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M|J|B BANKING LAW TODAY

THE MOST IMPORTANT 3 MONTHS OF THE LAST 30 YEARS

A discussion of how December of 2019 through February of 2020 will make or break many Ag banks

It is no secret that the ag economy has been depressed for a number of years. It is likewise no secret that 2019 yields in Minnesota are looking inconsistent at best. Factors such as early season flooding, green snap, and harvest delays have taken a massive toll on the production levels of many Minnesota farms. These production challenges, paired with another year of stubbornly low prices, means that 2019 – a year considered make-or-break by many experts – is not only going to be another bad year, but the worst year in over a decade for many. This leads to the inescapable conclusion that many Minnesota farms will fail in 2020.

If a farming operation is going to fail, the most critical time for managing the credit is actually not right after it goes into default, it is the few months before the credit is renewed for the season. What Ag banks do, or fail to do, from December through February can have a dramatic impact on the recovery prospects in a liquidation. This article discusses the biggest reasons why the next 3 months will make or break many ag banks.

Reason 1: Banks Will Be Making Critical Renewal Decisions.

The first and most obvious reason why the next three months are critical is that banks will be deciding whether or not to renew their agricultural customers. In a horrible economy this can be a difficult and gutt wrenching decision that can have profound rammifications. If an operation is going to fail, it is far better for it to fail before crops are in the ground, and possibly while there is still time to find an alternate lender. It becomes exponentially more difficult and costly to exit a credit after the crop is in the ground.

Once the crop is in the ground the money for the crop inputs are already out the door, and the bank cannot hope to monterize that investment until the 2020 crop is ultimately harvested. This shift in leverage allows the borrowers to demand concessions, additional time and often times additional advances.

Since the rammifications for making a bad renewal are so severe, the renewal analysis that will be occurring over the next several months is absolutely critical. Such analysis should, as a best practice, involve more than just looking at the financials, information and documentation provided by the farmer. It should involve an active analysis of the deposit account records to see if the actual cash deposits have been roughly matching the cash flow projections. The failure for these numbers to roughly match could signal either that the projections were incredibly misguided, or that crop proceeds have been syphoned off to other banks accounts. In either case, looking at the deposit records can be a powerful tool for banks in assessing whether a credit should be renewed.

Reason 2: Banks will need to be Locking Down 2019 Crops/Proceeds.

The second reason why the next few months are critical for banks is because the 2019 crop is now out of the ground and banks need to ensure that the crop is appropriately sold and that the proceeds are actually remitted to the bank. This is not always as easy as it sounds.

Yes, CNS Financing Statements do exist to help ensure that banks can capture commodity sale proceeds. But, as has been a frequent topic of discussion in our past newsletters, CNS Financing Statements can be defeated in a whole multitude of ways. Among other things: (1) the borrower can sell the commodities in a different state; (2) the borrower can sell the commodities through a family member or neighbor; or (3) the borrower can sell to another farmer/small buyer that either does not know about, or does not care about, CNS Financing Statements. Additionally, a CNS Financing Statement can lose much of its practical protection if the grain buyer utilizes direct deposit, since the funds can be in and out of the bank account before the bank has the opportunity to exercise control.

Over the next few months banks should be protecting against these risks by doing things such as: (1) filing CNS Financing Statements in neighboring states (when applicable); (2) sending direct notice of security interest to commodities buyers located in other states; (3) reviewing deposit records to identify previously undisclosed commodities buyers so that proper notice can be given; and (4) prophylactically sending out notices of security interest to the nearest commodities buyers in neighboring non-CNS states (using appropriate forms and taking care to properly protect confidential information). These actions will not completely eliminate the risk of conversion of crop proceeds, but they will help mitigate the risk.

Reason 3: Banks will be Preparing Renewal Documentation for High Risk Credits.

Despite the current economic challenges, many/most operations will be renewed in 2020. That said, these borrowers often present a very high level of risk, and banks are well advised to insist on additional documentation in connection to the renewal that will help mitigate some of this risk. Specifically, among other things, banks should consider the following changes in documentation practices:

- Utilizing enhanced security agreements with broader granting clauses that specifically apply to not only farm products, but also government payments connected to the farm products. When possible, these agreements should refer to the programs by name.
- Utilizing CCC-36 assignment of payment forms so that the bank will directly receive MFP payments.
- Utilizing a comprehensive Commodity Buyer Disclosure form where the borrower lists all applicable commodities buyers.
- Utilizing an Equipment Transfer Disclosure Form which requires borrowers to list all equipment transfers over the last year.
- Utilizing a Disclosure of Additional Agricultural Operations form which lists all family members/3rd parties that are conducting agricultural operations on the same premises as the borrowers, along with the character and size of said operation.
- Utilizing a Third Party Acknowledgement of Agricultural Assets form where other individuals operating on the same premises as the borrower acknowledge that the borrower is the sole owner of the equipment/assets listed in the borrower's financial documentation.

The above items will not eliminate the risks associated with loan renewal, but at least they will help mitigate the risks that can be readily controlled.

Conclusion

For all of the above reasons, the next three months may be the most critical period of time since the farm crisis in the 80s for agricultural banks. Everything banks do, or fail to do, can have substantial rammifications on the bottom line.

While none of us are able to predict the future, banks can maximize their chances for success by being informed, vigilant and prepared. Following the above recommendations, at least with respect to the bank's most troubled borrowers, would be a good start towards ensuring financial success and stability in 2020 and beyond.

-Matthew J. Bialick, Esq.

