INSIGHTS REPORT

VOLUME 03 WHAT'S INSIDE

Lower crop prices and tighter cash flow could make operating loans more important than ever. It's time to plan for lower grain prices in the coming year.

The 2014 Farm Bill shifted farm subsidies from direct payments to crop insurance. Here's how crop insurance tools and programs can help manage your risk exposure.

Data suggests a majority of aging producers have not discussed a succession plan with anyone. But what about the next generation and the future of rural America?

Every farm, business and community is unique. How can you adapt to changing local risks and opportunities while also keeping an eye on global trends and the nation's economy? With nearly 100 local offices and more than 1,200 employees, Farm Credit Mid-America is constantly working to help farmers in Indiana, Ohio, Kentucky and Tennessee leverage the economics of change in their favor. This report shares some of our insights to help you manage your operation and stand strong in today's competitive, ever-changing marketplace.

Steve Allard
Chief Credit Officer

FINANCIAL LIQUIDITY CAN HELP YOU WEATHER LOW GRAIN PRICES — WHILE MINIMIZING THE BURN.

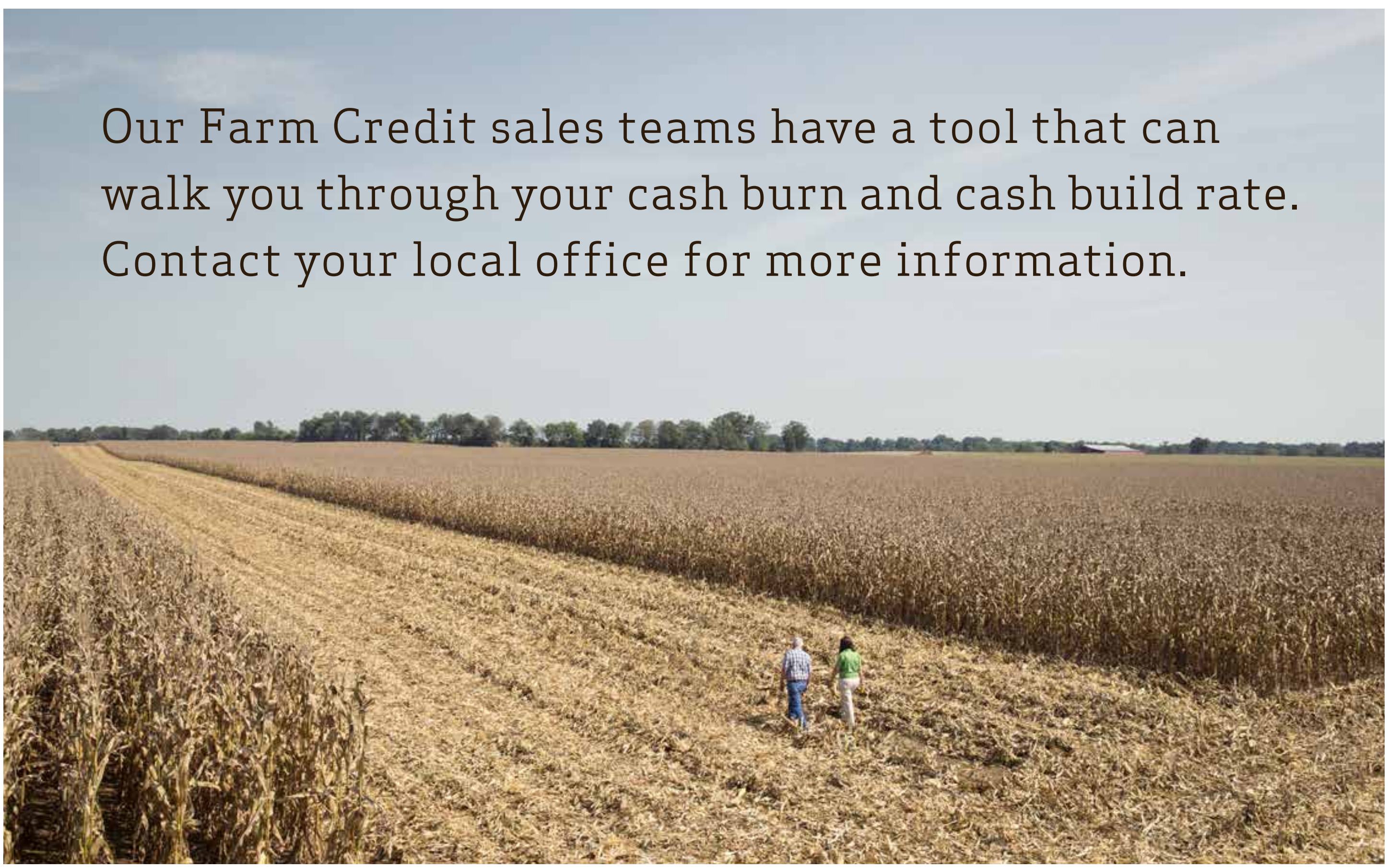
CASH BURN OR CASH BUILD

The only thing certain about commodity cycles is that they're uncertain. While natural and political factors can shorten or lengthen downturns, we must always be aware of changes in the global economy, including trade agreements, farm programs, currency values and interest rates. While these factors are largely beyond our control, they will affect you at the local level. Farmers must have a plan in place to maintain the financial liquidity needed to plant and harvest an annual crop in good times or bad.

Nobody knows for sure how long the current downturn in crop prices may last. Previous downturns in the U.S. crop sector — 1981 through 1986 and 1997 through 2002 — each lasted five years. And while each downturn has its unique set of circumstances, it's conceivable that the current slump in corn and other commodities may also last five years.

Given crop prices and production costs projected by the USDA for 2016, it appears many corn, soybean and wheat farmers will be operating at a cash flow deficit, or what is called *cash burn*. Because we're coming off several prosperous years, cash burn rates haven't been top of mind in quite some time. However, understanding cash burn or cash build rates is important, as they indicate if you'll enter the coming year in a position of strength or a position of challenge.

Determining an individual burn rate, and what a farmer needs to do to manage it, is an important exercise. Farmers can expect their lenders to want to have a good understanding of their working capital position and projected cash flow, including estimated crop yields and prices. Analyzing these variables along with individual fixed costs helps determine if the operation is in a cash build or cash burn situation. And in today's environment, we're finding that many farming operations are showing some level of cash burn.



In our work with customers, we've identified areas where they can minimize the impact of cash burn. By understanding fixed costs, outlining an approach to liquidity and utilizing financial tools to better manage risk, you can put yourself in a position to reduce the impact of low grain prices in the coming year.

