farm CREDIT MID-AMERICA | INSIGHTS REPORT

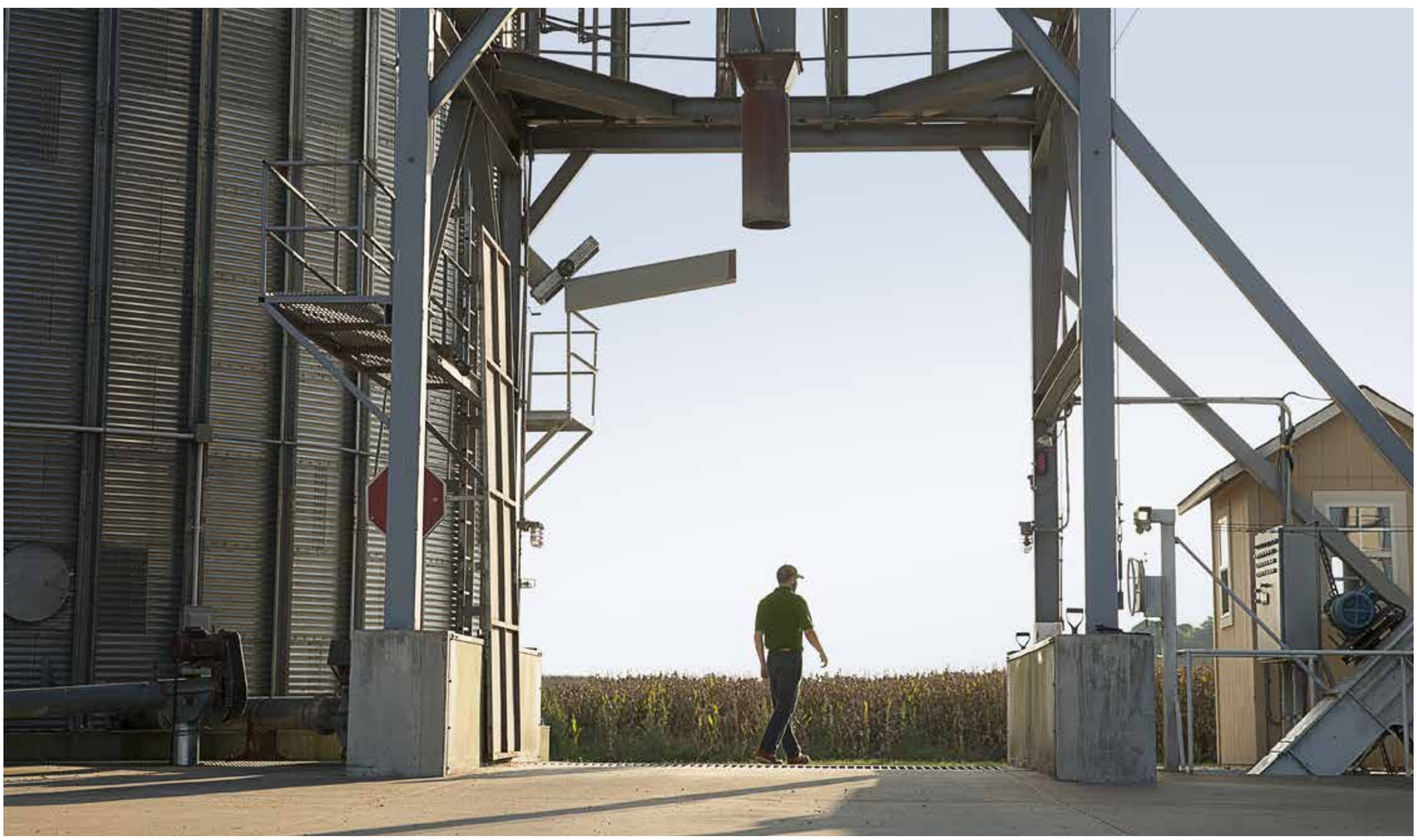
VOLUME 08 WHAT'S INSIDE

A variable swine market means there are key areas producers should focus on for short- and long-term planning.

