Nontraditional Finance: Overview and Trends

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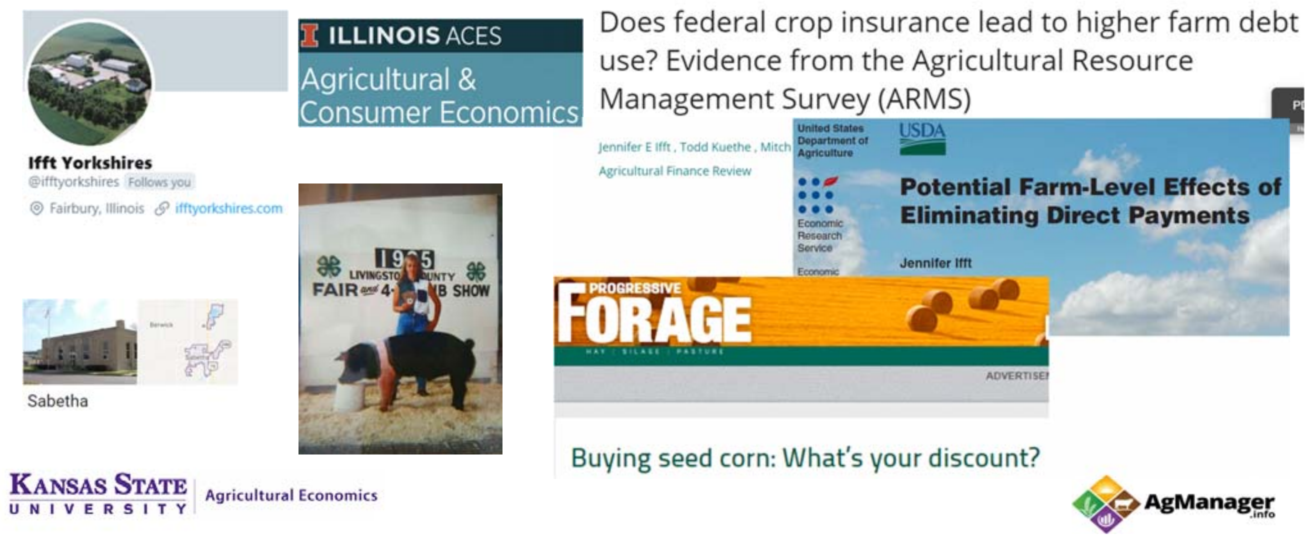
2020 KSU Agricultural Lenders Conference

Introduction

I've been in Manhattan for nearly 3 months and was most recently part of the faculty in the Charles. H. Dyson School of Applied Economics and Management at Cornell University.

Over the next year, I'll be developing a research, extension, and teaching program in agricultural policy. Expect to hear from me!

Introduction: traditional background

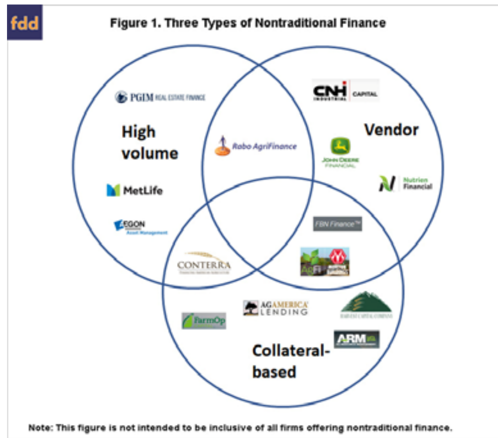


Introduction: nontraditional background

What is nontraditional finance?

Current definition: Lending that is originated outside of the "traditional" local branch-loan officer model

"Nontraditional credit suppliers or lenders…are those whose primary contacts with producers historically have been for goods and services other than credit" (Sherrick, Sonka, & Monke, 1994)



Other important categories

United States Department of Agriculture

Farm Service Agency

2 stories about nontraditional finance

Story 1: Evolving agricultural credit markets

- Almost everyone that *sells something* to farmers sells credit too
  - Increasing competition and segmentation
- Differentiation
  - Convenience
  - Service
  - Bundling
  - Standards
  - Source of collateral

Questions

- Lender: Who are competitors?
- Producer: What is the cost of to farm operation of different sources of credit?