Control fixed costs

Seed, fertilizer, fuel and other costs needed to produce a crop are categorized as variable costs. But farmers also need to understand their fixed costs, which can include land, buildings, equipment, employees, family living expenses and taxes. Fixed costs are costs that must be paid whether you put in a crop or not. After looking at thousands of customers' financial data here at Farm Credit Mid-America, we see a lot of variance in farmers' fixed costs. And it is a determining factor in whether the farming operation is in a cash burn or cash build mode. In fact, fixed costs are typically the one variable that separates high-cost and low-cost producers. And in this environment, it is especially important to be a low-cost producer. Recent actions taken by customers to manage fixed costs include terminating leases on marginally producing rental acres. Some are selling underutilized or non-critical assets. Others are renegotiating rental rates with landlords or critically analyzing any opportunities to buy additional land. Many are forgoing equipment purchases as can be attested by recently reduced profit forecasts of equipment manufacturers.

Rethink liquidity

In recent profitable years, many farmers paid cash for capital assets, including equipment and real estate. Or they made very large down payments and/or financed the balance on shorter than normal loan repayment terms. Those decisions appeared wise at the time but may now place additional strains on cash flow and liquidity.

Loan refinancing can have a direct, immediate and positive impact on your cash burn/cash build rate. Although a five to ten year loan may have looked like a good way to finance a real estate purchase when grain prices were much higher, now those large loan payments in a low grain price environment can create a real challenge for cash flow.

We're encouraging farmers to talk with us to make sure their loan structure and terms are right for today's environment and their situation. Stretching loan terms out from five or ten years to a more typical 20-year amortization reduces the annual cash flow requirement to service the debt.

Line up financing now

One crucial tool for providing liquidity is an operating line of credit. We've seen less demand for operating lines in recent years due to historically high net farm incomes reducing farmers' need for a line of credit. But that has also changed. And as soon as harvest wraps up, it's important to begin thinking about securing an operating line of credit for 2016. The earlier those discussions start with your lender the better, as the additional time will help you and your lender better understand your needs in 2016 and beyond.

Typically, you are only charged for having a line of credit when money is taken out. But if the money stays where it is, no interest is paid on it. And even if the cash goes unused, a larger credit line offers confidence that you'll have the financial resources to put in a crop this year. Liquidity offers flexibility to take advantage of opportunities, such as early-pay discounts on seed, crop protection chemicals or fertilizer.

