Ag News

Autumn 2017

from F&M Bank

Message from Mike Holloway

The harvest season will soon be upon us and our banking organization has actively participated in agricultural loans for farmland, equipment, livestock and farm operations.

F&M's ag banking team has a wealth of experience, which allows us to be more flexible in structuring financial services for your farming operation. Whether you need financing for daily operations or to fund growth and expansion, we have loans and programs that can help.

Please tell your friends and colleagues about F&M Bank and call or stop by if we can be of assistance. Thank you for your business!

Sincerely,

J. Michael Holloway
Senior Vice President and
Senior Loan Officer

Farm Lending Steady, but Risks Remain

According to the Federal Reserve Bank of Kansas City, agricultural lending at commercial banks was steady in the second quarter, but risks in the farm sector continued to weigh on loan growth and credit conditions. The volume of non-real estate farm loans increased only slightly from a year ago as interest rates continued to trend up at a modest pace and maturities continued to lengthen. The rate of farm loan delinquencies edged higher, but the performance of agricultural banks generally remained strong, even as farmland values in most areas continued to decline.

Farmland Market Defies Trend

"Steady with exceptions" might be the best way to describe the farmland market, judging by the semi-annual market update from Farmers National Company (FNC).

"The trend in today's land market is hard to discern as some sales bring a better than anticipated price, while others may show a decline in value from previous sales," says Randy Dickhut, senior vice president of real estate operations at FNC. "Agricultural land values in most areas can be expected to continue to gradually decline over the next several years if commodity prices and the underlying farm incomes remain at current low levels," Dickhut says. "Small interest rate increases, potential tax law changes and world economic uncertainties will also keep some outside pressure on land prices in the coming year."

One unknown factor that could adversely affect land values later this year is the potential increase in the number of properties for sale caused by financial stress in the ag economy, he notes. Despite anticipated additional declines in land prices in most areas, there are positives on the horizon for land values.

"Those include potential improvements in farm and ranch incomes after bottoming out. If we have limited stress sales and no other shocks to the markets, land values will move to stabilize over the next several years," Dickhut notes.

In both Iowa and Illinois, good quality land has been steady or experienced a slight decline in value in the past six months. Average quality land continues to see a slow decline in value while pasture land has experienced some strengthening. Overall, land values have stayed fairly stable due to the limited amount of land on the market over the past several years. Recent commodity prices indicate there is still room for a downward trend in land values. If more land becomes available on the market, values may decrease more rapidly.

Source: Walsten, Mike. "Farmland Market Defies Trend." Accessed August 28, 2017. https://www.agweb.com/article/farmland-market-defies-trend-naa-mike-walsten/

How Much More Do Capital Purchases on Grain Farms Need to be Reduced?

In a recent article, Illinois Farm Business Farm Management (FBFM) staff evaluated the impacts of machinery costs on Illinois grain farms, noting two important items. First, there is a strong link between lower machinery costs and higher farm profitability. Second, capital purchases have been coming down since 2013. On many farms, the necessity of meeting lower cash flows likely will require further reductions in capital purchases. However, additional reductions in capital purchases requires changing machinery complements held relative to complements on farms ten to fifteen years ago.

Capital Purchases on Illinois Farms

Capital purchases include investments in machinery, farm buildings, grain bins, drainage tile, and other longer-lived assets. On most grain farms, machinery purchases make up most of the capital purchases.

Between 2000 and 2006, capital purchases averaged $42 per tillable acre on farms enrolled in Illinois FBFM. After 2006, capital purchases increased dramatically. Capital purchases were $62 per tillable acre in 2007, $85 per acre in the years from 2008 to 2010, $119 per acre in 2011, $124 per acre in 2012, and $137 per acre in 2013. These increases in capital purchases corresponded to increasing net incomes caused by higher commodity prices.

Farmers have economic motives for purchasing machinery during periods of higher incomes. High incomes provide additional cash flow. Making capital purchases is one way to reinvest the additional cash flow in the business. Also, tax policies such as section 179 expensing and fast depreciation schedules allow much of the current year's capital purchases to offset higher taxable incomes, thereby reducing income tax payments during high-income years.

Since 2013, capital purchases have fallen dramatically. From the $137 per acre high in 2013, capital purchases were $96 per acre in 2014, $73 per acre in 2015, and $64 per acre in 2016. These declines in capital purchases correspond to net income decreases.

Is $64 Per Tillable Acre Low Enough?

Now the following question exists: Is the average $64 per acre of capital purchases in 2016 low enough or does it need to decline more in future years? On the side of further reductions is the high level of capital expenditures from 2011 to 2013. These higher levels likely built asset bases above those needed for normal operations. If a “draw down” period occurs, the question still is what is the long-run, sustainable level of capital purchases on farms.

