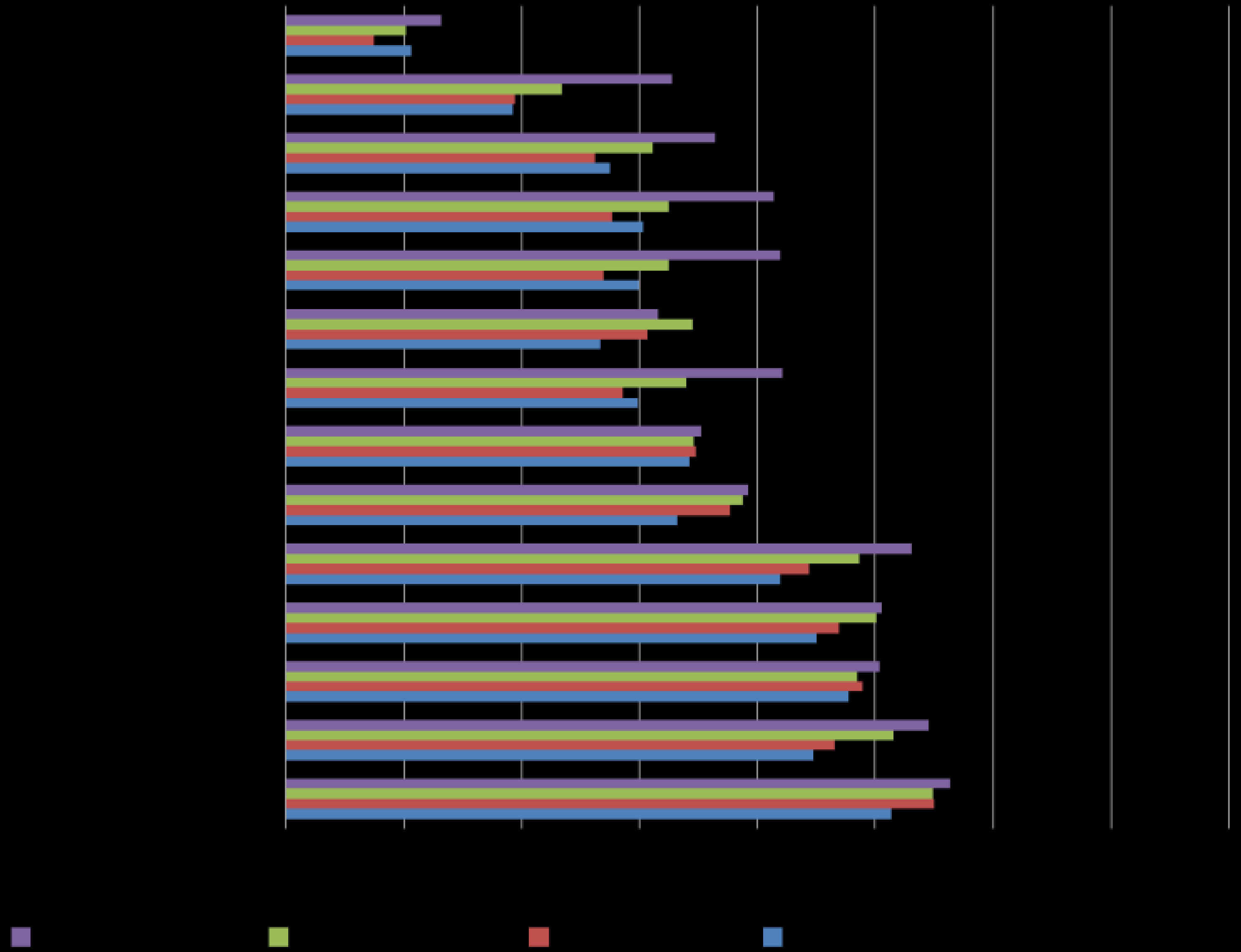
About half of the sample indicated that they expected no growth

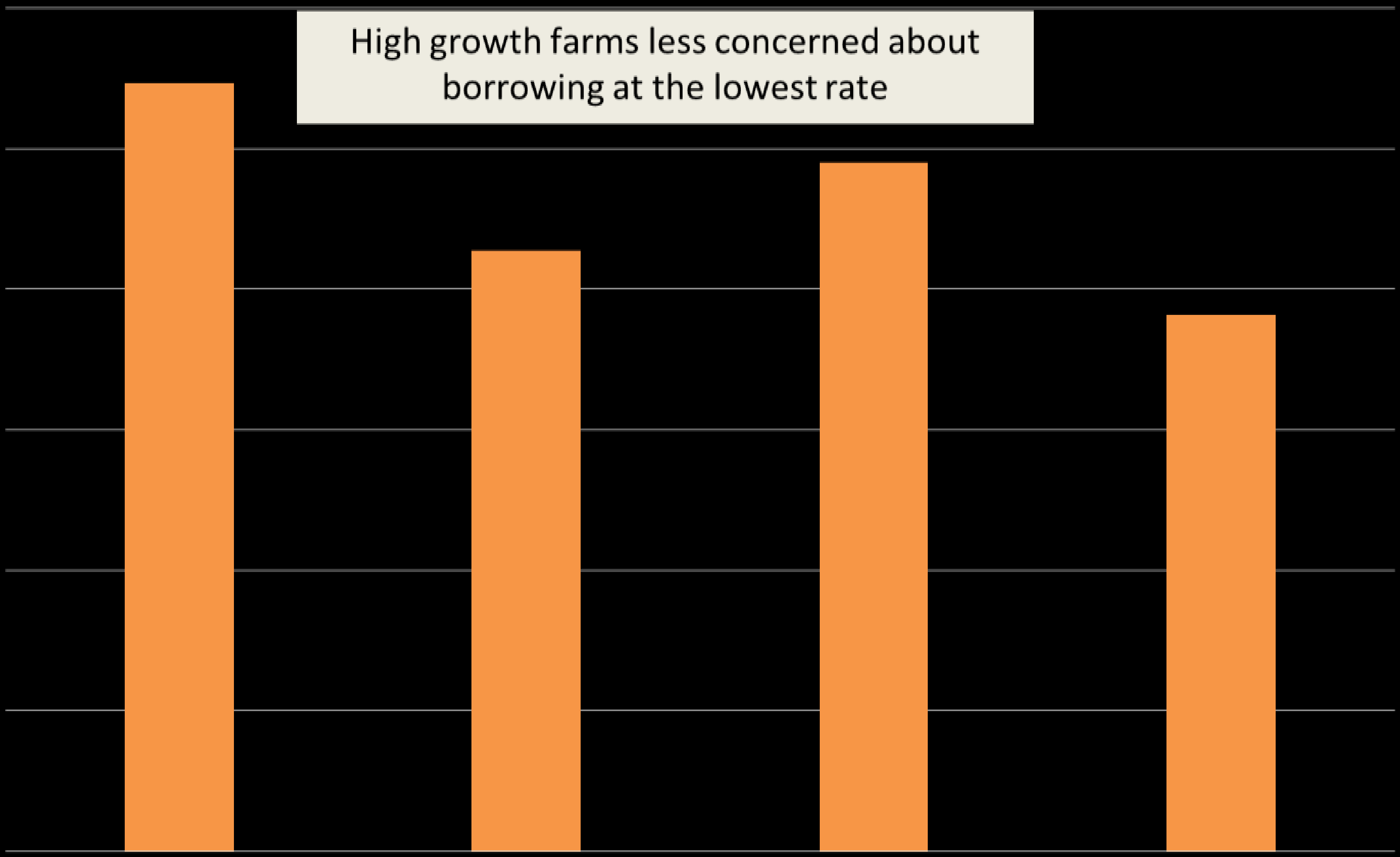
Overview of Farms with Positive Acre Growth	
Number of Producers	535
Acres in 2012	1,068,772
Acres 5-Years from Now (2017)	1,565,024
Acre Growth	496,252
% Growth (5-year total)	46.43%
Annualized Growth	7.93%

