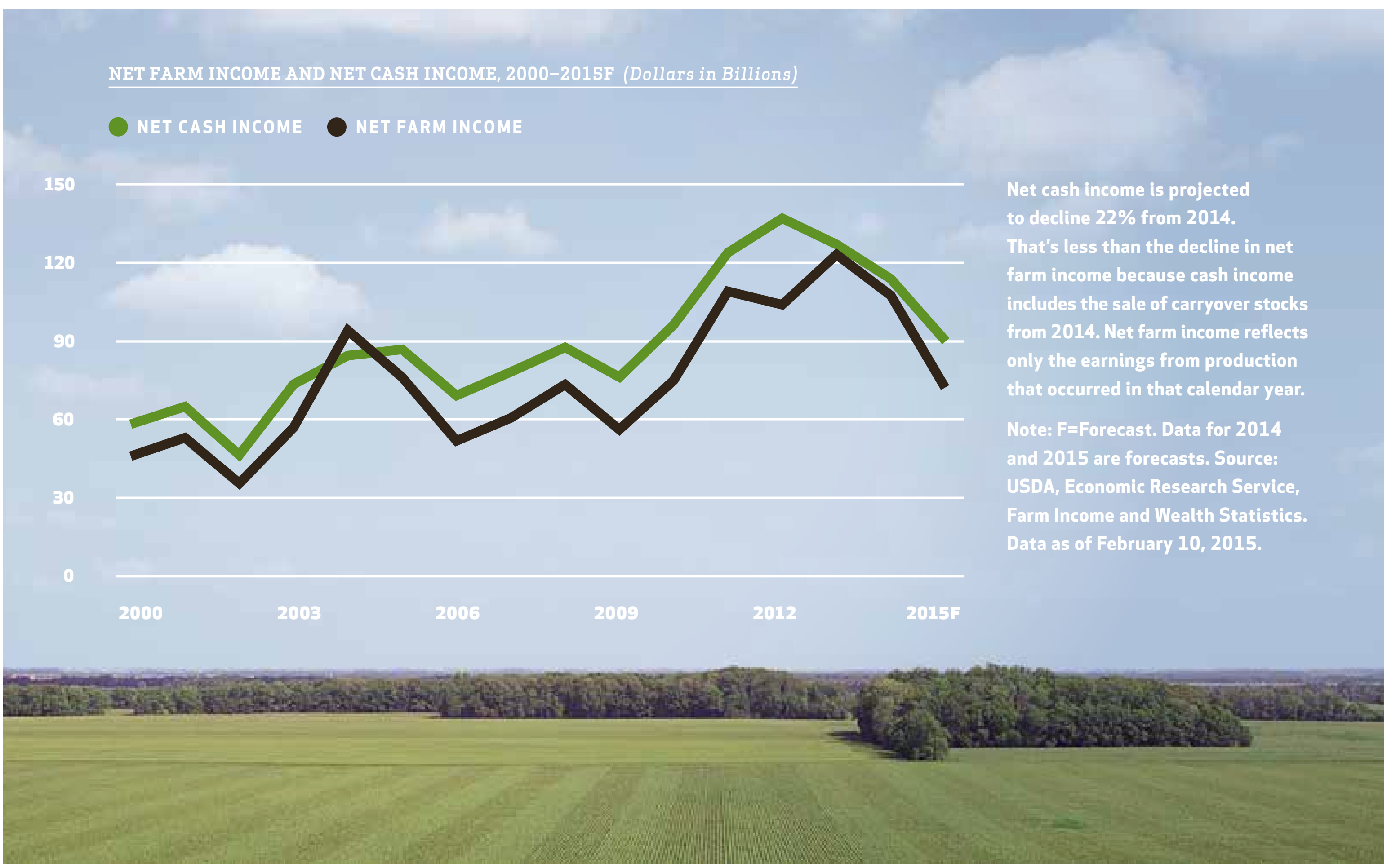
farm CREDIT MID-AMERICA | INSIGHTS REPORT

VOLUME 01

Have you noticed that crop input and farmland prices don't seem to go down as quickly as the price of corn and soybeans? A lot of farmers have, and it's starting to change the way they make farm business decisions. This issue of *Insights* shares observations from Farm Credit Mid-America about how recent trends are contributing to a profit margin squeeze. Additional ideas include ways Farm Credit can help you adjust your business plan to adapt to the current economic environment.



