ENDURING THE CYCLE
Lessons learned from those who have survived difficult times.

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ABSTRACT

The last several years produced strong profits for hay producers and enabled significant growth in many operations. However, cyclical changes are the norm in agriculture and set the stage for financial success or failure. Those who preserve capital and build liquidity in good times are often best positioned to handle tough times in agriculture. Profits incent new production and fuel spending habits that leave some ill prepared to survive the impact of price reductions that emerge in an oversupplied market. Hay producers experienced a very profitable year in 2008 while the dairymen who purchase their hay were on the front end of the most devastating economic downturn in decades. The global economic recession impacted hay export markets and feeder hay buyers. Most hay producers are financially sound and yet sell into a market that is strapped for cash. Account receivable turnover has slowed and many hay producers are becoming major creditors of their buyers. Access to credit and surviving cyclical changes involves a balanced approach to managing the 5 C's of credit that most lenders rely upon to guide them through sound and safe loan decisions.

Key Words: Character, Capital, Capacity, Conditions, Collateral

INTRODUCTION

Financial stress in agricultural throughout 2008 and 2009 contributes to challenges facing many lenders and allied industries that depend upon the financial well being of farmers and ranchers. The earliest challenges surfaced in dairy, beef, hogs and poultry where operating losses have been evident for nearly a year. Crop producers who experienced above average returns for several years now see margins compressed and a return to normal prices. Profits or losses in one sector of agriculture ultimately impact returns in another sector where mutually dependent synergies exist. Reduced hay prices in 2009 may be in response to efforts by many dairymen to contain cost and survive the most difficult economic downturn in decades in the dairy industry.

While hay producers experienced above average returns the past three years, cyclical changes are underway that shift the economic landscape ahead. Key questions include:

1. Where is the hay industry today?
2. What lies ahead?
3. What drives lending decisions?
4. What are the "survivors" doing?

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Where is the industry today? The table below, taken from Northwest Farm Credit Services (NWFCS) customer records, illustrates a three year trend of profits that were more than adequate to cover debt payments. Additionally, overall liquidity and capital position are sound.

(NWFCS Customer Sample – Same hay customers for each year reviewed.)

	2006	2007	2008
Sales	**$26,084,976**	**$30,911,452**	**$37,159,139**
Pre-Tax Profit Margin	**15.36%**	**22.42%**	**26.03%**
Debt Coverage Ratio	**1.39**	**2.00**	**2.57**
Current Ratio	**1.6/1**	**1.7/1**	**1.9/1**
Working Capital/Expenses	**27.3%**	**31.3%**	**36.8%**
Debt to Asset Ratio	**27.7%**	**28.6%**	**26.2%**

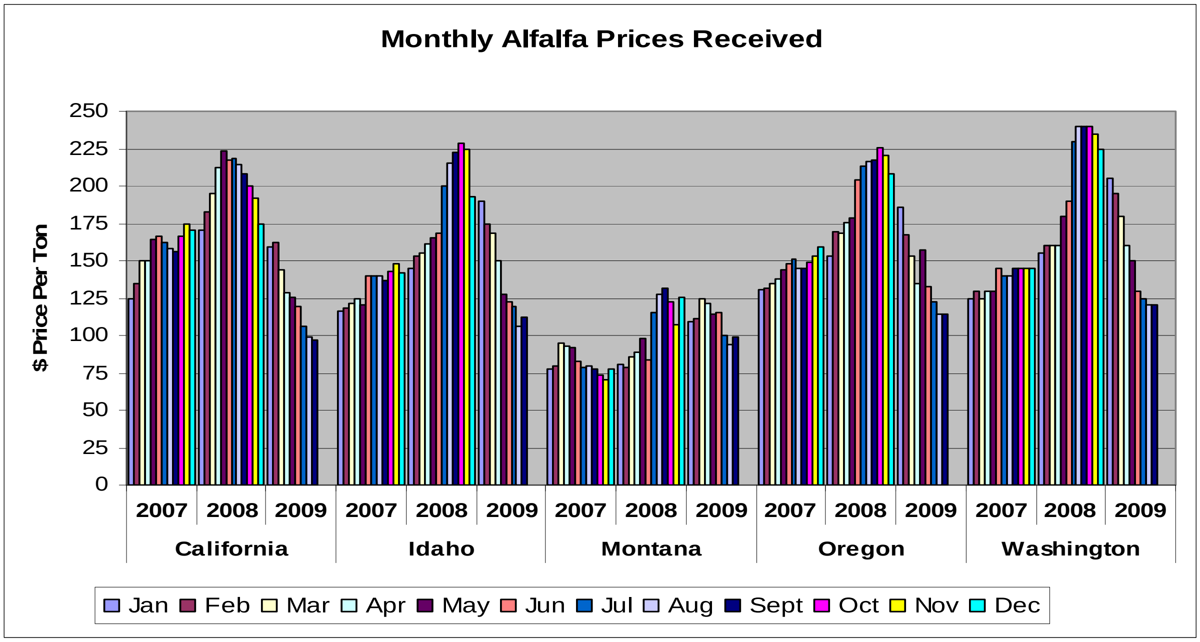
Observations from a lender's perspective:

1. Profits are well above historical averages that are closer to 8-10%.
2. Cash available before taxes and living expenses of $2.57 for every $1 of debt in 2008 followed two exceptionally profitable years and set the stage for potential:
    a. Expansion of operation to minimize taxes.
    b. Capital expenditures for improvements to property, plant and equipment.
    c. Discretionary and atypical expenses.
3. Overall liquidity and capital are sound.
    a. Working capital was greater than 20-25% of annual operating cash expenditures each of the past three years, a sign of financial health.
    b. Overall leverage is modest at 26-28% debt to asset ratio.
4. Balance sheet data is based upon current "market values" because few producers provide "cost basis" data on assets.
5. Tangible working capital liquidity was heavily influenced by the real and perceived value of crops on hand. (The data comes from those customers who produce primarily alfalfa hay.) The chart below compares crops on hand to working capital:

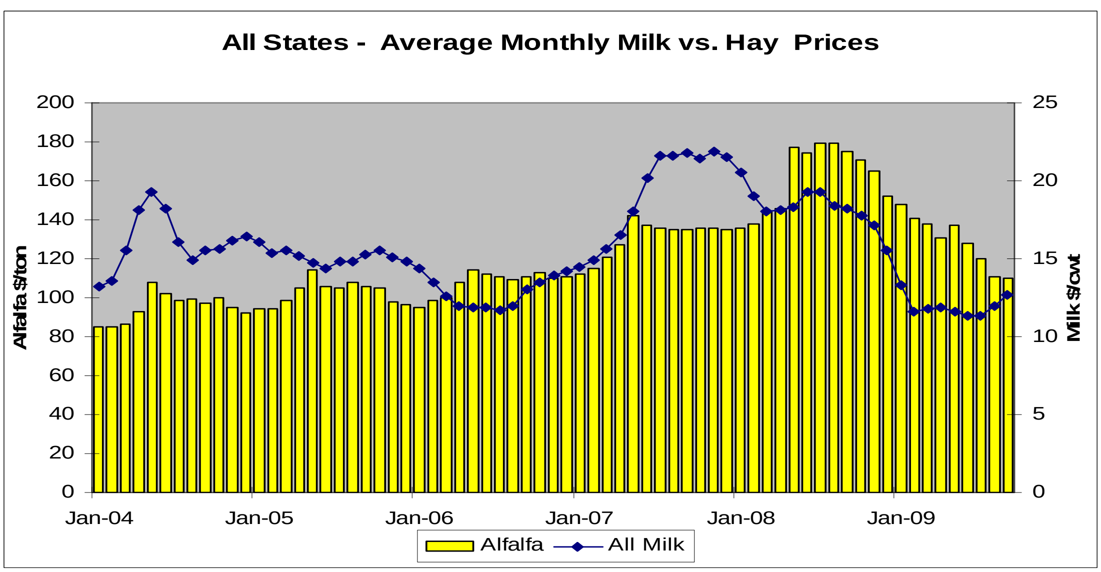
	2006	2007	2008
Total Working Capital	**$5,775,960**	**$7,427,655**	**$10,066,208**
Crops on Hand	**$5,677,399**	**$5,340,331**	**$7,730,268**
Crop Value as a Percent of Total Working Capital	**98.29%**	**71.90%**	**76.79%**
Working Capital Net of Crops on Hand	**$98,561**	**$2,087,324**	**$2,335,940**

Downward pressure on hay prices in 2009 may soon push working capital back to 2006 levels without much relief expected on typical operating expenses to produce hay. While hay producers appear in decent financial shape to withstand an economic downturn, cash flow challenges will likely surface that may deplete liquidity.

What lies ahead? The chart below on monthly alfalfa prices, provided by USDA statistics for California and the four Northwest states, may signal a shift in the economic landscape ahead**.**



Prices have dropped $95 per ton or 47% from September 2008 to September 2009. Additionally, demand for hay has softened based upon input from customers contacted. Dairy producers buying hay are looking at lower cost alternatives whenever possible. Hay prices from export markets have diminished also. Competitive pressures to move hay inventory are forcing prices down. The chart below illustrates the shift in hay prices in response to milk prices since 2004.