2 stories about nontraditional finance

Story 2: Financial distress

- "Financial bridge to struggling farmers"
- "Prolonging the agony and potentially building up [farm] losses instead of cutting the pain, cauterizing the wound and stanching the flow of financial blood now"

Questions:

- How much farm debt is out there?
- How much farm debt that is held by nontraditional lender is high risk?
  - Especially for lenders that face less regulation

https://www.wsj.com/articles/farmers-in-crisis-turn-to-high-interest-loans-as-banks-pull-back-11573381801
https://www.wsj.com/articles/americas-farmers-turn-to-bank-of-john-deere-1500398960

Outline

1. What are some different business models for nontraditional finance?
2. What is the cost of nontraditional finance?
3. How much nontraditional finance exists?
4. How risky is nontraditional finance?

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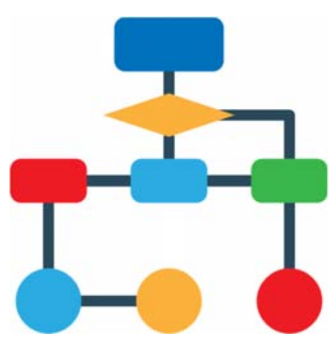
NTF Business models



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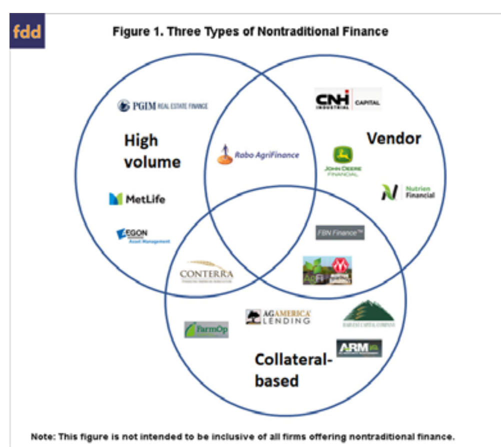
Ag lending 101 provides a useful lens for evaluating nontraditional lenders

- Requires
  - Overcoming serious information barriers (moral hazard)
  - Collateral *and* the ability to collect collateral
- Not “easy money”
  - Competitive market facing same risks as production agriculture
  - Interest rates vary widely, but terms, risks and associated product costs are also relevant

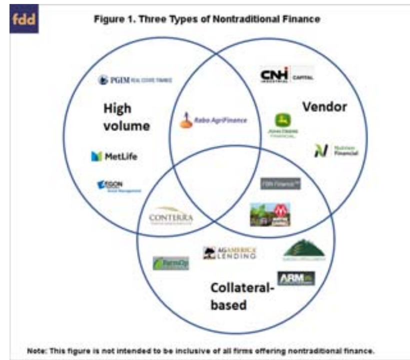
Business model: High volume, branchless

- Competitive rates
- Focus on (very?) large commercial farms
- Farm sector expertise
- Service is a key part of the business model
- Some firms have decades of experience
  - Metlife
- Others are relatively “young”
  - Conterra
  - Rabo



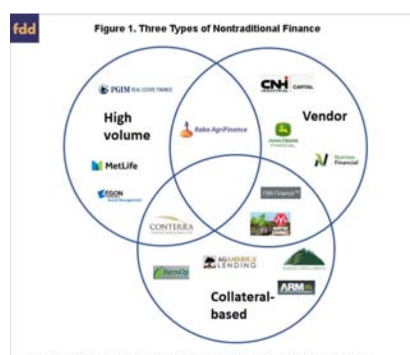
Business model: vendor credit

- Many forms of this
  - Trade credit ("effective credit")
  - In-house financing arm
  - 3rd party
- Often exists to support product sales
  - Some vendors prefer 3rd party (despite fee) except for riskier customers when it isn't possible
  - Cost of doing business in a competitive market
- With 3rd party, loan is often guaranteed by the supplier
- Rates competitive to low, may be absorbed by supplier as a cost of business or product prices
- Loan sizes relatively small, allows easy application (convenience matters)
- Anecdotally, repayment is high due to supplier relationship



Business models: collateral-based

- Farm expertise
- Typically narrower lending decision: collateral + repayment ability
- Rates vary from (somewhat) competitive to relatively high
- Different approaches:
  - Alternative lending: financially stressed / second or third resort
    - Rigorous oversight of risk management and collateral
    - Higher rate that reflects higher risk
  - Unconventional farms
  - More risk tolerant operations
  - Single lender for short term credit



How much does NTF cost?