NET FARM INCOME AND NET CASH INCOME, 2000–2015F *(Dollars in Billions)*

Net cash income is projected to decline 22% from 2014. That's less than the decline in net farm income because cash income includes the sale of carryover stocks from 2014. Net farm income reflects only the earnings from production that occurred in that calendar year.

Note: F=Forecast. Data for 2014 and 2015 are forecasts. Source: USDA, Economic Research Service, Farm Income and Wealth Statistics. Data as of February 10, 2015.

Gordon Hanson
Senior Vice President — Chief Risk Officer

DESPITE LOWER GRAIN PRICES, TOTAL CROP PRODUCTION EXPENSES REMAIN HIGH.

PROFIT MARGIN SQUEEZE RAISES RISK

The agriculture pendulum is swinging toward lower profitability and increased risk in the crop sector. Farm income from corn, soybeans and wheat has dropped sharply over the past three years, but total costs for land, seed and other crop inputs have not adjusted nearly as much. As a result, both net cash and net farm income are declining.

The margin squeeze is on and crop producers are undoubtedly feeling it. The average corn price peaked at near $7 per bushel in 2012, and has since dropped almost in half with some forecasts near $3.50 per bushel for 2015. A fundamental challenge for crop producers is that input costs jump very quickly when commodity prices rise, but tend to adjust much slower when grain prices fall.

Land Costs

Land costs remain high. Despite lower grain prices, land rents are slow to adjust. While some farmers are stepping away from unprofitable rental contracts, others are continuing with leased cropland at break-even profitability or even at a loss, at least for the time being. Crop producers know that losing a rental contract could possibly mean never farming that leased ground again. That makes for a very important and difficult decision, and contributes to the slow rate of adjustment in the land rental market.

It may take one to two years before many tenants and landlords work through rental contract renegotiations and the market finds a new equilibrium. But this is frequently a critical step for producers in managing their cost structure to promote long-term viability. It is best to approach these discussions with a constructive disposition and good information. Current crop budget information from agriculturally-focused universities, such as the Purdue University 2015 Crop Cost & Return Guide from the Purdue Department of Agricultural Economics[1] can be a great source of information.

Even something as simple as calculating your rent cost per bushel of expected yield can be helpful (i.e., $280 per acre rent / 180 bushel per acre corn yield = $1.56 per bushel rent cost). What might seem like a bargain when corn prices are $5 to $7 per bushel, can quickly become unrealistic with $3.50 per bushel corn. Open realistic discussions with both landlords and lenders help build and maintain credibility and strong relationships. And there is certainly substantial value in strong working relationships and a reputation for being a discerning businessperson with a realistic and long-term perspective.

Financial and Operational Risk Considerations

Looking only at the balance sheet financial leverage (use of debt) doesn't provide a complete risk picture. Most large crop producers are renting a significant amount of acreage, adding "operational leverage" to their business. Just as buying land financed with debt creates financial leverage, renting land generates operational leverage that also serves to magnify potential profits and potential losses. As such, either form of leverage tends to increase both opportunity and operating risk.

The use of multi-year land rental contracts makes land costs more predictable from year to year, but also creates an off-balance-sheet financial obligation. If grain prices decline for an extended time period, as is currently predicted, previously-negotiated rental contracts can lock the producer into potential operating losses for multiple years. Bottom line, both balance sheet leverage and off-balance-sheet obligations should be carefully considered and managed as part of effective financial planning and management.