With the current state of the ag economy, it's more important than ever to understand how to make the most of an operating loan.

Now that harvest is completed, we revisit five crucial steps to crop insurance planning and preparation.

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.



Ron Durre

Regional Vice President—Agribusiness, Farm Credit Mid-America

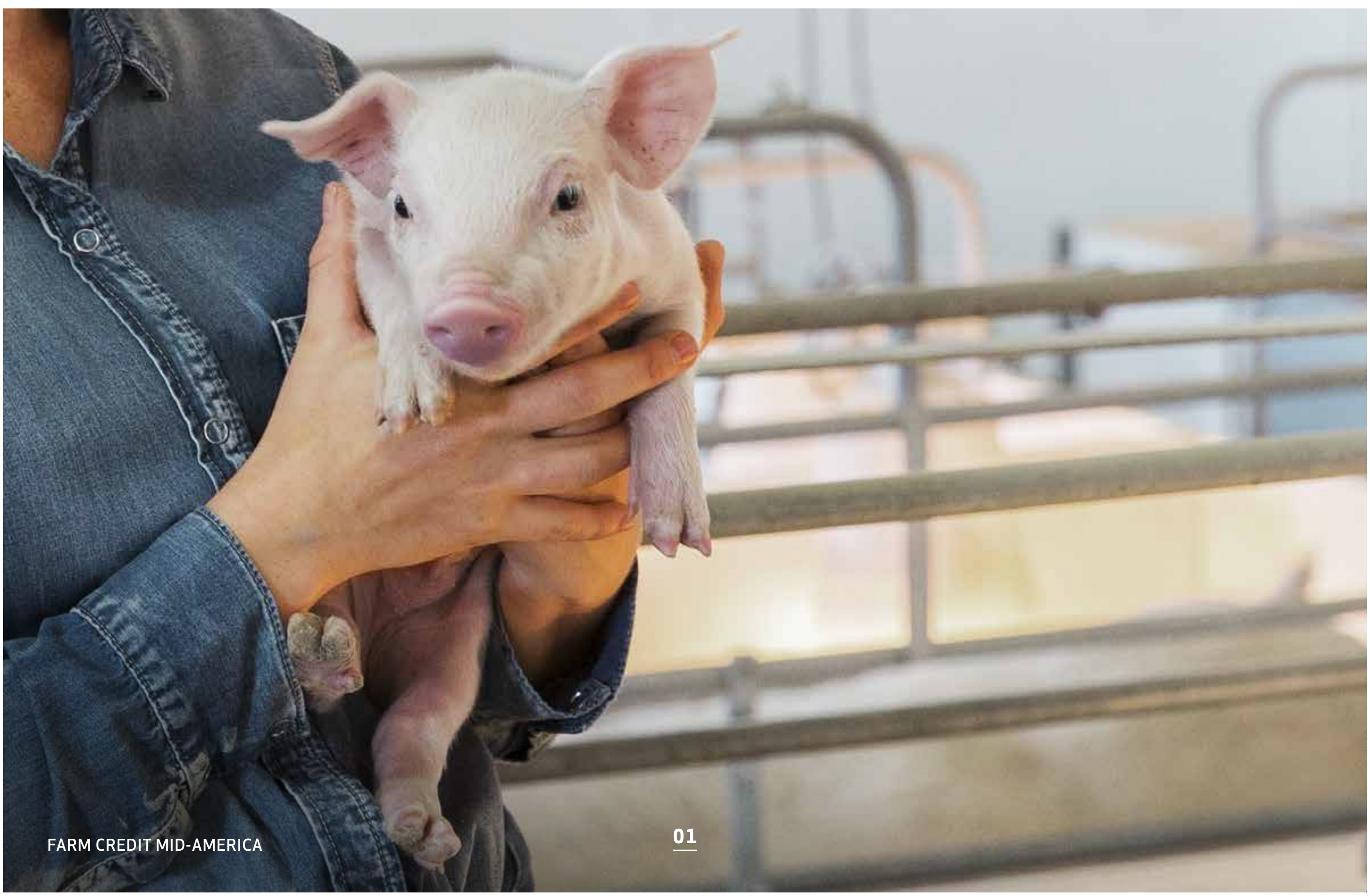
A VARIABLE SWINE MARKET MAKES AN OPEN DISCUSSION WITH YOUR LENDER MORE IMPORTANT THAN EVER