Farm Credit is committed to being a reliable source of credit for customers in any economy. We advise you to always make borrowing and buying decisions based not only on opportunities, but also business need.

Jason Alexander
Vice President—
Crop Insurance

FARM PROGRAMS AND CROP INSURANCE WORK TOGETHER.

RISK MANAGEMENT REVIEW

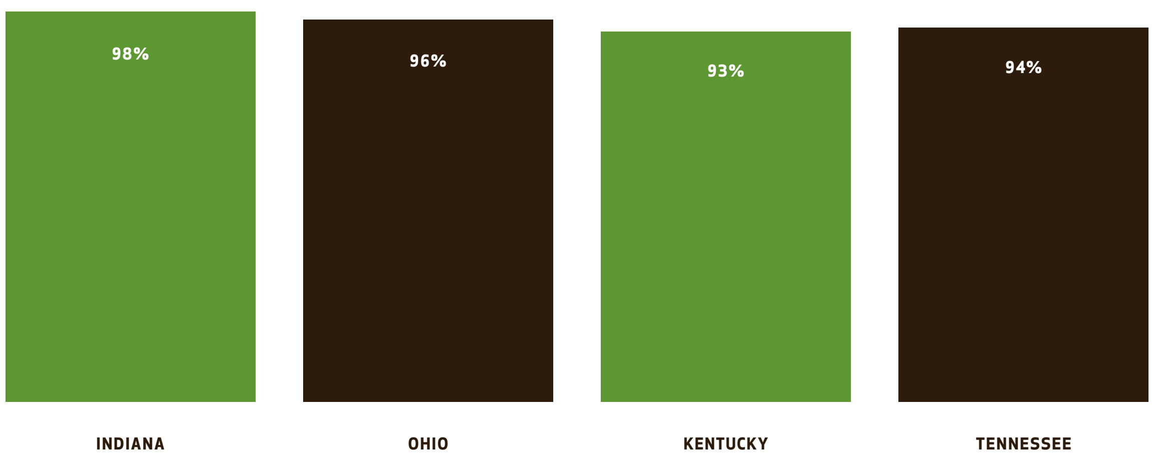
Spring flooding and other weather-related crop challenges have been higher than average for our four-state area in 2015. As a result, Farm Credit Mid-America has already processed more than 2,500 crop insurance claims. We had twice as many prevented planting claims as in the previous two years, totaling 281, with more than 175 of those in Indiana and Ohio. According to recent USDA reports, crops across most of the Corn Belt look good, while pockets of our four-state territory are below average due to spring flooding. Years like this are a reminder of why crop insurance is an important part of your risk management portfolio.

Crop insurance has evolved into a fundamental component of a complete risk management plan and, today, farm programs, financing, forward contracting, income diversification and crop insurance all work together. When deployed holistically, they create a valuable safety net, but it can get confusing if you don't have the right expertise at your side.

Farm programs and crop insurance work together

Farm programs are increasingly complex. After several years of strong crop prices, farmers were seeing prices trend down as they made their five-year elections for either Price Loss Coverage (PLC) or Agriculture Risk Coverage (ARC). And because the programs were new, we received many questions from customers about their choices. Recently released data from USDA now shows that, as expected, the vast majority of farmers chose ARC. Looking at our four Farm Credit Mid-America states, we largely align with the rest of the country's preference for ARC, which showed 96 percent of soybean farms and 91 percent of corn farms elected ARC-County. When we see such high levels of elections for the same program, it tells us farmers had a good feel for what program best fits their situation and they were properly educated on their choices. As Farm Credit partnered with FSA and universities to help farmers proactively inform themselves on program details, we saw that ARC was the popular choice at educational meetings held across our four states.

ARC–COUNTY ELECTION IN OUR FOUR STATE TERRITORY *(Corn and soybean acres)*



Source: Farm Credit Mid-America

CROP INSURANCE:

- Has moved from "exception" to "norm"
- Costs per acre = best investment
- Protects revenue
- Preserves key financials: liquidity, solvency and working capital
- Integral part of an overall management plan

Forward contracting and crop insurance

The high price of crop inputs must be weighed against yield targets and expected income. Forward-price contracts are a useful tool, but they also add additional complexity to your risk management plan. If a farmer is using forward-price contracts and a disaster causes production to fall off, then that farmer would have to explore other options, such as making a settlement, based on their contractual obligations while the price of the commodity likely will have increased because of the disaster and a short crop. So with revenue protection insurance, the farmer can take advantage of what is happening in the market without as much risk from having a short crop, and can meet contractual obligations by either buying the grain or making a financial settlement based on insurance.

