David M. Kohl

Professor, Virginia Tech
Agricultural Finance and Small Business Management

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Are you Ready for the Reset?

By: Dr. David M. Kohl

You have heard the old saying, "all good things must come to an end." Well, this is applicable to the great commodity super cycle which spanned from 2002 to 2012 with the zenith from 2007 to 2012, specifically, in the grain industry. While the duration of the current economic reset is difficult to predict, now is the time to proactively position your business with strategies to manage cost and in general, navigate the current economic times. From a broader perspective, there are several macro factors that will impact the agricultural economic landscape. As we examine the reset, we will focus on specific factors that producers, agricultural lenders, agribusinesses and other stakeholders should carefully monitor.

China does matter!

Some experts indicate that China's economic health does not matter to the financial potential of agriculture, rural America or the flyover states. I respectfully disagree and further expand that the economies of all emerging nations bear significant impact on agriculture's financial potential. Many in Washington, D.C. and New York's Wall Street use the term "flyover states" referring to the regions in between the East and West Coast population centers. While these regions may not be home to the most people per capita, they certainly matter in regards to gross domestic product (GDP), exports and the country's overall economic health.

Out of Brazil, Russia, India, China, South Africa, South Korea, Indonesia, Mexico and Turkey, otherwise known as the BRICS KIMT nations, many are in or near recession. While China's economic growth is rated officially at 6.9 percent, the lowest since 2009, it is most likely half that rate, which many say is approximately 3 to 4 percent. A weighted composite growth rate measured in GDP of these nations is slightly under 4 percent, less than half the rate during the stellar years of the super cycle. Should these nations' economies continue to decline, this will present challenges for those industries exporting commodities and services, across the globe.

China is the second largest economy and importer of agricultural products throughout the world. In addition, China is the fulcrum of the emerging nations' economies. Cumulatively, these factors dictate that China does indeed matter. The period of 2007 to 2012 was an economic aberration that created unsustainable variable and fixed costs, particularly, in the agricultural industry.

Oil, the Black Gold

Apply named by character, Jed Clampett of the *Beverly Hillbillies*, American sitcom from the 1960s, “black gold” is a lead indicator of economic direction. In each recession since 1969, shocks in oil price, either high or low, served as a precursor of economic turbulence.

In recent times, oil has been deflationary resulting in other commodities following its lead. However, the price of oil is currently impacted by several factors including, the slowdown of demand in emerging nations, the advent of cost-saving, extraction technologies, and the softening of alternative and renewable energy mandates. These factors make oil prices a variable to continue watching. Today, oil prices range from $40 to $60 per barrel with occasional spikes and declines due to geopolitical risk. As many agricultural products are petroleum dependent, factor this variable into your budget for input costs utilizing the “but, what if” sensitivity analysis.

The Central Bank

Central bank strategy in the U.S. and abroad will play a critical role in the duration and intensity of the economic reset. Initially, the U.S. Federal Reserve’s easy money policy placed $4.5 trillion on the central bank’s balance sheet. In turn, this fueled the intensity of the commodity super cycle. The weaker dollar encouraged exports and low interest rates inflated real estate assets.

Presently, the U.S. Federal Reserve is retracting while European and Japanese counterparts are adding stimulus. China has lowered interest rates six times since last November and their currency is now ranked the third most common global exchange ahead of the yen. As a result, this inhibits American exports which are critical to businesses across the agriculture industry and rural America. The relative strength and duration of the dollar must be monitored very closely.

These aforementioned macroeconomic factors will most likely result in resistance for higher commodity prices for the period 2016 to 2020. During this time frame, a supply and demand imbalance could cause commodity prices to temporarily rally, but only in the event of a significant natural or weather-related occurrence in major production areas of the globe. Mother Nature along with political sanctions, military actions, and changing consumer sentiment on food fiber and fuel, places global trade risk as the major risk in many agricultural industries.

Proactive Solutions

After this year’s harvest is complete, it is imperative to initiate discussions with your lender, farm managers and others to examine key areas of finance and management. From my observation of stakeholders across the country, the following are areas of concentration for these proactive, strategic conversations.

Many situations will require a reduction in family living withdrawals. This is easily said but extremely difficult to actually implement.   One possible solution is to construct a personal family living budget and then, write a monthly check for the budgeted amount. Of course, this requires a commitment to that specified amount. Lenders will monitor credit scores, credit card debt and credit history as regulators will require due diligence in these areas.

Second, reduce your variable and fixed costs. Some experts suggest reductions up to one hundred dollars per acre may be required to avoid negative margins. Of course, needed reductions will vary by producer depending on efficiencies and cost structures. To meet this metric, tough negotiations with agribusinesses and land owners will be necessary. Remember, there is no magical silver bullet in cutting costs or making profits. Most likely, a true reduction in costs will require a series of smaller cuts in several areas, rather than cutting one, major cost.

Next, eliminate unproductive assets. This requires evaluation of all assets; including, human assets. Recently, I worked with a producer in the Midwest region of the U.S. who evaluated his entire operation and determined his uncle was an expensive, unproductive asset. The uncle's cost to the business was $168,000 annually and nearly $.40 per bushel. While difficult, some situations dictate tough choices for sustainability.

Finally, tax records and tax forms such as Schedule F will not be sufficient for lenders or with regulators. From my work with individuals in the lending industry, it seems credit and specifically, operating money, will be carefully scrutinized. Accrual adjustments, scenario testing and "what if" planning will be expected on your cash flow projections. Know the financial, historical trends of your business and be prepared to present your case.

Some will make this time of economic reset the next topic of conversation at the local coffee shop. Others will make adjustments and utilize this reset to upgrade management, sharpen business acumen and maximize efficiency and resources. Today, agriculture faces economic change both inside and outside of the industry. Yes, there are challenges but this period will also offer opportunity. Be proactive and position your business for continued success.