PLAN AHEAD FOR SWINE PROFITABILITY

The hog market has changed rapidly the past year. Operators did well on the open market in the first half of 2016, but lost ground in the fall before rebounding late in the year. Conversely, producers who planned well with strong balance sheets are expected to have an easier time weathering the current downturn. And, while we used to see the hog market cycle up and down more readily than it does today, the cycle now is deeper and wider. Part of this is because production systems are very different from what they were 20 years ago when plenty of farmers were jumping in and out of the market. In the past, when the market dropped, farmers didn't have a lot of fixed assets wrapped up in hog production, so they could easily get out. And when prices went up, farmers would get back in. Today, we don't have that luxury. Producers who get into hog production now tend to stay in it because they have a lot of fixed assets that have to be covered. Expansion mode, which the industry is still in right now, takes time and investment.

The future is bright for U.S. pork

Hog production is still a growth industry. American pork producers are among the leaders in global hog production for a reason — we are one of the best places in the world to raise pork with highly developed infrastructure, knowledge, feedstuffs availability and markets to buy the product. While we experienced a slug of extra production in late 2016 that got ahead of market demand, we foresee continued increases in long-term demand from local and global markets. There's no doubt that a growing middle class with rising incomes in China and other emerging markets will demand more meat protein. Guessing when demand will catch up with current production, however, is an inexact science. That's why farmers, even as they add sows and expand production, must keep an eye on efficiency and staying a low-cost producer.



“Keeping an eye on liquidity positions and making adjustments to improve are key to survival now and success later.”

What's on the horizon for the market?

While no one can predict how the market will perform, we do know that the typical hog market cycle is about four years. And there are concrete reasons to be optimistic. Three large hog slaughter plants are being built right now in Michigan and Iowa, with two of them scheduled to come online in 2017 and the other scheduled for 2018, while two smaller plants being built in Missouri and Minnesota should be complete by early 2017. These plants will increase packing capacity and have a positive influence on the cash hog market.

Producers have been expanding too, with each new operation adding between 2,500 to 5,000 sows or more. Expansions that began one to three years ago are just starting to contribute to the supply pipeline now.

Make it through the cycle

We encourage producers to set up business plans, which leads to a better understanding of the market and low-cost production. Those who take this step tend to have solid equity positions and balance sheets with little operating debt.

However, there is still hope for producers who currently find themselves falling behind. If you’re in this position, it’s time take a serious look at where you want to be in the pork industry in the future as you focus on being a lowest-cost producer. Keeping an eye on liquidity positions and making adjustments to improve will be key to survival now and success later.

Key points to discuss with your lender

When it comes to short- and long-term plans, there are a number of operating and expansion-related conversations you should be having with your lender.

Consider the following:

- Communicate early and often with your lender.
- Can you meet the minimum recommended working capital level of at least $600 per sow? More is better, and some operators have three to four times this amount.
- What is your percentage of producer equity? We recommend at least 40 to 45 percent on cost basis in a farrow-to-finish operation. Expansions should have even greater producer equity to accommodate startup and operator losses.
- If planning an expansion, where are you in the process? Plan siting and permitting of expansions well ahead of time. Keep feed sources, labor and management, environmental regulations and hog manure management in mind.
- What is your marketing plan and what role do you want to play in the hog industry 10 years from now?
- How will an expansion affect succession plans for your family farm?

Thinking through these areas will help provide a clearer picture of opportunities and risk for your operation and open the door for productive discussion. Keep in mind that Farm Credit will work with many different kinds of hog operations to provide operating loans. We look for a solid business plan, sound management, good production and success going forward. Now is the time for pork producers to watch their balance sheets closely and always communicate any changes with your lender.