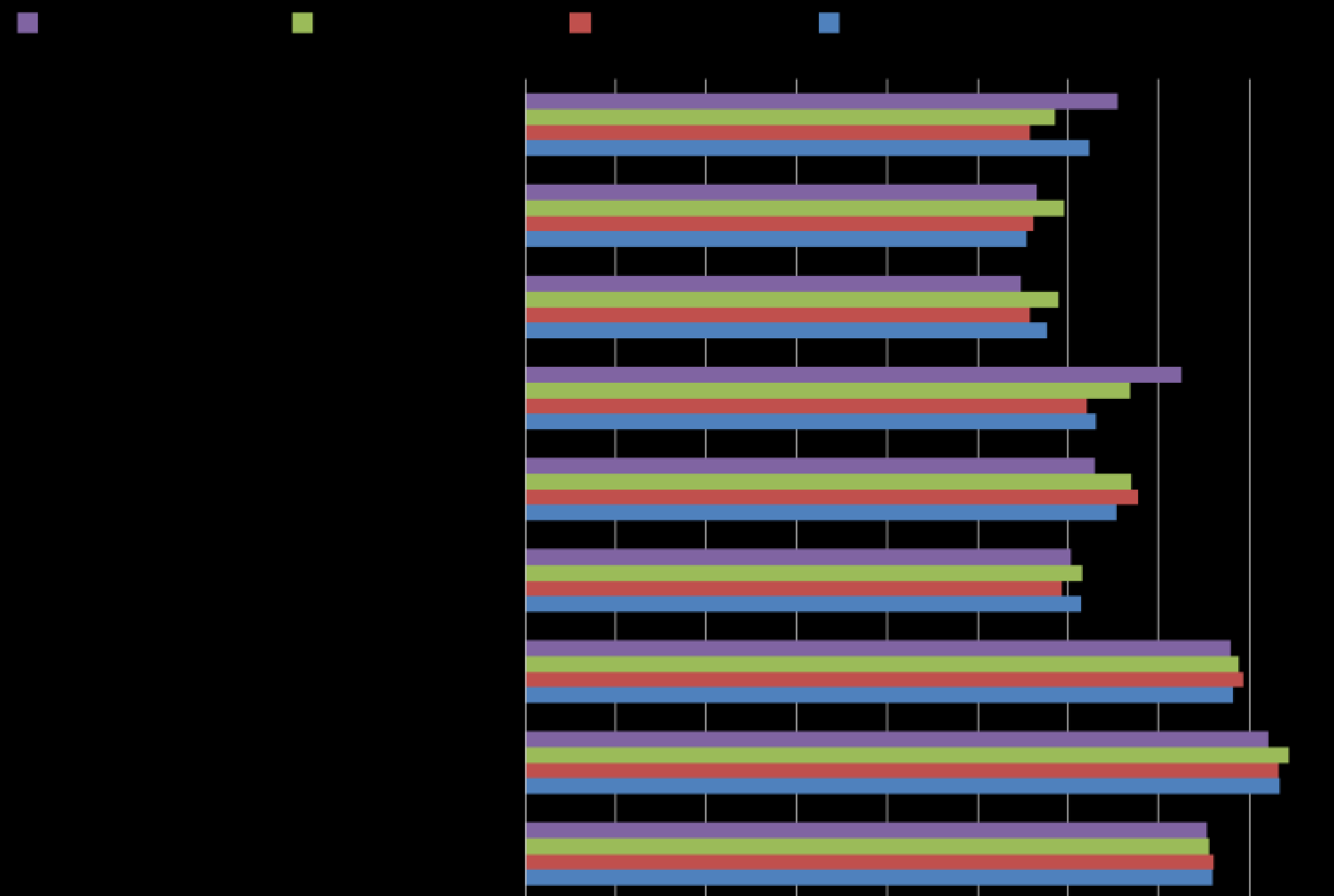
When you remove farms that aren't growing a much stronger growth picture emerges.




But large farms will grow by more than 2x as many acres




High growth farms less concerned about borrowing at the lowest rate



Today's Ag Environment

- Nearly unprecedented period of **prosperity** and **profitability** for row crop and grain producers
- Spectacular increases in farm real estate
- Rapidly rising cash rents
- For the first time in years we face some headwinds
  - Could the great boom be coming to an end?

The Last Decade Has Been Spectacularly Good

In **Real** Terms, Today's Farmland Value Increases **Exceed** those of the 70's

Region	Nominal Change Annualized Growth Rate	Real Change and Annualized Growth Rate
Iowa	-----------------------------Percent --------------------------	
1971-1981	410	127
	17.7	8.6
2003-2013	317	231
	15.4	12.7
North Dakota		
1971-1981	359	104
	16.5	7.4
2003-2013	298	215
	14.8	12.2
Indiana		
1971-1981	381	114
	17.0	7.9
2003-2013	168	113
	10.4	7.8

[a] Changes in farm real estate values from National Agricultural Statistics Service. Real values calculated using the CPI index.