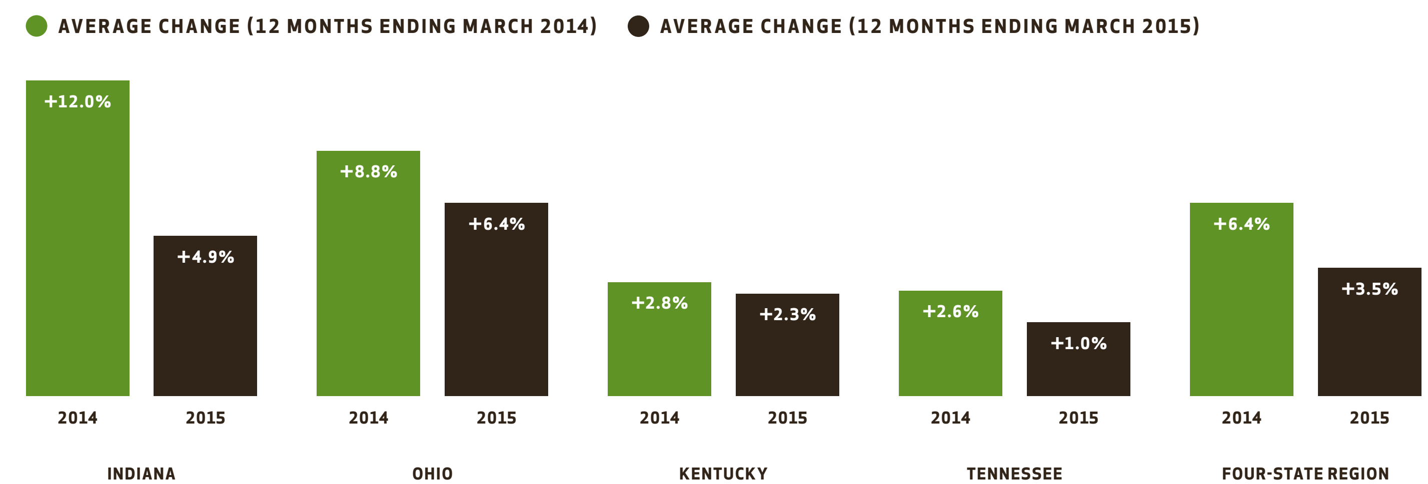
Real Estate Trends

Where are cropland values headed from here? Economic principles indicate that asset values should ultimately follow related income levels and trends, which were discussed above. Moreover, paying attention to other leading indicator states can provide some insight into future trends. Likely because it is close to the epicenter of the Corn Belt, Iowa farmland values tend to go up first and decline first. As such, it is noteworthy that Iowa farmland prices have dropped 15 percent in the last two years. The same economic factors that have already caused a pullback in Iowa land values will inevitably also influence Farm Credit Mid-America's four-state market area of Indiana, Ohio, Kentucky and Tennessee. While average land values in these states increased 6.4 percent for the 12 months ending March 2014, the rate of increase slowed to 3.5 percent during the next 12 months. That softening will likely continue, with a significant possibility of a decline in values.

