

What Support are Lenders Willing to Give?

Lori Lane

Farm Credit Canada. #1, 7710 - 50 Avenue, Red Deer AB T4P 2A5

Email: lori.lane@fcc-fac.ca

■ Introduction

In recent years, the hog industry across Canada had enjoyed rapid growth, with the “typical” operation moving toward larger, more technologically advanced and highly capitalized businesses. The evolution toward ‘business networks’ that link producer to processor, and, in many cases, add in the feed company, and other related businesses, has helped fuel this move and, in turn, the growth. And, it has given lenders a greater feeling of comfort with the industry – despite the cycles that inevitably remind us that “what goes up, must come down!”

But lately, we’ve heard more and more about over supply, demand that is flattening out, slower price recovery and greater uncertainty. Does this mean a complete reversal in the growth trend? And what about those who are trying to hang on through this? To answer this, I have been asked to share with you, Farm Credit Canada’s (FCC) approach during less than positive times for the industry.

■ FCC’s Lending Portfolio

To begin, I first need to remind you of who FCC is. As Canada’s largest agricultural term lender – our focus, expertise and passion is agriculture – and that means all facets of agriculture, at all points in their economic cycles. It does not mean jumping in when the going is good and running away when times are tough. But – because we work in the industry every day, it also means understanding the difference between a simple cycle and the kind of dramatic change in the profile of the industry that leads us to redefine what represents a calculated, yet reasonable investment risk as a lender.

So, let’s take a look at some numbers:

Table 1. FCC Portfolio - Principal not due

	Total (Billions)	Hogs (Millions)	% Hogs
December 31/99	\$6.08	\$502.5	8.3%
December 31/00	\$6.65	\$563.7	8.5%
December 31/01	\$7.41	\$687.4	9.3%
December 31/02	\$8.53	\$834.8	9.8%
YTD (Sept 30/03)	\$9.35	\$886.2	9.5%

Table 2. Year over year portfolio growth rate

	Total Portfolio	Hog Portfolio
1999 to 2000	9.4%	12.2%
2000 to 2001	11.4%	18.0%
2001 to 2002	15.1%	21.4%
2002 to Sept 2003	9.6%	6.2%

Table 3. Approvals per year

	TOTAL			HOGS		
	# Loans	\$ billions	Average Loan, \$	# Loans	\$ billions	Average Loan, \$
1999	13,469	1.58	116,945	430	0.0969	225,261
2000	13,412	1.71	127,735	607	0.1756	289,306
2001	14,943	2.16	144,509	610	0.206	337,875
2002	23,832	3.10	130,044	779	0.2564	329,102
2003 (to Sept 30)	17,434	2.47	141,848	438	0.1553	354,562

Table 4. Portfolio Performance – Portfolio at risk due to arrears

	% PND in arrears (PND in arrears vs. PND O/S in each category)			
	FCC	Hog	Crops	Dairy
1998	7.61	9.53	8.96	4.28
1999	7.54	8.19	10.0	3.08
2000	6.58	3.47	9.04	2.29
2001	5.67	3.54	6.76	2.50
2002	4.59	2.74	5.60	1.18
2003 (to Sept 30)	4.35	3.57	4.52	1.93

So, what does all this really mean? In summary, what these figures tell us is that, over the past five years, FCC's overall portfolio, as well as the level of investment in the hog industry has grown. In fact – the growth rate in the hog sector outstrips the balance of the overall FCC portfolio growth in all years except 2003 (**Table 2**). 2003 saw growth as well, but at a slower rate than previous periods. Looking at each year's approvals, we can see that, on average, the size of loans approved to hog operations is roughly 2.5 times that of FCC's total approvals (**Table 3**). We can also see an increasing trend in average loan size from one year to the next. Both of these measures indicate that FCC lending patterns are moving in tandem with the direction of the industry.