- Interest rates not consistent across type of nontraditional lender
  - Can be higher, same, or lower
- Interest rates are typically confidential
  - Apples-to-apples comparison is difficult
  - Other terms may matter too
- Product prices may be different
  - Cost to operation may be different than interest expense

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Implement dealers have competitive interest rates for smaller farms

- Commercial farms report better rates *in general*
  - 92 basis points
- Implement dealer financing may be more competitive for smaller farms
  - 52 vs 3 basis points

Average equipment* interest rates and loan volume, 2012-2016

Table 1: Average interest rate and loan size by sales class and lender type, 2012-2016 average

	Low sales farms	Moderate sales farms	Midsize farms	Small million dollar farms	Large million dollar farms
Traditional	4.75%	4.74%	4.63%	4.38%	3.83%
Implement dealers	4.23%	4.28%	3.94%	3.98%	3.80%
Public	3.39%	3.61%	3.81%	3.65%	4.55%
All others	4.76%	4.40%	4.32%	3.89%	3.72%
Traditional	$35,929	$94,035	$156,735	$300,930	$1,293,482
Implement dealers	$39,284	$95,154	$138,515	$206,850	$452,403
Public	$36,427	$80,639	$117,815	$172,721	$1,252,160
All others	$31,674	$141,427	$134,720	$211,444	$740,652

Source: USDA ERS/NASS Agricultural Resource Management Survey 2012-2016, authors' calculations

*Non-real estate long term loans, typically equipment or machinery
Source: Ifft, Kuethe, and Patrick (2018)

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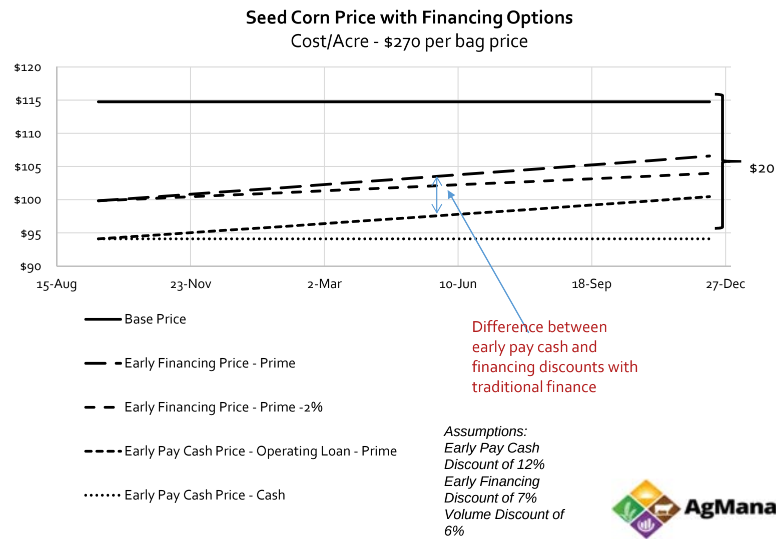
Vendor credit may come with higher effective input costs

- Seed corn discount case study
  - Traditionally-financed cash price often lower than effective vendor financed price
  - Due to loss of early cash pay discount, promotional financing will usually be more expensive than ‘traditional financing’

Fiechter & Ifft, *farmdoc daily* series, October 2019



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How Much

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Many factors drive the growth in sources of credit for agriculture

Supply side factors

- Outside capital
- Innovation
- Lending standards
- Some commercial banks are pulling out of agriculture

Demand factors

- Diverse U.S. farm business
  - Large and small
  - Complex
  - Fast-growing
  - High share of rented land
  - Increased appetite for risk?
- Financial stress

How big is nontraditional finance?