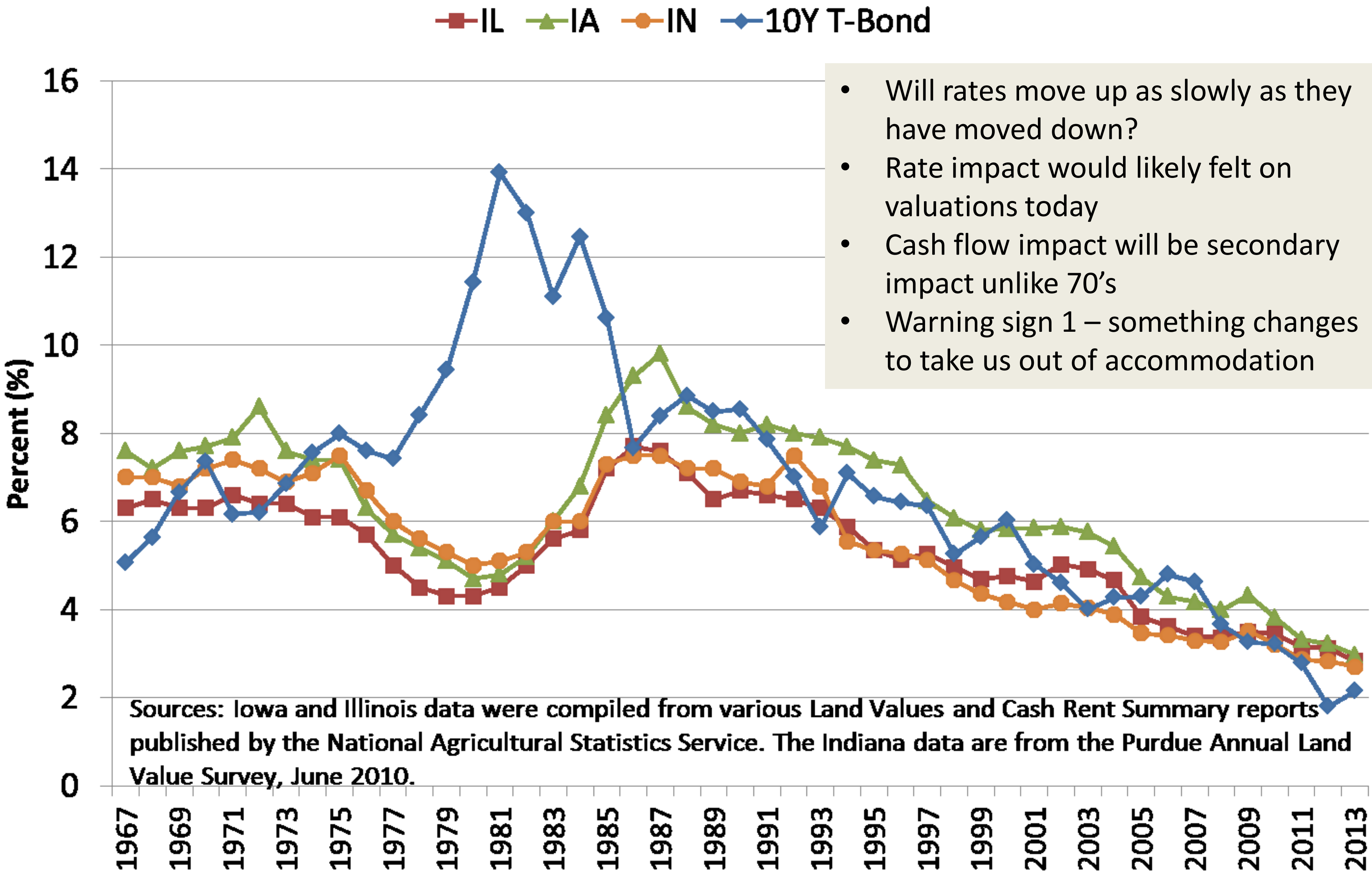
The Perfect Storm

- Biofuels
- Emerging market demand
- Poor weather
- Low interest rates

Farmland has now likely caught up to these changes!

Key question is now whether the future looks similar, better, or worse

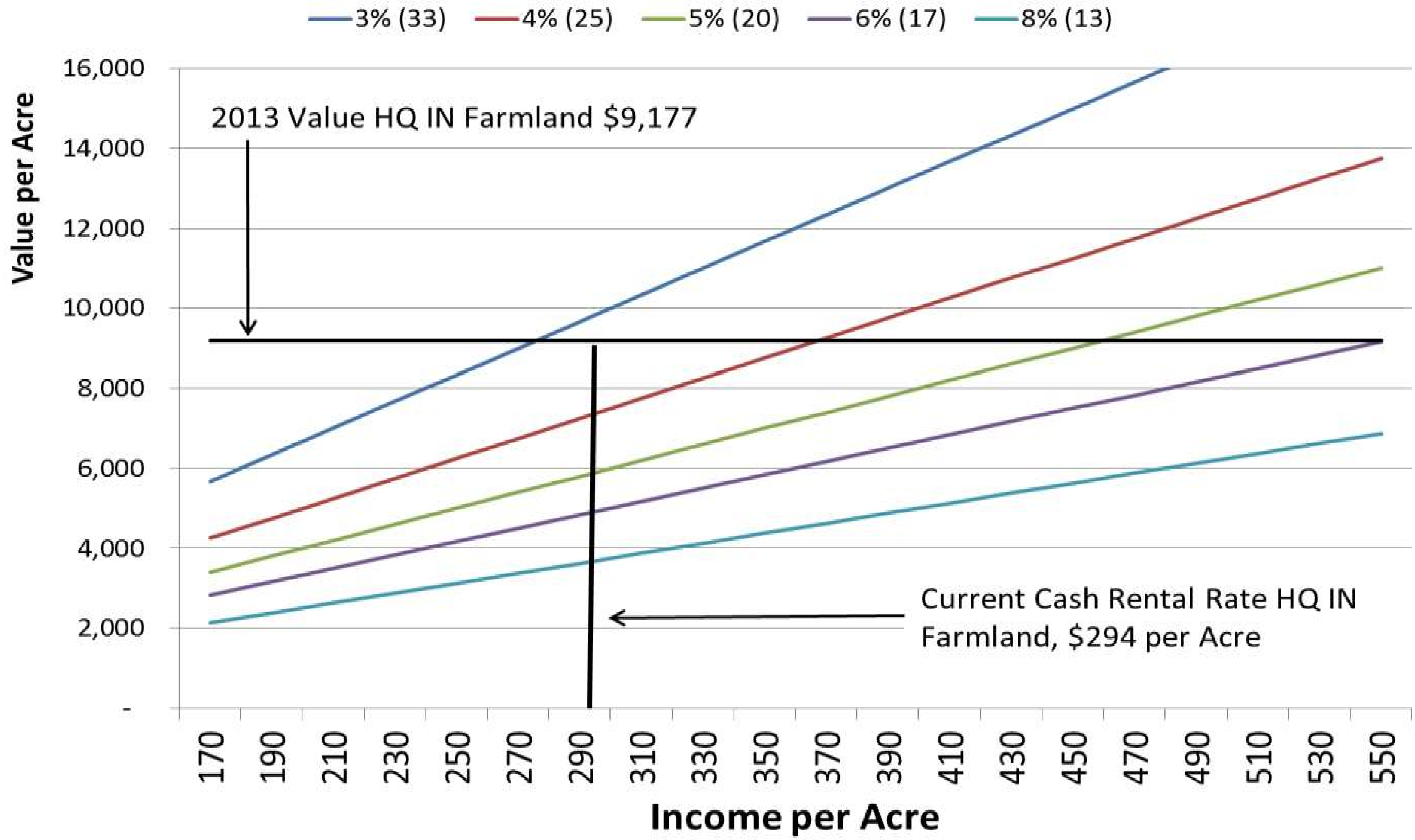
Farmland Capitalization Rates and Interest Rates on 10 Year US Treasury Bonds, 1967-2013



- Will rates move up as slowly as they have moved down?
- Rate impact would likely felt on valuations today
- Cash flow impact will be secondary impact unlike 70's
- Warning sign 1 – something changes to take us out of accommodation

Sources: Iowa and Illinois data were compiled from various Land Values and Cash Rent Summary reports published by the National Agricultural Statistics Service. The Indiana data are from the Purdue Annual Land Value Survey, June 2010.

Land Values Under Alternative Capitalization Rates (Multiples) and Income Levels



What Causes Booms to End Poorly?

1. Dramatic reduction in demand (1980s) particularly exports, but now watch out for RFS
2. Over response on the supply side coinciding with #1
3. Too much leverage
4. Turmoil in broader economy