Finally, the arrears information (**Table 4**) provides a snapshot of the health of the portfolio – with the expectation being that dairy represents the lowest repayment risk, and crops being the greatest – due to volatility. Not surprisingly, the performance of hog loans sits somewhere between the two. Two interesting trends to note is the dramatic improvement in the health of the hog portfolio, and its migration closer and closer to the performance of supply-managed industries. Perhaps this, too, is an indication of the reduction in volatility that the 'business network' concept has created. Coming off a disastrous year in 1997, the hog portfolio has recovered to the extent that, currently, it performs better than the overall FCC portfolio, though take note of the slight reversal of this trend from 2002 to 2003 year to date. Given that arrears are a lagging indicator, we are watching this one closely.

■ Changing Borrower Profiles

Now, let's take a look at the financial profile of who we are lending to:

Table 5. Historical average financial data

	Assets \$ million	Liabilities \$million	Debt/ Equity Ratio	Revenue, \$million	Expenses \$million	Non- Farm Income \$	EBITDA \$
Hogs							
Mar-02	4.62	2.12	.85	1.87	1.55	22,000	296,000
Mar-03	5.79	3.14	1.18	2.57	2.22	24,000	319,000
Aug-03	5.95	3.24	1.20	2.53	2.20	28,000	302,000
Feeders							
Aug-03	3.67	1.98	1.18	1.12	0.93	37,000	193,000
Farrow-Wean							
Aug-03	7.24	4.30	1.47	2.98	2.67	30,000	275,000
Farrow-Finisher							
Aug-03	7.26	3.82	1.11	3.50	3.05	20,000	410,000
Weaner / Nursery							
Aug-03	6.32	3.68	1.39	2.27	2.14	52,000	124,000

The trend in the total hog portfolio supports the changing profile of the typical hog operation, with those involved in farrowing investing more in capital assets, as would be expected. Note the presence of non-farming sources of income regardless of the nature of the operation. While we can't interpret this to mean that all hog borrowers have non-farm income sources, this is indeed, the case when we are financing smaller operations that do not participate in some form of business network. That - or the hog enterprise is part of a diversified operation. Otherwise, borrowers in these times need a direct link to a packer through either participation in a large scale "loop" or through vertical integration.

■ Looking Ahead

Despite the historical data, in more recent months, the overall activity has slowed down, with the majority of new construction being finishing barns. If any sow barns are being built, they have tended to be in Alberta. Over the past few years, the tendency has been to make the existence of a supply contract a condition of financing. However, of late, we have been hearing more and more of the difficulties around getting contracts, causing us to relax this requirement. The reality, however, is that, in the absence of a contract, equity requirements revert to more traditional levels (40% or more).

In previous years, writing new hog loans under FCC's Flexi-Loan Program was used in some, but not all cases. This program allows producers to take up to three, one-year principal holidays through the life of the loan. The payment holidays are taken when prices take a downturn, or feed costs are unusually high, or for any other reason at the borrower's discretion. Use of the Flexi-Loan Program has now become standard practice, and many of our borrowers are currently on interest-only payments.

Lending decisions are based primarily on long-term average prices, though we do like to see a short-term cash flow as well. In terms of financial covenants, in general, FCC tends to place emphasis on current ratio and debt/equity. That is not to say that every loan will have covenants imposed in these areas. The decision to impose financial covenants, and determining what they should be is made on a case-by-case basis. Similarly, requests to waive covenants in difficult times such as this are treated in the same fashion. On a more "global" basis, it is typical, during very difficult times in any industry, for FCC to activate its disaster strategies/customer support programs. In a nutshell, these programs are proactive strategies aimed at working with customers to develop plans to help them manage through difficult times. Again, these strategies are developed on a case-by-case basis.

■ Conclusion

Having said all this, the hog business continues to change and there are already many emerging issues that we are watching closely to see how they will impact the industry and, in turn, the way in which we will finance it in the future. They include:

- The recognition that all business networks are not created equally, and, therefore may carry/mitigate different risks;
- Country of Origin Labelling;
- Exchange Rate Risk;
- Environmental/Waste Management Issues
- Impact of BSE