Gary Coleman
Regional Vice President—Indiana, Farm Credit Mid-America

AN INCREASE IN OPERATING LOAN DEMAND MEANS A CORRECT UNDERSTANDING OF USAGE IS ESSENTIAL

MAKE THE MOST OF OPERATING LOANS

Farmers in our four-state area took a double hit in 2015–2016 with lower grain prices and stubbornly high input costs. As a result, there has been a precipitous drop in farm income and an increasing reliance on farm operating loans. Farm Credit has seen a much higher demand for operating loans and an increased draw rate this past year. Farmers also held those loans longer. Where three years ago farmers were holding their loans for only five or six months of the year, more operating loans in 2016 were held for eight months or more. Also, many farmers who didn't need operating loans in the past needed them this year.

Getting ahead of the game in today's market

As farms continue to be challenged in the current market, a key figure producers and their loan officers must look at is cash burn rate, or how working capital will decline due to operation. The great challenge is finding ways to stay in business, get a crop in the ground and maintain enough cash flow to reduce the burn rate until grain prices rebound. Cutting costs and increasing efficiency have never been more important. And smart management of operating loans is playing a crucial role in maintaining the liquidity needed to plant next year's crop.

There are hundreds of stories of farmers who have been dealing with this challenging environment. One farm family I know, for example, is a 3,000-acre, grandfather-father-son operation in Indiana. As they worked through the peak of the grain cycle they were able to build a significant amount of working capital and equity while purchasing a small amount of real estate and a small amount of equipment to meet their needs. With working capital and stored grain available going into 2016, they were still concerned about low grain prices and weren't sure if they'd need an operating loan or not. They decided to take out an operating loan in case grain prices went down. As it turned out, their crop was good but prices were low, so they didn't need to use all of the loan they'd drawn and they paid it back early. Now they're looking at 2017 and considering what-if scenarios for grain prices again. They're planning to set up another operating loan just in case they need it.

Using operating loans correctly

Is taking out an operating loan you might not need a good idea? In the above case, it was, because the farmers were very disciplined about how they used the loan. They looped in their loan officer well ahead of time and paid it back as soon as they'd sold that year's crop. By paying it back promptly when they sold the grain, they reduced their interest expense, keeping in mind that revenue from sold grain should always go to paying back an operating loan.

Another area to consider is your level of crop insurance to protect against a bad crop year. Using an operating loan without crop insurance or not having the right level of crop insurance adds risk to your operation. Crop insurance is a guarantee that you can pay off the operating loan and avoid running the loan over into the following year if nature turns against you.

Another thing the Indiana farm family got right was avoiding the use of short-term operating loan cash to make large capital purchases. You can get into trouble, for instance, by using money from an operating loan to buy a large tractor or building that should have been financed by a longer-term loan. If something happens where you can't pay the operating loan off in a year, you could get caught with a big interest bill and penalties. Plus, it could hurt your ability to get an operating loan for the next production year. If you need to borrow to make a capital purchase, talk to your loan officer to get the right kind of loan, allowing you to spread the payments over several years.

Getting the right size operating loan is important too. A loan that's bigger than you need for crop inputs can unnecessarily increase your interest payments and debt-to-asset ratio. Communicate with your loan officer early and often to outline specifically what your expected input cost per acre will be. By taking a sharp pencil to your input costs, you not only help find an appropriately sized operating loan, but can discover where you may be getting overcharged on inputs. Of course, it can spark ideas to cut costs and be more profitable as well.

“Smart management of operating loans is playing a crucial role in maintaining the liquidity needed to plan next year’s crop.”

Chris Coffey
Assistant Vice President—Crop Insurance, Farm Credit Mid-America

A QUICK GUIDE FOR CROP INSURANCE PLANNING TO BEGIN 2017

CROP INSURANCE PLANNING IN 5 STEPS

With a successful harvest completed, it's time to start thinking about next season's crop insurance plan.