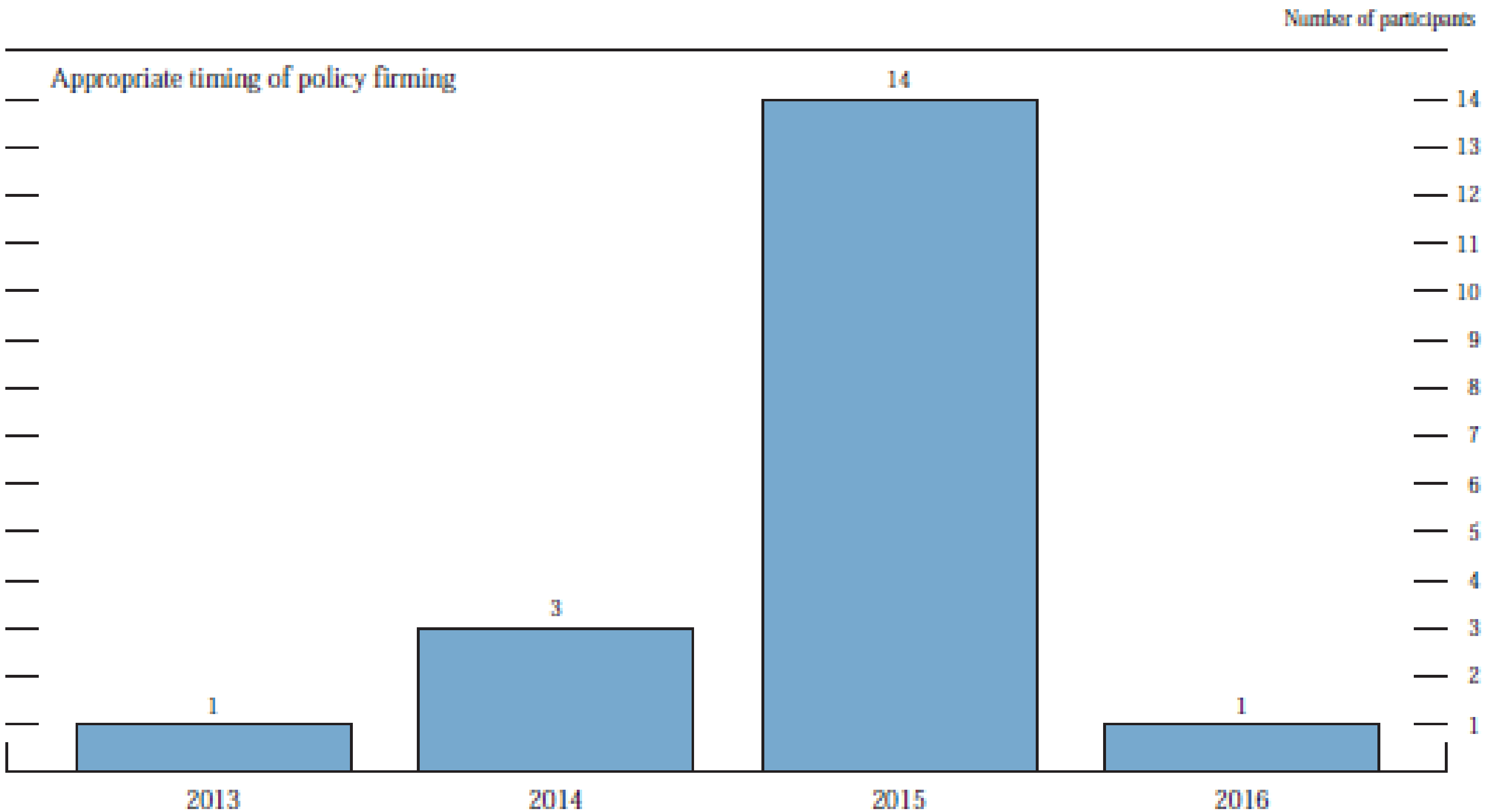
If we can keep these from happening we likely can have a soft landing. **Problem**: Of the 4 we only strongly influence #3 and can potentially influence #1 through policy

What are the Keys Going Forward

1. Interest rates/cap rates
2. Demand growth
   - Biofuels
   - Emerging markets/trade
3. Supply response
   - Weather
   - U.S.
   - Rest of the world
4. Leverage choices

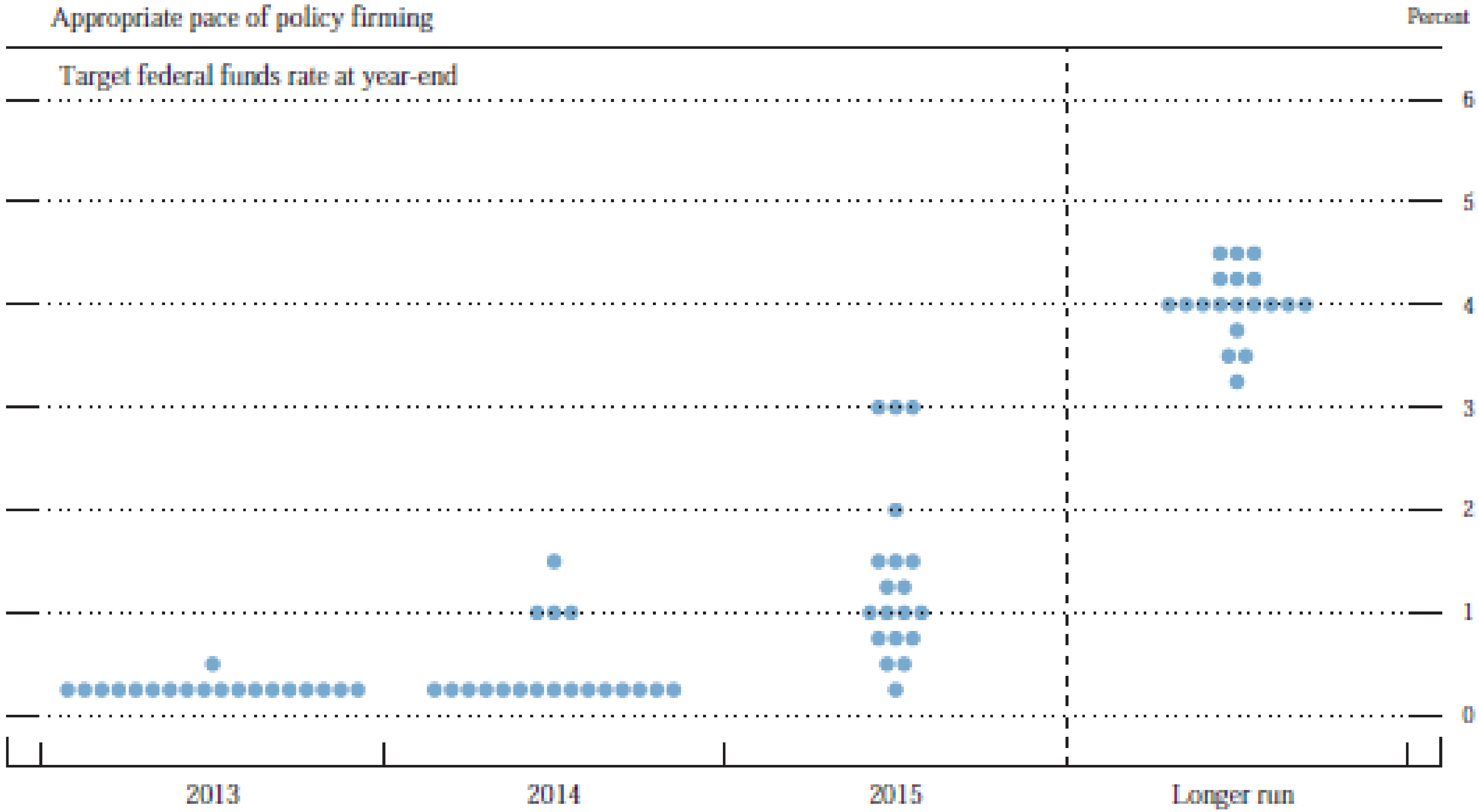
Eventually 2015 will get here! Expect lots of gyrations and angst ahead of tightening!

Figure 2. Overview of FOMC participants' assessments of appropriate monetary policy



Source: Board of Governors of the Federal Reserve System, July 2013
http://www.federalreserve.gov/monetarypolicy/files/20130717_mprfullreport.pdf

Most FOMC participants expect relatively modest tightening. Notice difference between long-run and 2015. Just when does longer run arrive? In most members view – not until at least 2015.