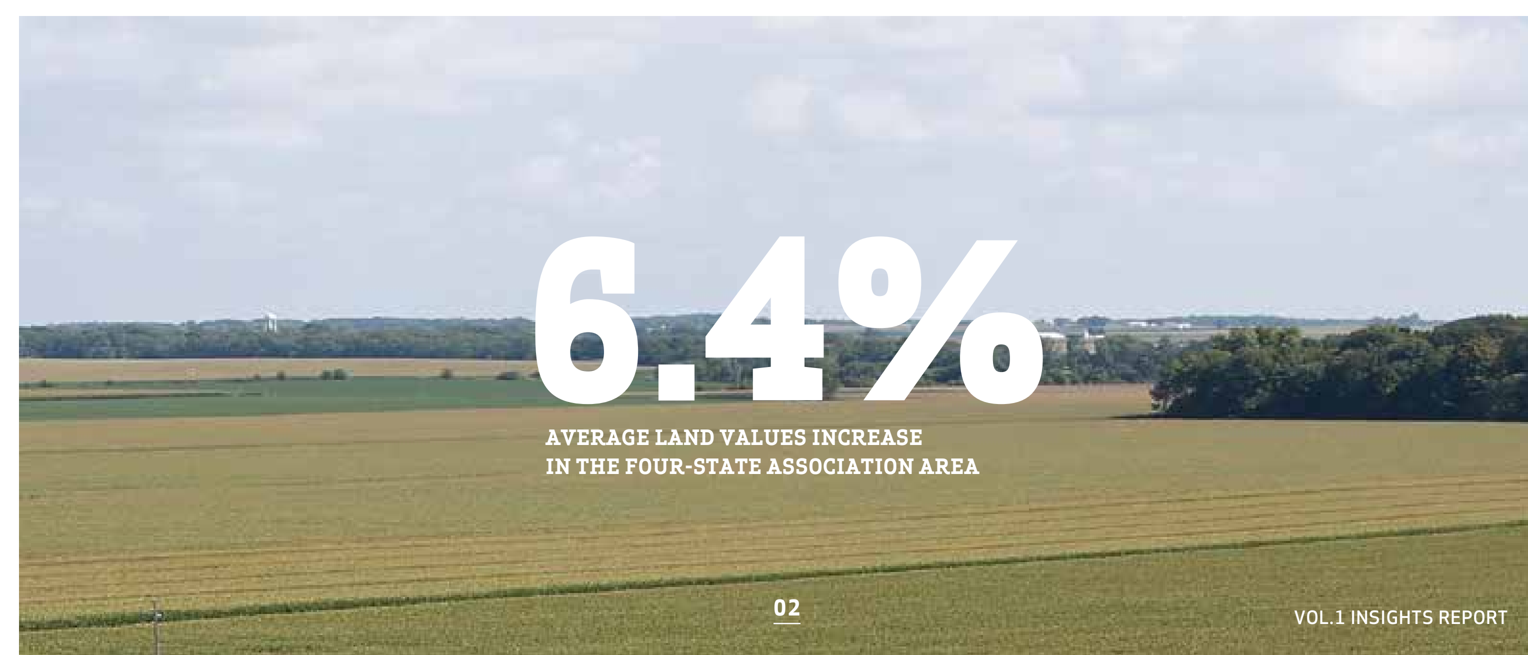
Control What You Can

Markets will always fluctuate and costs will always vary, but knowing and carefully managing your cost structure can give you a competitive advantage during both good and bad times. We don't know how long the current profit margin squeeze is going to last, nor can anyone know when the next boom might begin. But crop producers can best manage through these inevitable cycles by carefully controlling costs, in addition to other risk management techniques through a strong marketing program and appropriate crop insurance coverage. ❖

2014 AND 2015 AVERAGE LAND VALUE CHANGES



Slowing increase in land values in Farm Credit Mid-America's four-state lending territory.



Steve Allard
Chief Credit Officer

WHETHER RENTING OR BUYING, FARMLAND IS AN INVESTMENT THAT REQUIRES A PLAN.

UNCERTAINTY, RISK AND INTEREST RATES

While global events and government fiscal policy is out of the realm of what a farmer can regulate, they can take control of their own financial risks. I encourage farmers to understand the importance and magnitude of every buying decision, whether it's discretionary spending, fixed operational costs or spending on variable input costs like seed, chemicals and fertilizer. Locking in today's lower interest rates by converting short-term variable rate loans into long-term fully fixed rate loans is an additional way to mitigate risk. Fixed and variable costs impact the competitiveness and flexibility of every farming operation, and there is a great deal of variability from one piece of land to the next in yield potential and input costs to raise a crop.

Input Costs and Reasonable Yield

Costs can be managed several ways. Consider how farmers arrive at the yield goals they are shooting for. When going for profitable crop yields, there is a law of diminishing returns on inputs. That's why managing inputs appropriately and with good data is important. The key is in understanding yield potential on the land you're farming and applying inputs to achieve reasonable goals.