Short answer

We don't know, anything up to 20% of farm lending nationally would be a reasonable guess (higher for KFMA farms)

Longer answer

- Estimate/educated guess by lending category
  - High-volume, branchless: 8-10%
  - Vendor: 3-7%
  - Collateral based: 1-2%.
- Comparison: FCS 43%, Banks 40%, FSA 3% (ERS 2019)
  - Note: percentages will not total 100

Reference: https://farmdocdaily.illinois.edu/2020/03/how-big-is-nontraditional-finance.html

Some nontraditional lenders rival largest Farm Credit lenders

- Farm Credit Services of America: $29.7 billion loan volume in 2019
- Metlife: $21.0 billion agricultural loan portfolio (as of March 31, 2020)
- Rabo Agrifinance: $15 billion loan volume reported in 2019 (not based on regulatory reports)
  - Rabobank N.A. had ~$4.7 billion in non-real estate & real-estate ag production loans on Dec. 31 2018
- American AgCredit: $11.8 billion loan volume in 2019
- Conterra: $4 billion in loan assets across portfolios in 2020
- John Deere Financial: $3.1 billion in "loans to finance agricultural production" reported June 30, 2020
- Frontier Farm Credit: $2.0 billion loan volume in 2019
- Farm loans holdings of the largest 30 U.S. banks declined 17.5% between Dec 2015 and March 2019 ($18.3 billion held in March 2019)
- 2020 USDA farm sector debt forecast: $433.8 billion (August 2020 forecast)

https://www.fcsamerica.com/about/newsroom/financial-reports
https://investments.metlife.com/financing-solutions/agricultural-finance/
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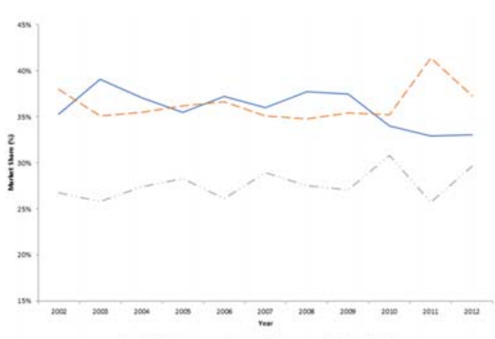
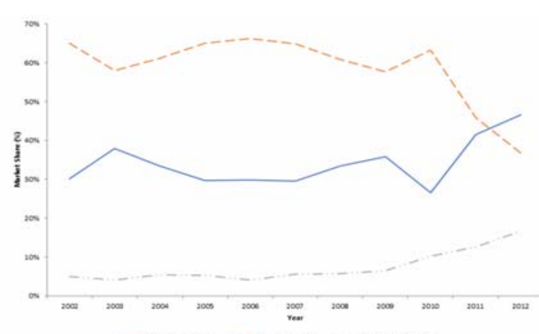
https://www.ers.usda.gov/topics/farm-economy/farm-sector-income-finances/highlights-from-the-farm-income-forecast/

NTF market share is growing in Kansas

Share of loans

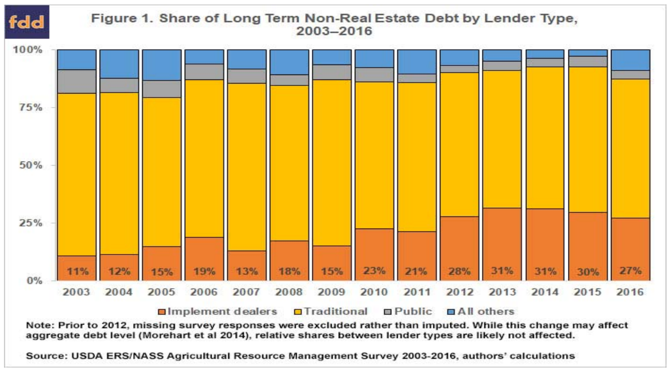


Share of loan volume



Source: Brewer et al 2019

NTF market share appears to be growing nationally



Source: Kuethe, Ifft, and Patrick (2018)

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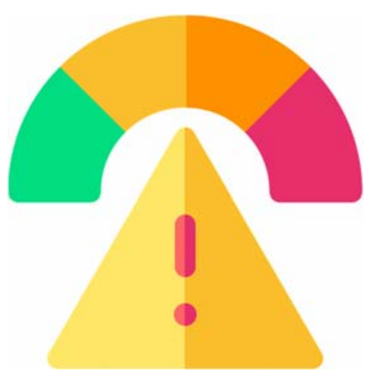
How Risky is NTF?