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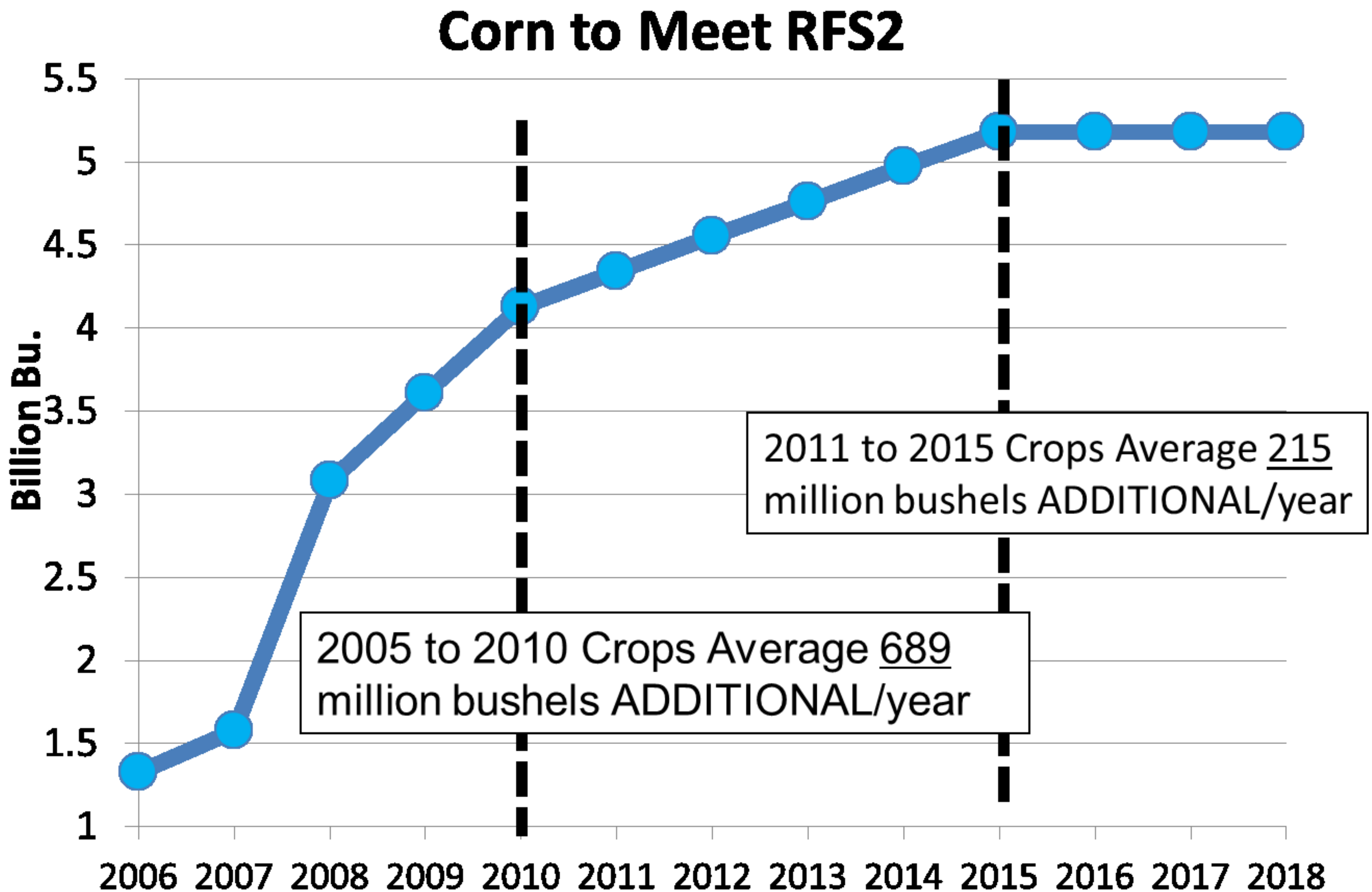
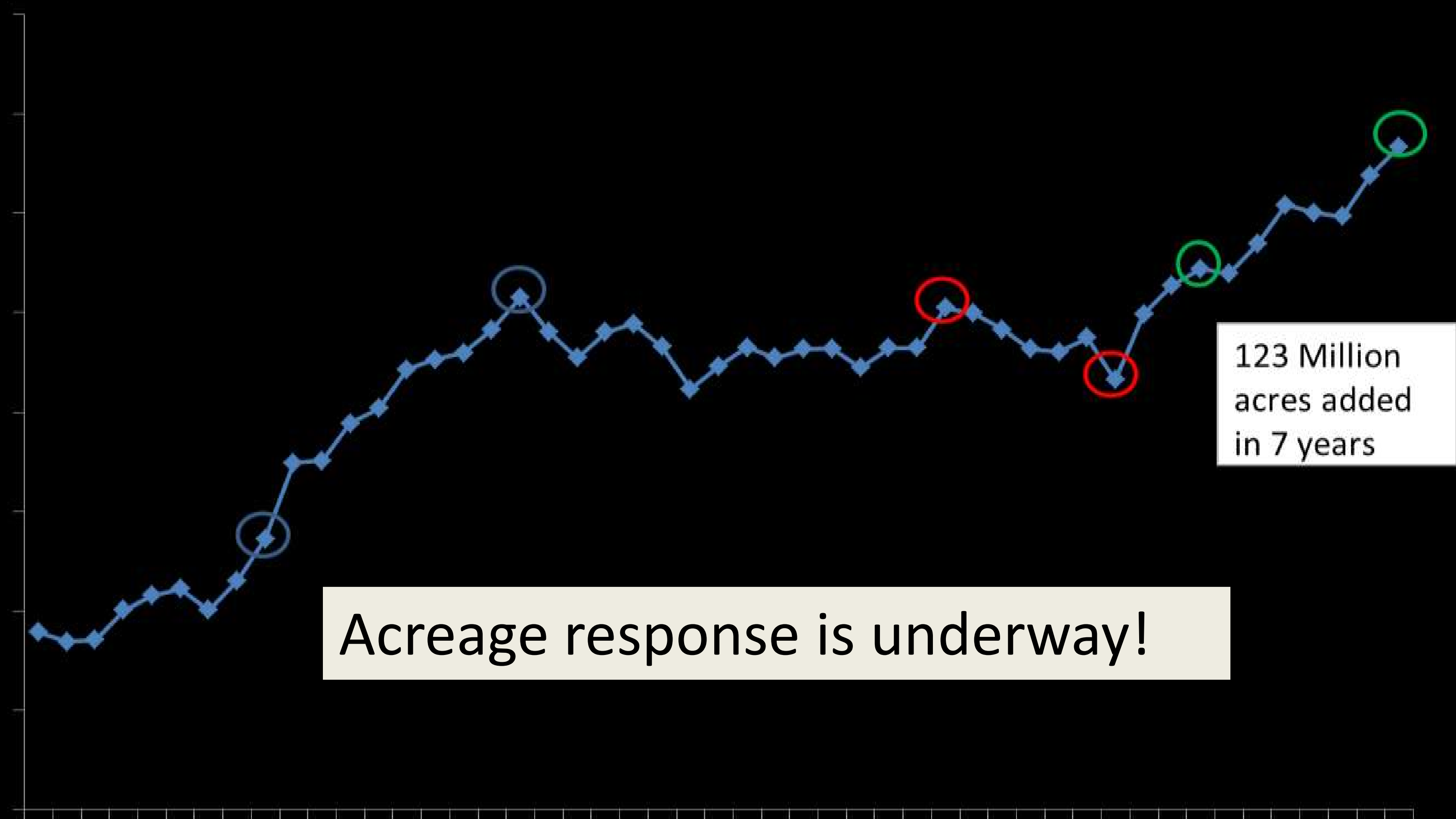
Big Demand Increases From Ethanol are Likely Over



Source: Abbott, Hurt, and Tyner, "What's Driving Food Prices in 2011. Farm Foundation Report.