Each field, by nature, has a limit to its predictable or reasonable yield. One strategy is to look at yield data over a 10- to 20-year period and fertilize with the amount of fertilizer and legume nitrogen credits needed to produce the best yield that's likely in an average year. There's a big difference in how you view yield and how that will add to the overall cost of the operation. You can compare your own historical field data to university data to determine pounds of nutrients needed to produce a bushel of corn. Crop consultants, agronomists or land-grant universities are all resources that have data to determine ideal fertility rates.

Cost of Land

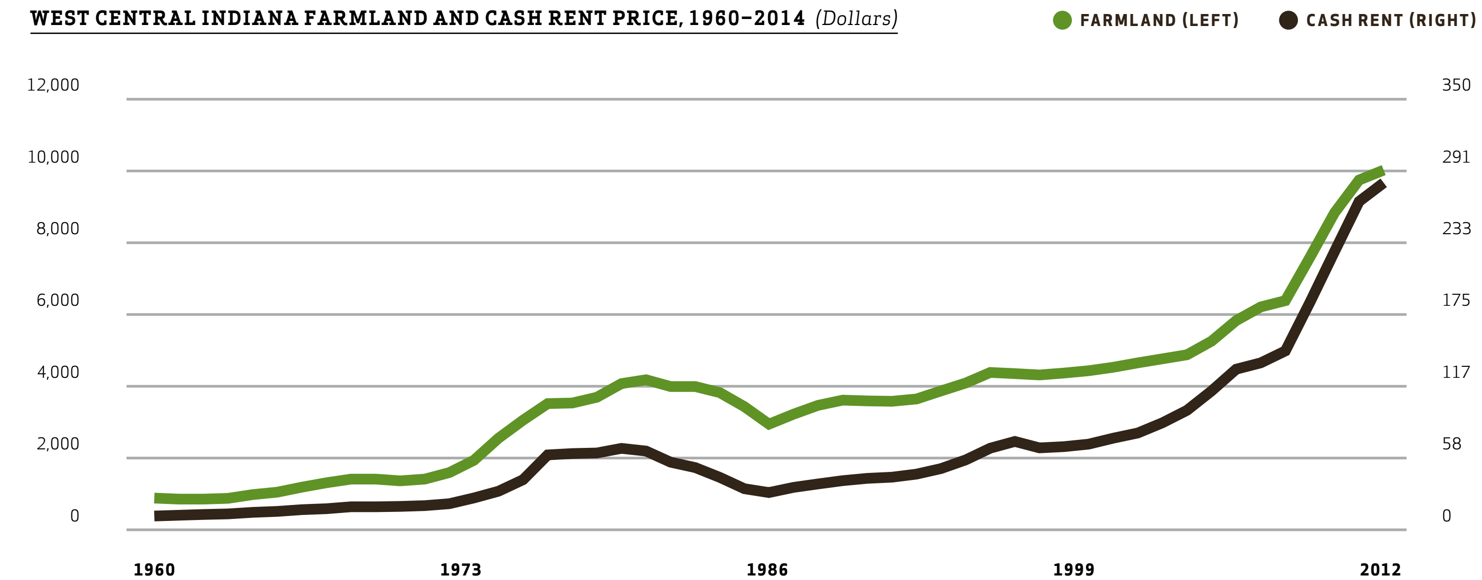
Whether you are financing and buying land or renting it, it's wise to look at the land's historical profit potential with reasonable yield and commodity price expectations.

On rented land, we see an increasing number of farmers negotiating with landlords on new terms. For those rental rates, it is a much different market today than it was in the recent past. Every rental arrangement has specific components and a history that needs to be considered. But we do see rents being renegotiated with varying degrees of success. Farmers that approach landlords with good production records can show the true value of the rented land in relation to the price per bushel that is likely in today's commodity markets.

Competition for rented land remains very high. Farmers may have a longer-term view that includes budgets and cash flows for 2015 and likely 2016. Some are willing to pay rents at levels that provide a very modest or negative return in hopes of possessing land rights when stronger future grain prices return. Real data and prices that are available today may aid in the negotiation with landlords. It's not always going to be foolproof, but with good yield data and reasonable expectations, you can be in a better position to decide whether it's worth working the land to farm it for minimal profit until grain prices rebound.