Some farmers resist making changes to their risk management plans and prefer to let their crop insurance policy renew as is. But this approach could be leaving money on the table or exposing them to unnecessary risk. Every season brings new challenges and opportunities, which means every aspect of your operation should be reviewed and updated to maximize your profit potential.

As we've discussed in the past, it's important to partner with a team of experts to make sure you're well informed during this process. We suggest enlisting a diverse group that includes a loan officer, a crop insurance specialist, and outside experts such as a grain marketer and insurance provider. The added visibility from such a team is crucial in attaining operational profitability. Follow these five steps in partnership with your team to help you secure the right amount of coverage to position your business for success, no matter what 2017 brings.

1. Report your 2016 production numbers

An updated and accurate balance sheet is critical to your operation's success, especially when it comes to crop insurance planning. The sooner you provide 2016 production numbers to your crop insurance specialist and loan officer, the sooner you can have an accurate picture of your coverage options.

Production numbers are added to your farm's 10-year production history to calculate accurate crop insurance quotes. They also help your loan officer understand your lending needs and renew your operating line, if necessary. Other information to report at this stage includes:

- Grain being carried over from this year's harvest. An adjuster will measure your bins to provide an accurate number of bushels, which your loan officer can reflect in your balance sheet.
- Crop insurance claims from the past growing season as a result of low yield. This provides greater clarity to your lender about where you stand.

2. Estimate 2017 crop input costs

From seed and chemicals to fertilizer and fuel, every farmer should know expected input costs in detail. This is perhaps the single most important part of crop insurance planning, yet many farmers are satisfied with the general lump sum they keep in their heads. Incorrect or insufficient record keeping is the most common mistake we see. It may seem like a chore, but being off by a few thousand dollars here and there can quickly add up.

An accurate understanding of your expected cost of production gives you two pieces of critical information: how much money is required to grow your crops and how much insurance is needed to cover that amount in the case of a crop failure. Poor record keeping can lead to borrowing too much (or too little) and insuring too much (or too little). At best, unnecessary expenses subtract from your bottom line. At worst, your business has greater exposure to risk and may not be covered adequately.

This is also a good time to share any changes in your operational structure, such as changes to acreage, shareholders or rental agreements.

3. Understand your guarantees

With input costs accurately estimated, your crop insurance plan should focus on risk. In the past, farmers could often guarantee more than their total input cost. With low grain prices, this is usually no longer the case. The difference between your total cost of inputs and your guarantee depends on how much risk you and your team feel is best.

This is where good communication is key, and you and your crop insurance team must be aligned. By providing accurate information on your operation and your plans, your team can develop more accurate estimates for spring guarantees. For example, since your coverage is based on a 10-year production history, it's likely your guarantees will increase due to this season's higher-than-average yields. Your team can run you through several scenarios, estimating future crop prices and providing estimates for various coverage levels.

4. Set planting strategies

Getting rough estimates of spring guarantees can help you maximize profit potential for years to come. It's crucial to be informed and use that information to make better decisions regarding:

- **Crop input costs and cash rents:** Having a defined safety net helps you prioritize your input investments and identify areas of potentially increased return on investment.
- **Crop selections:** Modeling scenarios with your crop insurance specialist will help you take advantage of grain prices by identifying which crops should generate the greatest revenues.
- **Grain marketing:** Knowing the base level of production you need to meet and the guarantee you will set helps you take advantage by using market risk management tools to contract grain at prices you find favorable.

5. Finalize spring plans

Winter is time for making 2017 planning decisions and adjustments based on the market. Come spring, it will be time to catch up with your team and finalize decisions with respect to spring market prices and your planting decisions. Some farmers have daily risk management discussions with their crop insurance specialists prior to planting, working to get guarantees to a comfortable level.

Remember that crop insurance and lending is a partnership. Working with your risk management team is the most effective way to develop the best crop insurance policy to protect your business, so make it a point to keep your crop insurance specialist and team updated as you work through the offseason.

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