123 Million acres added in 7 years
Acreage response is underway!

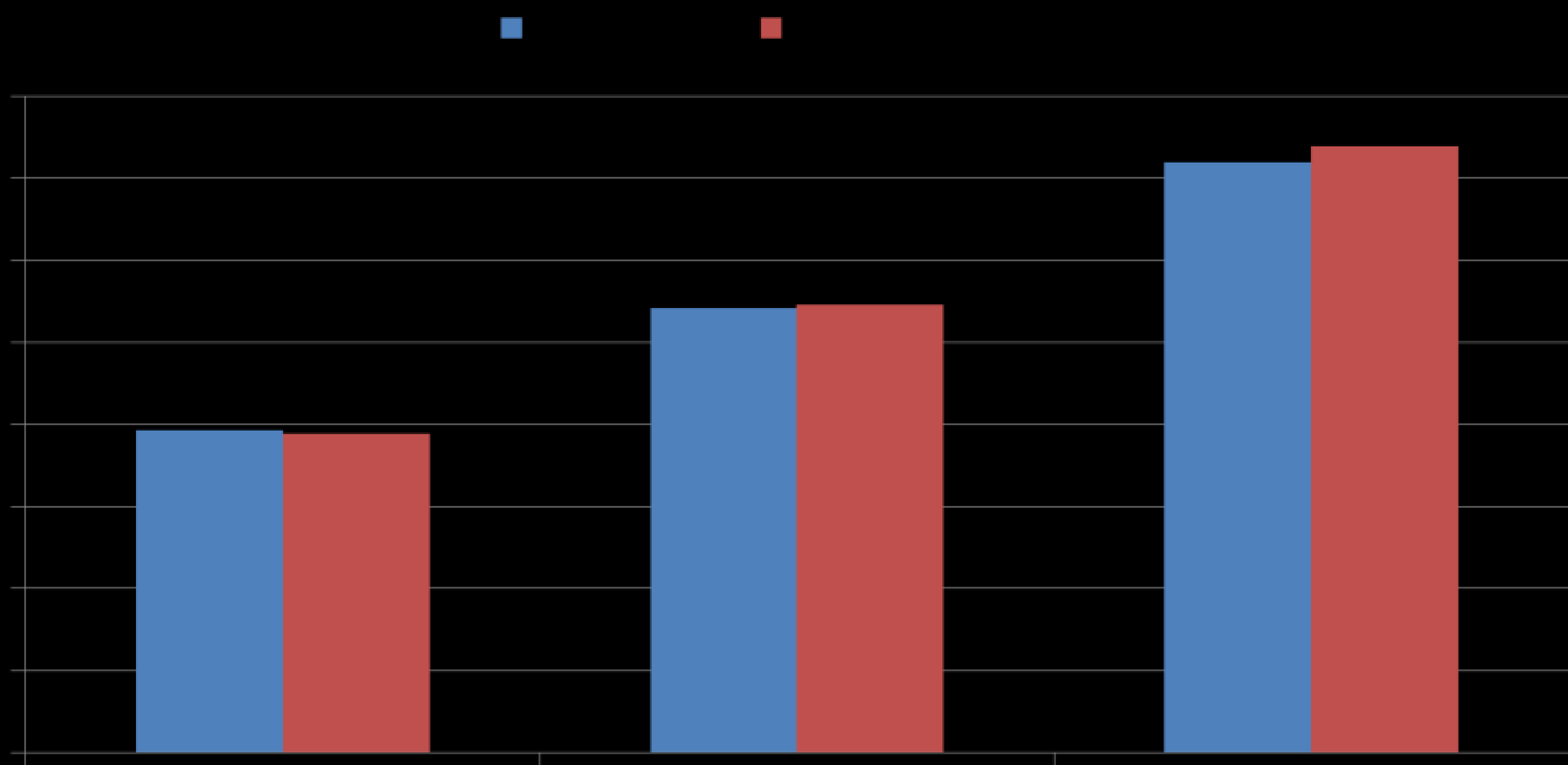
So What Ends the Up Cycle?

- Exports slow
- Supply response continues
- Weather returns to “normal”
- Policy changes (it could get better)
  - Ethanol
  - Trade
  - Farm bill? How important today
- Monetary policy changes
  - Increases in real interest rates

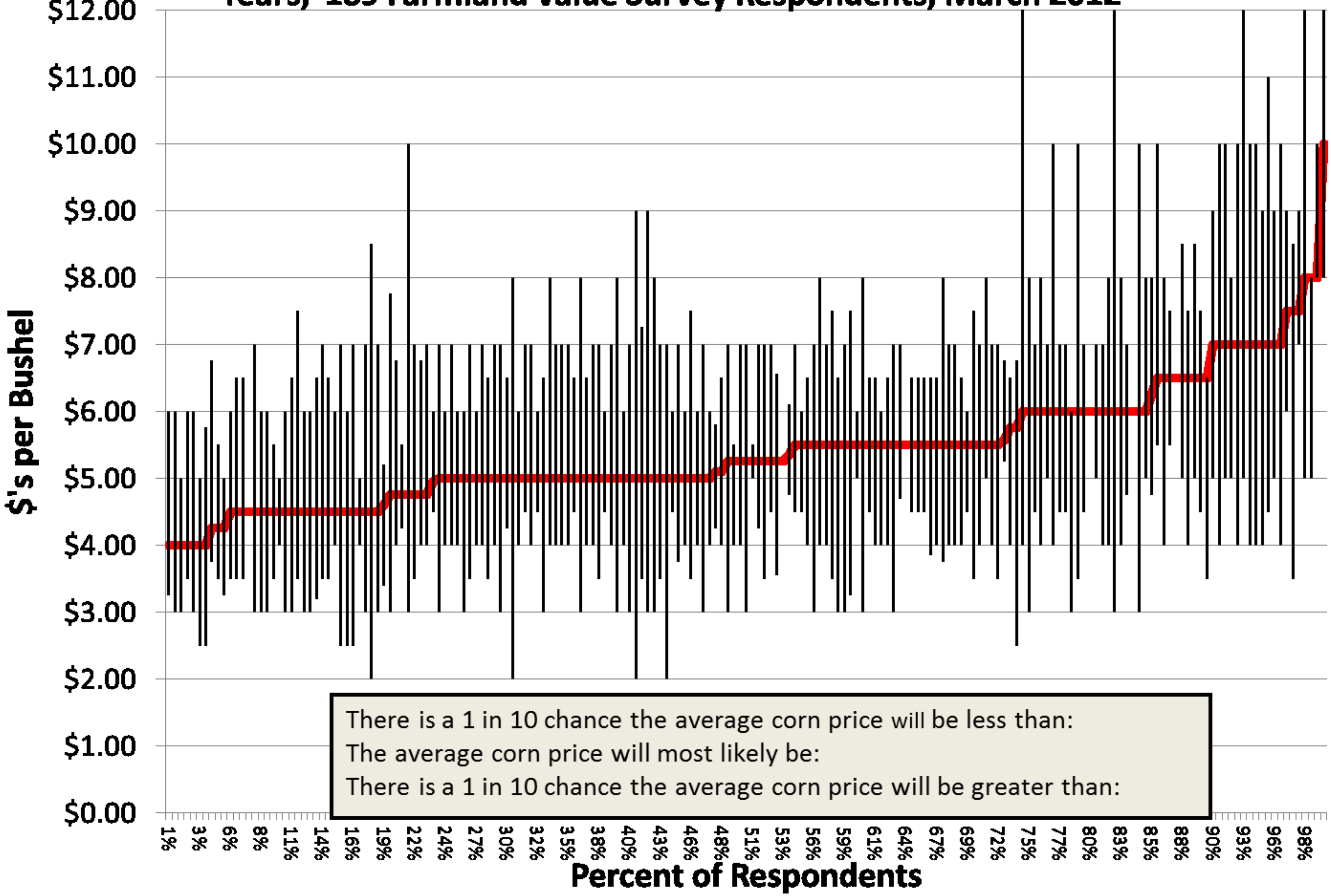
What will amplify the cycle?
CREDIT use and TERMS!