If you plan to expand by buying land with credit, the key to success is very similar to a rental negotiation. Bring yield and input cost data and have discussions with your lender to talk about the income you would expect by marketing a crop to pay off the loan. Having good information and a plan can reduce your uncertainty as well as your lender's. ✤

WEST CENTRAL INDIANA FARMLAND AND CASH RENT PRICE, 1960–2014 *(Dollars)*



Courtesy of Purdue University, Center for Commercial Agriculture

Daniel Taylor
Senior Vice President — Credit

THERE IS BOTH AN ART AND A SCIENCE TO IDENTIFYING FINANCIAL HEALTH AND LENDING.

THE FIVE Cs OF CREDIT

Some might not believe it when I say that agricultural financing is about more than just a balance sheet. There is both an art and a science to identifying financial health and lending in general. In fact, at Farm Credit Mid-America, we begin to teach our financial officers both the art and the science within a few days of joining the team through the Five Cs of Credit: Character, Capital, Capacity, Collateral and Conditions.

The most important C is character – and I don't mean character in the conventional sense of charm and charisma. Character goes beyond credit bureau ratings and how our customers pay their accounts. It encompasses things like how a customer markets their crop. It looks at what kind of risk management tools they use. We look at their risk management strategies: do they use crop insurance? Do they have a crop consultant helping them with crop scouting, soil sampling and fertilization rates? It also looks at how reliably they handle payments on their operating line of credit and other obligations.

Responding to Tight Margins

We expect a farmer of good character to use credit to buy crop inputs, grow the crop, market the grain, bring the checks in and pay back the loan to restart the cycle. But we work with farmers through both good and challenging times, and seeing how a farmer handles adversity and works with creditors helps us to structure their loans and operating lines from year to year.

Farmers had a lot of gross income coming in when corn was $6 or $7 and soybeans were $12 or $13. Now that prices are lower, we've started to have some different conversations as growers come back to us to renew their operating lines. With lower gross income, there's less need to make tax-based equipment purchases. Does the grower really need new equipment now, or can they keep what they've got for a few years? Is it time to sell some equipment, or do they need to keep their equipment to maintain capacity but pledge it as collateral? The environment is different now and it's not the same conversation we were having with producers five years ago.

Typically, our scope of review is the past three to five years. So we can look back and see that a customer has had a few really great years and perhaps expanded their operation with more equipment and land. Now that margins are tighter, we're looking more closely at how farmers are going to operate in 2015 in terms of what their inputs will be, what their expenses are and how they will structure their marketing contracts to maximize revenues.

Staying Liquid

We're sitting down with farmers to confirm how they'll make their farm operations work financially in 2015. We've got a lot of farmers who are either going to break even or be slightly in the red on their net margins for 2015. That may be okay if the grower has a working capital position and capacity that can support a year or two of operating losses. Some producers do and some don't. In such times, staying solvent is about assets and liabilities and the structure of their obligations on the balance sheet. A healthy and honest discussion can help identify the farmer's equity, what they're bringing to the table and how much of it is being carried by lenders.

One of the quickest places that we'll see a farm operation break down is in the liquidity position. It's basically where farmers are going to go on a rainy day, or when they are operating at a little bit of a net loss. If growers have a pretty good liquid cushion, they can weather that storm for one year, two years, maybe more. A lot of it ties back to the rapid growth of the past five years and the amount of cash a producer has invested back into their operation. Now that grain prices are lower and margins are tighter, it may be a good time to work with your lender to understand liquidity, the operations equity position, and possibly buckle down on non-critical capital spending for a few years.

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[1]Purdue University 2015 Crop Cost & Return Guide from the Purdue Department of Agricultural Economics: www.agecon.purdue.edu/commercialag/resources/farmmgmt/materials/2015%20crop%20budget.pdf.

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