Enlist a team of risk management specialists

Tying everything together into a complete risk management matrix can get complicated quickly. Today, it's important to enlist the help of a team of experts to make sure you're well informed. We suggest bringing a diverse team to the table, including a grain marketer, an outside insurance provider and, now more than ever, a crop insurance specialist. We view crop insurance as a pillar of managing financial risk and increasingly recommend that farmers include a crop insurance specialist in these conversations to make sure their financial positions are addressed. With these experts at the table, you can adequately walk through what's happening with your crop, your insurance, how much repayment capacity you have, your balance sheet, profitability and what kind of claim you can expect with different scenarios. This kind of visibility is crucial in attaining operational profitability.

We're seeing this approach play out more frequently in a new era of risk management. For instance, we recently brought a team to meet with one of our long-time loan customers and spent half a day together going through risk management tools and looking at his operation. The customer called a couple of days later to tell us he learned more about how insurance and marketing tied together in his meeting than he had in all of his previous educational efforts combined. His story is a perfect example of how, in an era where crop insurance requires a dedicated, year-long approach, viewing it as a key part of your core risk management strategy should be viewed as the norm, not the exception.

Crop insurance has evolved into a fundamental component of a complete risk management plan and, today, farm programs, financing, forward contracting, income diversification and crop insurance all work together.

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Director—
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Jessica Lehman
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Business Segments,
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OLDER FARMERS HOLD MOST FARM ACRES, BUT WHAT ABOUT THE NEXT GENERATION?

SUCCESSION PLANNING: STEPS FOR A SOUND TRANSITION

On America's farms, the average age of owners and operators continues to rise. According to the U.S. Department of Agriculture (USDA), the average farmer is now a bit over age 58, and the vast majority of those producers have been working their land for 10 or more years.[1] In addition, producers age 55 and older own nearly 70 percent of all U.S. farmland, while leasing just over half of the nation's agricultural acreage.[2]

For those reasons, it's no surprise a huge transfer of land will occur in the next few decades. However, an array of data suggests much of it won't remain in the family. For example, a 2013 AgWeb survey of over 1,000 producers found 80 percent had thought about succession issues, but less than half had created a transition plan.[3] Meanwhile, a separate study by Iowa State University discovered 47 percent of surveyed producers had not discussed succession with anyone, and only 27 percent had identified someone to take over the farm operation.[4]

However, this is about more than transitioning a business; this is about helping secure the future of rural America. And for those deeply concerned about the future of family farms, those numbers are not an encouraging sign.

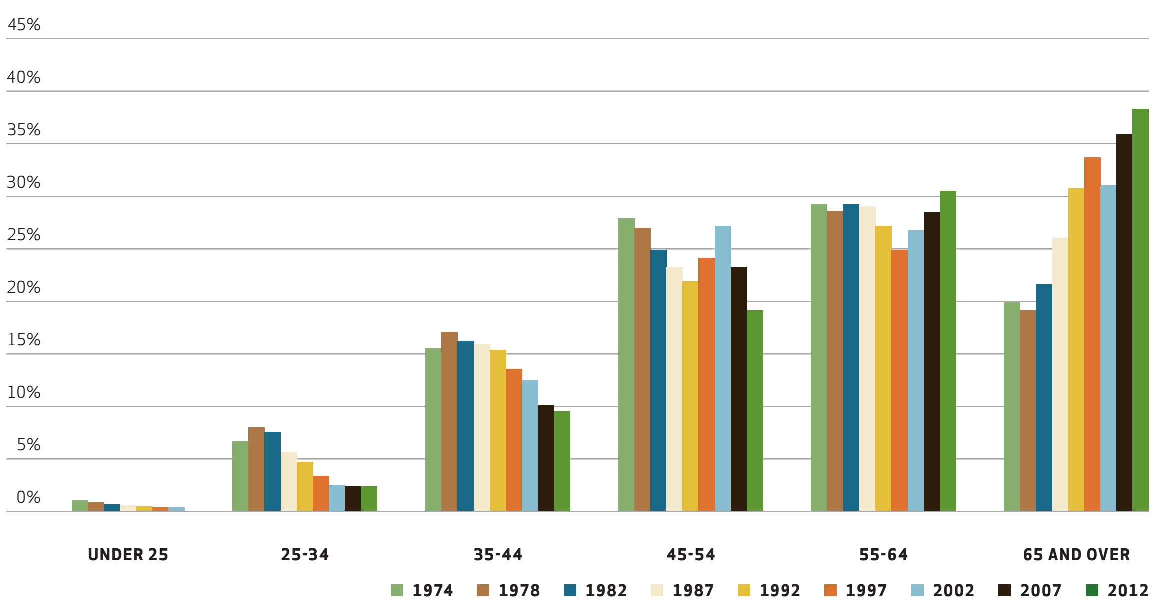
Uphill climb for younger farmers

When we talk about succession planning in this setting, it's less about the assets, and more about transferring family values, business management skills and leadership skills to the right person in the next generation.