What Do Market Participants Think about the Future?

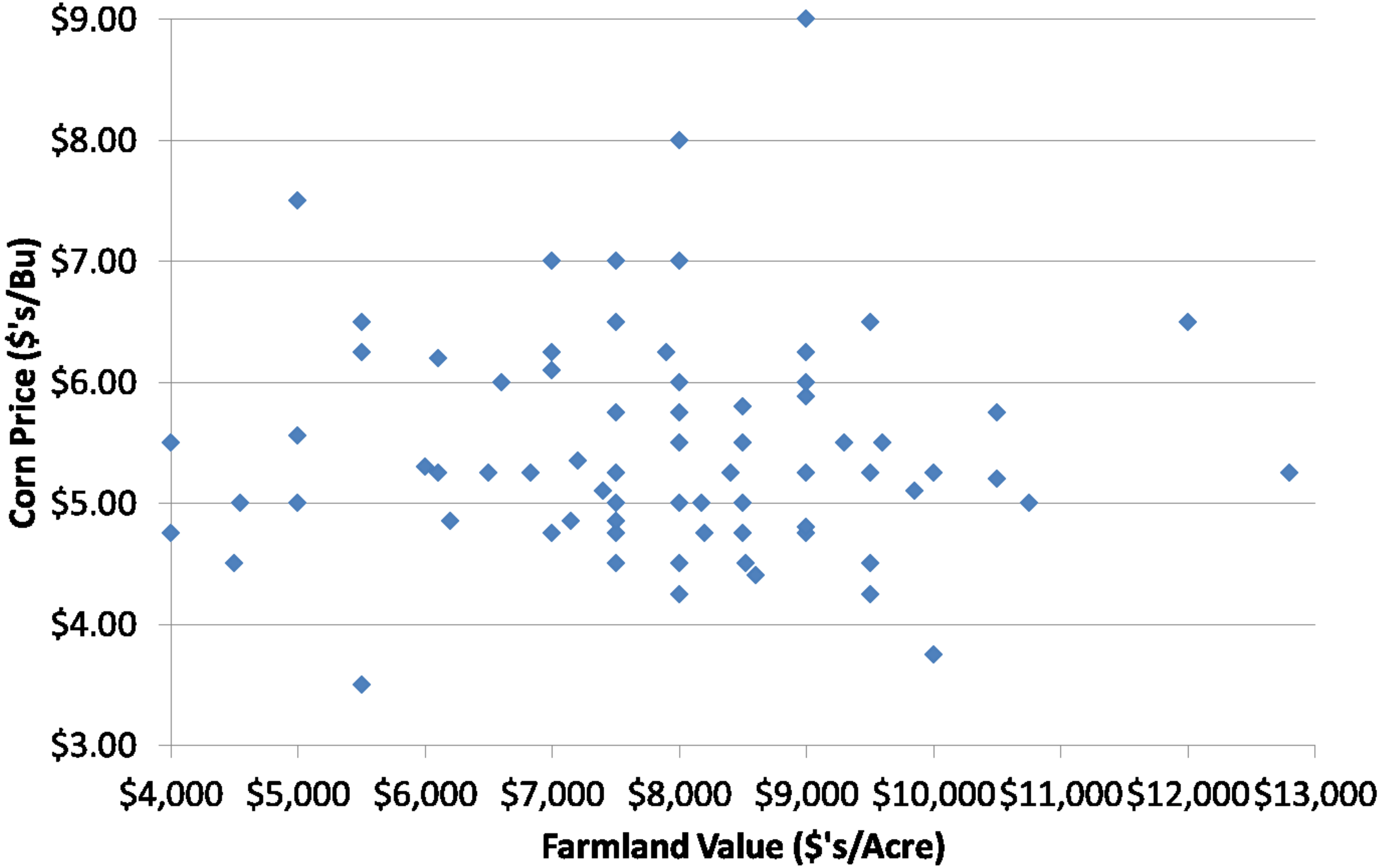
- Two surveys March 2012 and March 2013
- Asked about
  - Farmland prices
  - Cash rents
  - Crop prices

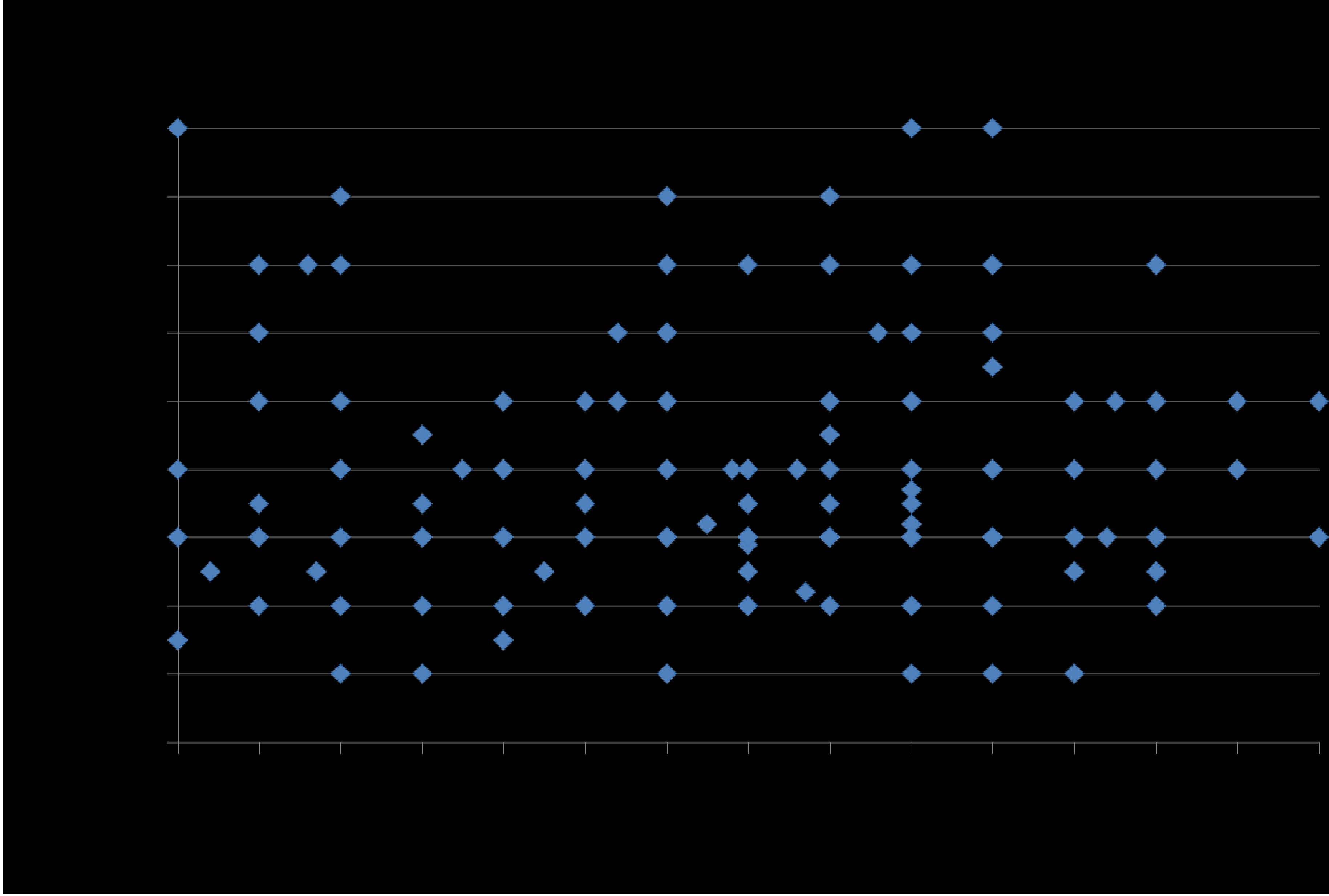


Distribution of Expected Average Cash Corn Prices Over the Next 5 Years, 189 Farmland Value Survey Respondents, March 2012