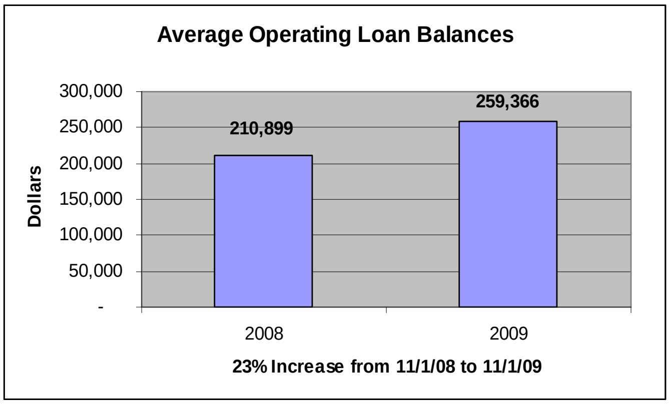


Observations from a lender's perspective**:**

1. Profitable times have given way to intense competitive pressure to move product. Price reductions on inventory driven by current market conditions will most likely diminish profit margins and impact balance sheet liquidity.

2. Dairies that are the primary market for hay produced continue to struggle and look at any and all options to contain costs.
3. Using the financial data collected from the customer survey above and the following assumptions:
    a. Inventory quantities are similar at the end of 2009 to 2008 levels;
    b. The 47% reduction in price continues through the end of the year;

    Working capital would drop to $5,969,165, slightly above 2006 levels, but still very reasonable when compared to cash expenses that have averaged nearly $25 million the past three years.
4. Customers in the sample above spent $.77 to produce $1 of revenue on the average the past 3 years. Prices on hay are down 47%. Cash flow challenges are anticipated that will further deplete working capital unless input costs drop proportionately, which appears unlikely.
5. Operating loan balances are up 23% from 11/1/08 to 11/1/09.



The industry is on the front end of what could be a tough economic cycle. Fortunately, most producers are going into this cycle well positioned financially to withstand adversity. However, with liquidity depleted, some hay producers may not be in a position to withstand a second downturn if it were to occur in the next three to five years without debt restructuring.

<u>What drives lending decisions?</u>

The Five C's of credit have traditionally driven credit decisions for most lenders and includes:

> **Character** may be the most important of the 5-C's of credit. The customer's willingness to honor obligations and commitments speaks volumes about the value he or she places on honesty and integrity in a relationship.
>
> **Capital** addresses the customer's balance sheet health to support a credit transaction. Liquidity and equity quickly become focal points in examining any credit decision. Working capital adequate to support at least 20% to 25% of annual cash operating needs is an early indicator of financial health along with a 2/1 current ratio. Both are liquidity measurements. Overall equity and leverage ratios may not be as important as liquidity measurements in driving lending decisions. Hay producers have a modest level of debt (26%) compared to other businesses. The customer records above show an industry well positioned from several years of profits to handle a moderate economic downturn.

Capacity examines the customer's ability to service annual debt and capital needs from core earnings of the business. Hay producers averaged nearly $2 of funds available before taxes and living expenses for every $1 of debt payments the past 3 years. The hay industry may be on the front end of cash flow challenges related to reduced prices on hay sold, but should have adequate liquid reserves on hand to cushion shortfalls for awhile.

Collateral is what customers pledge to protect the interest of a lender. For the customers included in the statistics above, real estate represents 46% of total assets followed by machinery and equipment representing 22% of total assets. These assets support both short and long term lending decisions with advance rates ranging from 60% to 75%. For operating lines of credit, lenders prefer to limit loan balances to no more than 65-70% of receivables, inventory and livestock.

Conditions take into consideration the economic and environmental impact of an industry financed. Observations above point to the end of a profitable period for most hay producers and the onset of challenging economic times. Primary markets for product, including dairy operations, are struggling and impact prices received for hay sold. Sluggish demand for hay contributes to price reductions.

Each of the **5 C's of Credit** drive credit decisions. Ultimately, the driving force behind a sound credit relationship is the proven ability to honor commitments in good and bad times. Cyclical changes occur in all segments of agriculture that determine profits or loss. The ability of a customer to navigate through tough times often comes down to preserving capital in good times.

What are the survivors doing? Customer attributes most evident that contribute to "surviving" cyclical changes in agriculture, or any business venture, come down to the following:

1. Leadership with vision, courage and a commitment to endure tough times.
2. Open and honest communications with suppliers, creditors and customers.
3. Solid business and financial plan to manage cash reserves.
4. Operational excellence that includes cost accounting systems enabling accurate tracking of the costs of production.
5. "Lean and Mean" approach in tough times. Limit capital expenditures to meet long term objectives.
6. Face time with key customers and a commitment to tap into new markets to sell product.
7. Realistic assessment of inventory value, marketability and turnover.
8. "No excuses" attitude on current conditions and a vision on moving forward.
9. Product quality, diversity and identity that sets you apart from competition.
10. Investment in core business and people that contribute to your success.

Examples illustrating "survival" observations will be part of the presentation at the Western Alfalfa Conference based upon lending experiences over the past 30 years.

Conclusion: Hay producers are coming off of three profitable years of production and should be well positioned for economic challenges ahead. Price reductions evident in the market place will impact profit margins and potentially erode tangible balance sheet liquidity. Most should be well positioned for the downturn.