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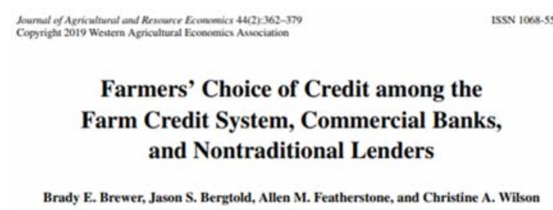
Nontraditional finance is related to financial status: Kansas

- KFMA data through 2012
- Farms using nontraditional lenders are younger with more equipment and less land
- Farms that have use both traditional and nontraditional lenders are more leveraged
- If farm economy declines, more leveraged farms likely to add a second or third lender

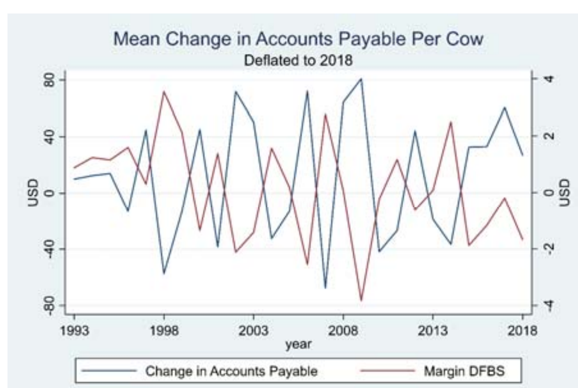

Journal of Agricultural and Resource Economics 44(2):362–379
ISSN 1068-55(

Farmers' Choice of Credit among the Farm Credit System, Commercial Banks, and Nontraditional Lenders

Brady E. Brewer, Jason S. Bergtold, Allen M. Featherstone, and Christine A. Wilson

Nontraditional finance is related to financial status: New York

- In NY dairy farm accounts payable go up when margins go down
- This growth is driven by farms that are more leveraged
- Historically these farms had higher levels of rented land



Nontraditional finance is **not** related to financial status: national implement dealer financing

For implement financing: no observable differences

Table 1. Share of Farms with Long-Term Non-Real Estate Debt and Experiencing Potential Financial Stress by Lender Type, 2012-2016

	Solvency	Liquidity	Profitability	Repayment Capacity
	D/A ratio > 50%	Current ratio < 1	Net cash income < 0	Debt coverage ratio < 1
Implement Dealer	15%	48%	41%	44%
Traditional	14%	44%	42%	44%

Note: Traditional lenders include commercial banks, Farm Credit System lenders, credit unions, and Farmer Mac.

Source: USDA ERS/NASS Agricultural Resource Management Survey 2012-2016, authors' calculations

Source: Patrick, Kuethe, and Ifft (2018)

Discussion: nontraditional lender "survey"

- Business appears to be growing for many nontraditional lenders
  - Demand for refinancing
  - Greater flexibility offered
  - "Big banks" are getting out
  - Some indications of new hiring
  - New entrants (GreenSill)
  - Adaptability to remote work/lending environment
- Similar to traditional lenders
  - Margins are low to negative, generally challenging lending environment
  - Government payments are important
  - "Haven't seen anything like it" vs shocks accelerate existing trends

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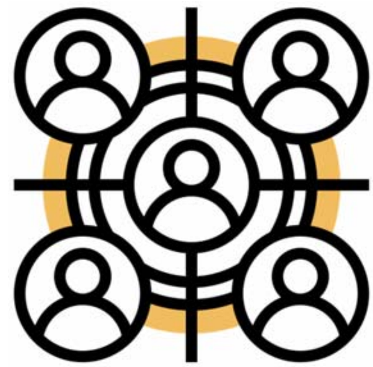
Takeaways: nontraditional lenders….

- Create additional value and risk in agricultural credit markets
  - May complement or compete with traditional lenders
- Make farm management more interesting
- May partially be motivated by strategies to maintain or increase market share (applies to vendor credit)
- Make tracking financial stress in agricultural more challenging



Moving forward

Nontraditional finance

Research on UCC filings (equipment lending trends)

KFMA data analysis

Special issue of *Agricultural Finance Review*

Other areas

Secondary debt markets in agriculture?

Extend lender surveys to nontraditional lenders?

Questions?
Comments?
Thank you!

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