Outside Insights

A Forum for Thoughts and Articles from Sources Outside of the M|J|B Law Firm

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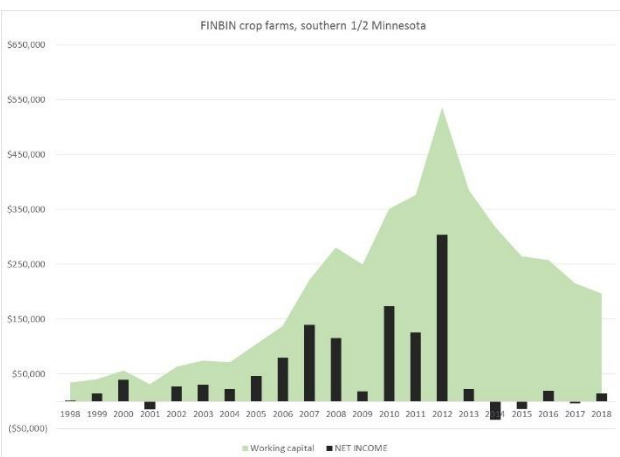
Collateral or Cash Flow: is there a Difference?

An Article by Tom Walker of Praexis Business Labs

"If something cannot go on forever, it will stop," said economist Herbert Stein back in the 1970s.

US agriculture illustrates that point, often with painful clarity. For our subset of operators, the crop farmer in Minnesota, 2019 will almost certainly mark the *7th* successive year of operating profits at breakeven, declining working capital, and no clear prospect for improvement. This cannot continue indefinitely, and therefore, by some means or another, it will stop.

The picture is dramatic:

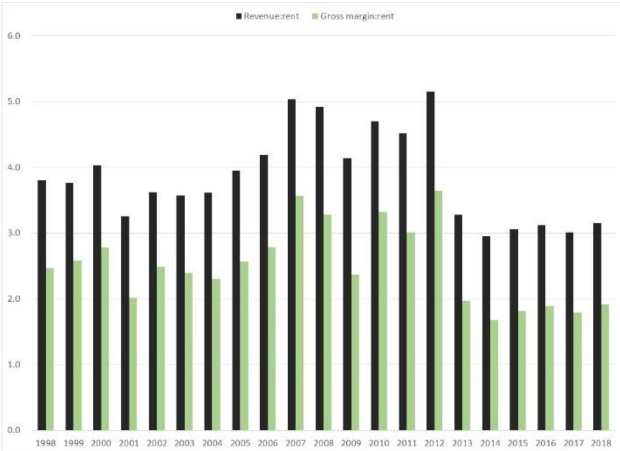


It also illustrates the cyclical nature of agriculture, and the not unreasonable hope that macroeconomic forces, not to say production technology, will shift and realign and farmers will see the return of some economically sustainable profits. Rather than create a macro-economic case for recovery, permitting us to argue speculatively until real life makes it too late, I want to look at a very specific element of finance that will have tremendous bearing on who is financed and who is sent packing this winter, one that loan officers are undoubtedly already in deep analysis to understand: land prices.

Ag publications routinely assert that the strength of land values is shoring up balance sheets and staving off a more precipitous reckoning, and that they show little sign of weakening significantly. Ergo, ag looks strong and adjustments will be gradual and minor.

The logic, as ever, is sound. You can't help but wonder, though, since assets in the long haul are priced according to their ability to generate a stream of income, how it is that assets that have for seven years NOT fostered an income stream can avoid some sort of adjustment.

I would prefer to be practical, though. In short, high corn prices some years ago predictably took the price of key inputs, land included, along for the ride. As is typical, the costs have been slower to follow crop prices back down. Therefore, we have a rather a-historic relationship between the cost of land (focusing on rents here) and the income derived from it. All the data is from the same group of farms as above.



Whether you focus on the top line (crop-derived revenues included insurance and government support) or on the gross margin (top line less major variable inputs, mostly seed, fertilizer, fuel), rents are generating, in 2018 (2019 isn't in yet and seems likely to be worse) 20% less in contribution to covering rent and other overhead than the historical norm.

A reset to the historical mean would take current rents from \$206 to \$158. What are the implications for the value of the underlying land? Historically the net return on farmland is 5-7%. Using a 5.5% rate, \$158 rents yields a \$2,153 underlying economic value.

Surveying the FINBIN farm database, this sort of revaluation would be on the order of 33-48% *less* than currently relied-on land values.

One can quibble, and indeed, this is NOT a forecast. People often say, for instance, that cap rates will remain lower than historical norms because our historically low interest rates have become a permanent feature of the economic geography—yet another new paradigm and all that.

It is, however, a very pointed indicator of the level of stress, and a key cause of that stress, that afflicts farmers as they tally 2019 results and try to judge the prospects in 2020. I can't help but surmise that for all the near-term pain a revaluation would cause to balance sheets, it would do great wonders for the return to profitability on real, working farms.

-Thomas Walker, Jr., Agricultural Economist with Praexis Business Labs, 651-999-9970

M | J | B Law Firm Welcomes Steve Ringquist as a Partner!

We are thrilled to announce that banking law attorney Steve Ringquist has joined M | J | B Law as a partner! Steve brings over a decade of experience handling all facets of the banking and agricultural finance process including: drafting all manner of loan documents; negotiating workouts and forbearance agreements, handling intercreditor disputes, and pursuing both regular and complex liquidations.

Steve is also an accomplished writer and presenter who is firmly committed to providing bankers with the type of practical education that M | J | B Law prides itself on. We could not be happier with this new addition to our family!

If you would like to reach out to Steve, or simply welcome him yourself, he can be contacted at 952-567-0664 or steve@mjblawmn.com

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