But over the past three decades, a confluence of factors has made it harder for young people to successfully take up farm life. Since the early 1980s, the midpoint acreage for farmland rose from just under 600 acres to over 1,100 acres, since larger holdings were able to deliver better return on equity for major crop operations. The most significant increase took place in the nation's heartland, where acreage-intensive crops such as corn, soybeans and wheat make up a majority of the annual harvest.[5] During this same period, the number of young farmers has trended steadily downward.

In the accompanying chart, note how acreage owned by producers in the 25–34 and 35–44 age brackets peaked in 1978 and has declined ever since. Conversely, land holdings have steadily increased in the 65-and-over group and remained relatively steady in the 55–64 age range.

% OF ALL OWNED ACRES BY AGE



Source: USDA Census of Agriculture, 1974-2012

While farming has always had high barriers to entry, it's clear that sound planning can go a long way to ease the crunch of land, equipment and input costs for younger people who want to carry on a farming legacy. While those plans clearly involve people, they also need to include a long-term view of how the land will be managed.

Succession planning: starting conversations, building blueprints for a sound transition

According to the U.S. Small Business Administration, only 30 percent of family-owned businesses (including farms) survive to be operated by a second generation, and a mere 16.5 percent make it to the third generation.[6] Since the vast majority of all American farms are family-owned, the kitchen table is often the best place for owners to have early conversations about their legacy dreams. Even for families with young children, it's not too early to begin planning for succession.

As the next generation moves into adulthood, it's a good time to start having "family meetings," during which farm owners can outline their hopes for the farm's future. More specifically, discussions should cover the core skills needed to own and manage the farm, and review how that meshes with the talents of children who wish to remain on the land.

To help provide structure to these conversations, four primary steps for effective succession planning are listed to the right.

All succession plans will benefit from outside expertise in accounting, financial planning, insurance and law. To build the right team, seek out recommendations from friends who have moved through recent generational transitions, or consult with a local agricultural business specialist at a local university extension office. Before hiring anyone, producers should conduct personal interviews to ensure they can comfortably communicate with all members of this important team.

1 FARM INCOME
This involves an assessment of current income and projections on whether that revenue stream can continue to support the next generation.

2 RISK MANAGEMENT
Assuming general farm liabilities, such as mortgages, equipment payments or land rental costs are covered as part of a farm income discussion, a major risk management consideration is potential medical costs down the road.

3 MENTORSHIP AND FINANCIAL INDEPENDENCE PLANNING
Owners who have developed good negotiation skills, marketing savvy, strong decision-making and emotional maturity must find ways to translate them into leadership and management training for the farm's chosen successor.

4 ESTATE PLANNING
First, an estate plan must account for often-varied interests among key stakeholders, such as family members who wish to stay actively involved on the farm and those who don't. Additionally, a sound plan will employ trusts, partnerships, insurance policies or other tools to minimize taxes while clearly defining both financial and personal interests.

Resources

[1] Kurtzleben, Danielle (February 24, 2014). "The Rapidly Aging U.S. Farmer." *U.S. News and World Report*. http://www.usnews.com/news/blogs/data-mine/2014/02/24/us-farmers-are-old-and-getting-much-older.

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[3] Humphreys, Kate (November 8, 2013). "The Drive to Succession." *Farm Journal Legacy Project.* http://www.farmjournallegacyproject.com/article/the_drive_to_succession_NAA_Katie_Humphreys/

[4] Iowa State University (2006). "Iowa Farmers Business and Transfer Plans." Iowa State University Extension. http://www.extension.iastate.edu/bfc/sites/www.extension.iastate.edu/files/bfc/Farm%20Business%20Transfer%20Plan.pdf

[5] United States Department of Agriculture (2013). "Farm Size and the Organization of U.S. Crop Farming." Economic Research Service. http://www.ers.usda.gov/media/1156726/err152.pdf

[6] Ohio State University (May 10, 2013). "Transitioning family farms to the next generation." Ohio State University College of Food, Agricultural and Environmental Sciences. http://cfaes.osu.edu/students/about-us/campus-news/transitioning-family-farms-the-next-generation

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