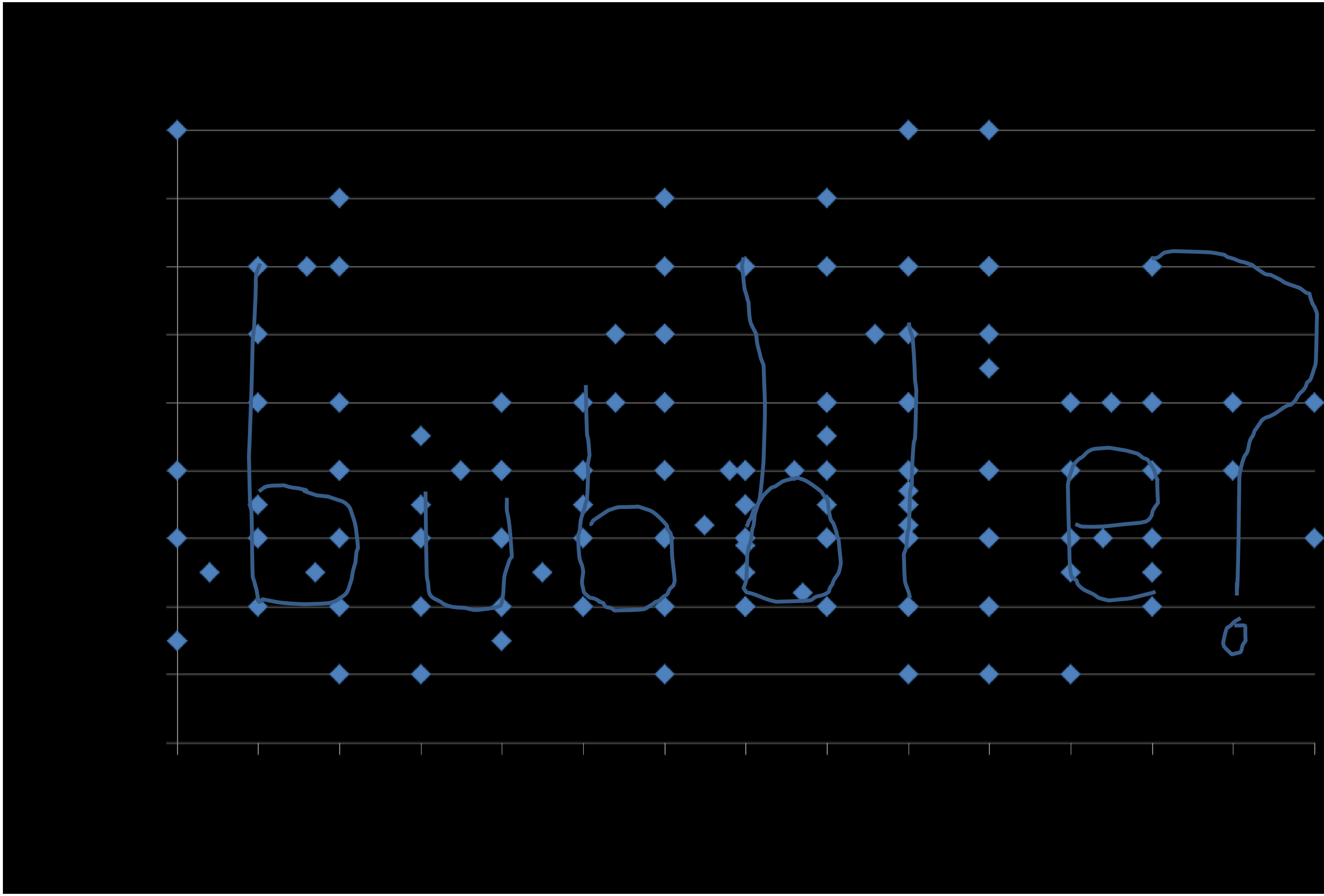


Relationship between Expected Cash Corn Prices and Farmland Values, 92 Respondents, March 2013





March 2012 also showed almost no systematic relationship between perception of land value and expected corn prices



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So What Does All this Mean?

All of this Comes with a Resurgence of Risk

- Lower commodity prices
- High cash costs – fertilizer, seed, chemicals
- High land rents/values
- Margin compression/risk
- Few risk management options for multi-year risks
- Less effective government safety net
- More counter party risk
- Increased working capital needs
- Financial reserves critical

The Credit Climate (the Potential Surprises)

- Reduced liquidity/working capital
- Lower collateral/security values
- Debt structure challenges
- Deferred tax obligations/increased tax burdens
- Margin compression
- Reduced income subsidy for land purchases/expansion
- Higher interest rates
- Counterparty risk

What Strategies Make Sense for Farmers

- Maintain strong working capital positions
- Lock in long term interest rates
- Moderate asset ownership and growth
- Carefully assess facility/equipment ownership/costs
- Don’t overbid on farmland or other assets
- Cash match sales and input purchases
- Buy insurance
- Protect margins
- Pay down (prepay) debt
- Invest in operational excellence

What Not to Do

- Use/accept inadequate documentation of performance
  - Profitability and profit drivers
  - Productivity/efficiency
  - Cost control (accuracy and timeliness of data/information)
- Underestimate start-up/implementation challenges of expansion
- Use overly optimistic projection/expectations
- Ignore risk assessment/management/mitigation strategies
- Grow too aggressively
- Expand beyond management capacity
- Depend excessively on equity as the back-stopper
- Ignore potential "Black Swans"

What to Watch for in Slowdown

- Impacts on main street in rural economies
- Equipment dealers and other input suppliers are on the front line of any slowdown
- Highly leveraged farms – farms with lots of recently purchased land
- Poorly managed farms with adequate financial strength today
- Farms with lots of long-term cash leases and other off-balance sheet financing

Be Wary of

- Appraisal values on collateral
  – Unfortunately both the income approach and comparable sales methods have the same flaw
  – Approach lags the markets and accentuates trends

Final Thoughts

- Tremendous volatility in the ag marketplace
- For crop farmers it has been all favorable
  - How good are they at managing risk? (It has been easy so far)
  - How exposed are they to others risk management activities? Volatility creates winners and losers
  - How are they managing costs?
  - What about non-land capital investment?
  - When need for operating capital comes it will be substantial and much larger than before the boom

Final Thoughts

- Times have been **VERY** good
  - It is conceivable they could get better
  - It is also conceivable they could be worse
  - It is very difficult to predict what takes us out of this cycle, but too much credit can magnify the outcome either way
- Most signs point to slowing
  - I wouldn't bank on the next 7 years being as good as the last 7, but I think they will be acceptable for good managers