A starting point for evaluating the longer-run level of capital purchases is to note that there was a six-year period during the early 2000s when capital purchases averaged $42 per acre. Current expectations of net income are not that different from incomes experienced during the 2000-2006 period. Given similar incomes, the $42 per-acre benchmark is a good starting point for determining a longer-run capital purchase.

However, the new level of sustainable capital purchases likely is above $42 per acre because machinery prices have increased. For example, a 255-horsepower tractor in 2006 had a list price of $216,000. A similar tractor in 2017 has a list price of $340,000. The increase in the tractor list price was an average of 4% per year over the eleven-year period from 2006 to 2017. Similarly, the list price of a combine capable of handling an 8-row corn head was $241,000 in 2006. The list price of a similar combine in 2017 is $398,000. The increase in the combine’s list price was 5% on a yearly basis. In the intervening years, technological change causes the 2017 machines to be better than the 2006 machines. Still, farmers must still cover the additional costs of the new machines.

Capital purchases averaged $42 per acre from 2000 to 2006. Given a 4% yearly increase in machinery prices, a $42 per acre purchase in 2006 would equal to a $63 per acre purchase in 2017 (i.e., a yearly increase of 4% causes the 2006 level to be $63 per acre in 2017). This suggests that $63 per acre in 2016 would purchase roughly the same machinery level as a $42 per acre purchase in 2006. This $63 equivalence level is very close to the average $64 per acre level of capital purchases in 2016.

The necessity of matching lower revenue with expenditures will require farms to further reduce capital purchases from the $66 per acre average level in 2016. Setting a goal for the low to mid $50 per tillable acre seems reasonable. Given machinery price increases, lower capital purchases mean holding a different machinery complement in 2016 as compared to that in 2006. Lowering capital expenditures can occur through a combination of using the same machinery complement over more acres and reducing the amount of machines. Machine reduction could occur through less tillage.

Importance of Machinery-Related Decisions and Strategies

Strategies for lowering machine costs are not new and

likely revolve around:

- Properly matching equipment to the farm size,
- Having as low of a machinery inventory given a farm size as possible,
- Spreading machinery investment over more acres through farming more acres, custom farming some acres, or sharing equipment across farms, and
- Having proper replacement strategies.

Implementing any of the above strategies is not easy.

Perhaps an area to evaluate is tillage. Reducing tillage will lower the need for tillage equipment and could reduce horsepower requirements of tractors. Eliminating tillage equipment and larger-sized tractors will reduce machinery investment and costs. If yields do not decrease with less tillage, the strategy results in higher farm profitability.

Summary

Overall, farmers have reduced capital purchases in recent years. More reductions likely are needed. Because of increases in machinery prices, further reductions in capital purchases will require changing machinery complements. Those changes likely will result in different machinery complements to that held during the 2000-2006 period, the period before higher incomes experienced from 2006 to 2012.

Source: Schnitkey, Gary. "How Much More Do Capital Purchases on Grain Farms Need to be Reduced?" Accessed August 28, 2017. http://farmdocdaily.illinois.edu/2017/06/how-much-more-capital-purchase-to-be-reduced.html

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Four Reasons Why We Aren't Likely to See a Replay of the 1980s Farm Crisis

There are plenty of alarming signs indicating a possible farm crisis: current corn prices are half the 2013 peak level of US $7/bushel; farm income has declined for major commodities (corn, wheat, cattle), falling from the previous year to levels well below recent years; weak farm income and worsening credit conditions continue to trim farmland values, which are expected to trend lower in the months ahead, thus weakening the equity position of producers and the collateral value for lenders. Given the heightening farm financial crisis, many agricultural lenders, academics, and other stakeholders in the US farm sector worry another farm crisis is looming. However, there are four economic and legal reasons why this farm downturn is unlikely to slide into a sudden collapse of agricultural markets.

Reason 1: Much stronger, real income accumulation before the current downturn

When debunking or confirming the idea of a farm crisis replay, it is useful to closely investigate the previous farm crises of the 1920s and 1980s, and it's equally important to investigate the golden eras before them. Through that comparison, the much stronger income accumulation during the late 2000s, fueled by growing export demand from China, historically low interest rates, and the expanding biofuel market, puts agricultural producers and businesses a much better condition now to weather storms.

Reason 2: Historically low interest rates

Put simply, land value is the net present value of all discounted future income flows. With certain assumptions imposed, one could think of land value being net income divided by interest (discount) rate.

