David M. Kohl

Professor, Virginia Tech
Agricultural Finance and Small Business Management

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Agricultural Profitability at the Crossroads

By: Dr. David M. Kohl

There has certainly been a dramatic shift in agriculture in the last four years. During the recent super cycle, commodity prices reached the highest levels that many producers had ever experienced. Some producers indicated to me that they generated more profits from 2008 to 2013 than the previous 40 years of farming combined. Those record prices were like a magnet attracting young people and novice producers to the industry. For those already in agriculture, the super cycle was comparable to an adrenaline shot, stimulating expansion and growth in almost all commodity sectors.

Today, producers along with many others, realize that period of time was an aberration. Of course, the last three years of farm financials also concur. Crop prices continue to hover in a multi-year low as storage bins overflow. Even though the slowdown in the livestock industry lagged the grain sector by a few years, animal producers are now adjusting to lower prices as well. In my travels, many ask me when prices will return to profitable margins and what economic drivers could alter the future of farm fortunes. Well, as producers seek the return road to profitability, there are some signs for which to watch.

<u>Supply, supply, supply</u>!

"High prices secure high prices" is an old saying in economics. The boom and bust cycle is occurring not only in American agriculture, but in countries and sectors across the globe. In the past decade, approximately 200 million additional acres were added into production worldwide; closely mirroring the U.S. Grain Belt in production capacity. Crop and livestock expansion in South America, China, Europe, and the regions of Asiana and the Black Sea had a dramatic impact on worldwide commodity prices. Additionally, Europe dropped milk quotas which only fueled the situation. Moving forward, those businesses that focus on cost adjustments and efficiency will be most competitive and successful on the road to profitability.

Demand, demand, demand!

On the demand side of the equation, emerging nations were instrumental in the peak of commodity prices. However, many understated the role these nations, and specifically China, played in increasing fixed and variable costs. Inputs such as steel, fertilizer, feed, chemicals and others rapidly backed out of the threshold of profitability and started to squeeze margins.

During the time of the commodity super cycle, the emerging nations experienced a gross domestic product (GDP) growth rate of 6 percent to 10 percent on average. These growth rates moderated, of course, to a current rate of 2 percent to 4 percent with nations such as Brazil and Russia now in prolonged, deep recessions. Thus, a close eye on the economic status of these countries will provide the proactive manager a window view of opportunity in marketing and risk management, both short and long-term.

King dollar

Another element that makes today's travel on the road to profitability more challenging is worldwide currency wars. The power of a currency change was clearly displayed when the U.S. Federal Reserve lowered rates and stimulated the economy by a quantitative easing of $4.5 trillion. This action in turn, quickly lowered the value of the U.S. dollar, and made agricultural and manufacturing goods more attractive in global regions such as, the emerging nations with their expanding population and income growth.

Now, the tables have turned. The U.S. Federal Reserve curtailed its stimulus while others in Europe and Asia continue to add stimulus. Much like the aforementioned U.S. Federal Reserve actions, these countries have lowered the value of their currency, which makes American commodities and manufactured goods less competitive in international trade. The important question, however, is not the strength of the dollar, but the duration of its strength.

On the other hand, when agriculture producers must compete with low prices, often goods are less expensive for the U.S. consumer. For example, the U.S. is importing beef from South America, Mexico, Australia and other places which directly reflects in current price for U.S. beef. In addition, any upward change, particularly in U.S. interest rates will result in a longer duration for the strength of the dollar.

While there is currently a surplus of commodities worldwide, the one variable that can alter balances quickly is a weather abnormality in a major global production area. Occasionally, I have the opportunity to conduct programs with Eric Snodgrass, Director of Undergraduate Studies for the Department of Atmospheric Sciences at University of Illinois at Urbana-Champaign. At a recent conference, he provided some interesting perspective. In producing regions of the world, periods of dry weather are forecasted to occur with intense rainfall, and all over a short period of time. This pattern is likely to become the new normal, which can create income variability as the supply and demand equation is altered. With that said, the aforementioned trends and forces, both domestically and globally, are economically comparable to the 2000 to 2008 time period.

So, what will be the future implications for agriculture? First, this year's renewal season for operating loans and others will require producers to be proactive in their requests. That includes updated and accurate financial information, including balance sheet, accrual income statements and projected cash flows. Next, there will be ample opportunity for growth or startups for young producers. Actually the current economic environment is much better for starting businesses than it was at the peak of profits. A majority of assets including machinery, equipment, livestock and land are experiencing some downward adjustments, which reduces the capital required to launch or grow a business. In addition, in this environment others are finding that the older generation is more willing to consider parting with the farm.

In general, there appear to be three types of young agricultural producers emerging. Some are entering the family business. Others are partnering with a producer that has no next generation to continue the business. The third type is a new generation of producers, thinking out of the box to align consumers and multiple enterprise businesses. Along with their family dynamics and demanding work ethics, farmers have a long track record of creativity and ingenuity. Undoubtedly, these young partners will continue and expand that can-do spirit.

December of this year through next April will be a critical period in agriculture. The refinancing of operating losses will be much more difficult and operating monies from agribusinesses will tighten. This will create financial liquidity issues. Both rented and owned, more land will come into the marketplace, resulting in double-digit percentages of downturn and adjustments, in some regions.

The road to profitability will have its potholes and speed bumps, and yes, some exit ramps, too. The well-prepared navigator will bring business and financial planning, as well as a financial marketing dashboard of indicators and metrics along for the trip. In addition, producers must monitor performance and make the needed adjustments to accommodate to current conditions. Lastly, executing the strategized plan will move one along the road to profitability at a much more efficient and successful pace.

<u>A quote of the times</u>

"More money will be made behind the desk, in the books, on the computer and networking with people, than with production and land, at any cost!" Don't be tempted to try and produce your way to profits because it just won't work in most years!