Low interest rates are favorable to keep the farmland market afloat: on the one hand, it encourages stronger loan demand due to lower interest payments, and on the other hand, low interest rates also signals that the returns for other competing assets, such as stocks and bonds, aren't so robust that farmland investors are willing to accept a lower rate of return. Figure 1 reveals that even with recent hikes, interest rates are still very low compared to the 1980s, and the Federal Reserve is likely to raise the interest rate at a slow pace as opposed to a sudden hike, which makes loan restructuring possible for producers wanting to take advantage of current favorable interest rates

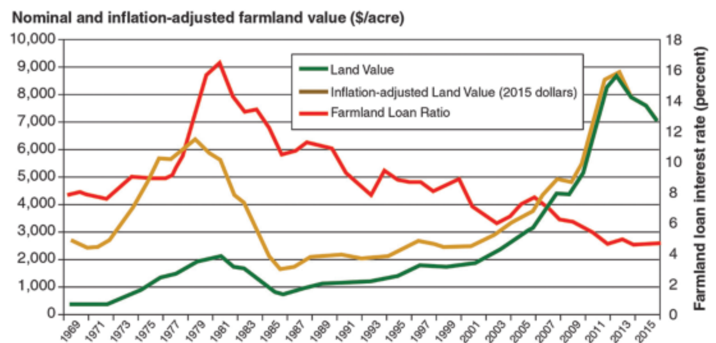

Figure 1. Iowa Farmland Value and Farmland Loan Interest Rates 1969-2016

Source: Farmland value data is from Iowa State University land value survey and the farmland loan interest rate is from the Federal Reserve bank at Chicago.

Reason 3: More prudent agricultural lending in part driven by more stringent regulations

The most striking aspect of the 1970s land boom during this high-inflation era is that debt capital largely financed the massive investment in agricultural assets. One reason is that loan requirements by lenders like Farmers Home Association were fairly lenient—it was not uncommon for agricultural lenders to give out large-cap loans up to 80 or even 85 percent of the collateral value. What made it worse was the way collateral value was calculated—market value unadjusted for inflation, which means that the book

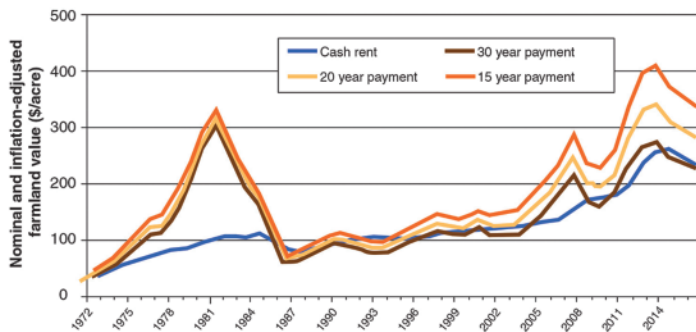

Figure 2. Cash Rent and Annual Mortgage Payments for Iowa Farmland Loans Under Prevailing Interest Rates

Source: Farmland value data is from Iowa State University land value survey (Zhang 2017), cash rent data is from the ISU cash rent survey, and the farmland loan interest rate is from the Federal Reserve bank at Chicago.

value of collateral rose when inflation skyrocketed. Figure 2 shows that both factors, in addition to high interest rates, contributed to the staggering agricultural debt and highly leveraged agricultural sector. By 1978, the debt incurred averaged 76 percent of the purchase price, and between 1970 and 1980, the amount of farm mortgage debt increased 59 percent.

After the 1980s farm crisis, the regulations on agricultural lending limits got tighter, and agricultural banks reverted to a 65 percent loan-to-value ratio, which became an even more stringent 50 percent loan-to-value ratio after the 2007–2008 financial crisis. Nowadays, one more factor helps limit the amount of debt and leverage faced by the US agricultural sector—collateral value is often calculated using a cash flow approach, as opposed to inflated market value. For example, in 2012 even though corn prices are approaching $7/bushel, the long-term average price of $4/bushel is often used by lenders like Farm Credit Service in calculating collateral value.

Reason 4: Stronger government safety net

It is very important to point out the strength of the agricultural safety net—in 1987, only 50 million acres in the entire United States were insured in the Federal Crop Insurance program. Today, just the total cropland insured in Iowa exceeds 25 million acres, representing 93% of Iowa's corn and soybean production acres. There is arguably stronger support from the livestock insurance program as well. In addition, payments from federal and state commodity programs and disaster relief programs provide significant revenue and price protection. The 1980s farm crisis represents the failure of the government's safety test in the "stress test," however, agricultural producers and the farm sector in general now have a much stronger safety net compared to the 1980s.

Despite the deteriorating agricultural financial conditions and continued decline in farm income, the current farm downturn is more likely a liquidity and working capital problem, as opposed to a solvency and balance sheet problem for the entire agricultural sector. Rather than an abrupt farm crisis, we are likely experiencing a gradual, drawn-out downward adjustment to the historical normal return levels for the agricultural economy.

Source: Zhang, Wendong. "Four Reasons Why We Aren't Likely to See a Replay of the 1980's Farm Crisis." Accesses August 28, 2017. http://www.card.iastate.edu/ag_policy_review/display.aspx?id=69

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