TRENDS IN AGRICULTURAL FINANCE – 2016

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CHAPTER 14

BIOGRAPHY

Stephanie E. Kaiser is a member with Puls Haney Kaiser PLLC. Stephanie previously served as the General Counsel and Chief Legal Officer of a lending institution, has been a partner with the law firm of Kelly Hart & Hallman, LLP, and has been a partner with the law firm of McGinnis, Lochridge & Kilgore, LLP. Stephanie has extensive experience in representing individuals and various business entities in a wide variety of litigation, bankruptcy, banking and finance, corporate, regulatory, farming and ranching, and administrative law matters. Such matters include banking and financial service disputes, fraud cases, breach of contract and breach of fiduciary duty disputes, cases involving theft, conversion, and misapplication of fiduciary property, patent and trademark infringement allegations, Lanham Act allegations, lease disputes, insurance coverage disputes, construction law matters, and FDCPA and FCRA allegations, as well as corporate matters, including custom loan documentation, participation agreements, and syndication loans, standards of conduct, and compliance issues. Stephanie is a Barrister Member and is the Immediate Past President of the Robert W. Calvert American Inn of Court, is a Fellow of the Texas Bar Foundation, has been recognized by *Texas Law & Politics* as a "Texas Rising Star" in business litigation (2006-2012), has been recognized as a "Top Attorney" by *Fort Worth, Texas* magazine (2012), and was named as one of the Top 40 under 40 by the *Fort Worth Business Press* (2013).

REPRESENTATIVE EXPERIENCE

Represented clients in a variety of litigation matters, including wrongful death, fraud, fraudulent transfer, breach of fiduciary duty, breach of contract, conversion, Texas Theft Liability Act, DTPA, Lanham Act, patent and trademark infringement, negligence, gross negligence, shareholder derivative, and misappropriation of fiduciary property matters.

Represented various creditors in bankruptcy court proceedings, including adversary proceedings involving preferences, fraudulent transfers, and breaches of contracts, and contested confirmation and valuation proceedings. Also represented various creditors in state court proceedings to: recover monies owed, including obtaining writs of sequestration and possession of collateral; defend against collection efforts; and obtain injunctive and other relief.

Represented creditor in obtaining dismissal of Chapter 11 bankruptcy case with prejudice for bad faith filing.

Represented professional association in litigation, corporate, labor and employment, Board, administrative and regulatory matters.

Advised and trained clients on various litigation, bankruptcy, administrative, regulatory, labor and employment, and consumer law matters.

Represented clients in handling special assets and resolving issues involving distressed debt.

Represented various medical and dental practitioners in state board and administrative matters.

Served as sole arbitrator and mediator in matter involving two financing institutions.

Represented clients to recover assets in matter involving extensive Ponzi scheme.

Represented real estate investment trust and other lessors in various lease agreement disputes involving real property located in Texas and Mexico.

Represented creditor in seeking declaratory relief in multi-state dispute over real estate and non-judicial foreclosure.

Represented religious organization in insurance coverage of sexual abuse allegations.

Defeated claims of fraud and negligence on summary judgment.

Represented various plaintiffs and defendants in insurance coverage disputes.

Represented widow and child of man who was shot, abandoned, and killed by employees of a Webb County ranch in obtaining favorable jury verdict, judgment, and settlement.

Represented victim of negligent and excessive force by nightclub security guard in obtaining favorable jury verdict and judgment, including award of punitive damages that was affirmed by Third Court of Appeals.

Defended cable company in federal court against Fair Debt Collection Practices Act and Fair Credit Reporting Act class action case. Plaintiff dismissed complaint after Motion to Dismiss was filed on behalf of cable company.

Represented alarm company in federal court against Lanham Act allegations.

Obtained favorable settlement for tower construction company in defending against gross negligence allegations relating to deaths of two employees, who fell from three-hundred foot tower.

Obtained injunctive relief on behalf of a daycare against state agency.

Advised clients and prepared documents on various financing projects, including syndication, participation, and custom loans.

Advised clients on consumer laws, including Dodd-Frank Act and CFPB, and provide training on same.

Serve as Standards of Conduct Official for client.

EDUCATION

Texas Christian University, B.A., *Summa Cum Laude*, 1996
The University of Texas School of Law, J.D., 1999

ADMISSIONS

State Bar of Texas, 1999
United States District Court, Eastern, Northern, Southern, and Western Districts of Texas

RECENT SPEECHES AND PRESENTATIONS

Speaker, Distinguishing between Consumer and Non-Consumer Loans and Related Considerations, AgFirst Farm Credit Compliance Conference, 2016

Speaker and Co-Presenter, Borrower Rights 101 Training, AgFirst Farm Credit Compliance Conference, 2016

Speaker, Ethical and Practical Considerations concerning Multi-State Agricultural Operations, 9th Annual John Huffaker Agricultural Law Course, TexasBar CLE, 2015

Speaker and Co-Presenter, Standards of Conduct Roundtable, AgFirst Farm Credit Compliance Conference, 2015

Speaker and Co-Presenter, Borrower Rights 101 Training, AgFirst Farm Credit Compliance Conference, 2015

Speaker and Co-Presenter, This Year in Borrower Rights, AgFirst Farm Credit Compliance Conference, 2015

Speaker and Co-Presenter, Handling Adverse Actions and Adverse Credit Decisions, AgFirst Farm Credit Compliance Conference, 2015

Speaker, Update on Agricultural Finance Issues (The Amended Rules under CFPB and Agricultural Finance), 8th Annual John Huffaker Agricultural Law Course, TexasBar CLE, 2014

Speaker, The New CFPB Appraisal Rules, FCC Services RAAW Conference, 2014

Speaker, Tips for a Collection Lawyer in Court, 12th Annual Collections & Creditors' Rights Course, TexasBar CLE, 2014

Speaker, Exemptions from Borrower Rights and Consumer Finance Protection Bureau Rules, AgFirst Farm Credit Compliance Conference, 2014

Speaker and Co-Presenter, Standards of Conduct Roundtable, AgFirst Compliance Conference, 2014

Speaker and Co-Presenter, CFPB Compliance Overview and Analysis of the New Rules and Compliance under those Rules, 2013

Speaker, Qualified Mortgages and Ability to Repay & Higher-Priced Mortgage Loans and New Appraisal Rules, 2013

Speaker and Co-Presenter, Sequestrations and Agricultural Issues in Bankruptcy, 7th Annual John Huffaker Agricultural Law Course, TexasBar CLE, 2013

Speaker, Mortgage Servicing Rules and High-Priced Mortgage Loans under Regs X and Z, AgFirst Compliance Conference, 2013

Speaker, Borrower Rights, Litigation, and Bankruptcy, 2013

Speaker, Referrals, Texas Foreclosure Process, Deficiency Judgments, and Bankruptcy Basics, 2012

Speaker and Panel Member, Borrower Rights and Distressed Loan Collection and Bankruptcy Issues, The Farm Credit System Attorney's Conference, 2012

Speaker, Ethics Issues in Bankruptcy, The Farm Credit System Attorney's Conference, 2012

Speaker, Borrower Rights and Loan Regulatory Issues (Beginner and Advanced), Farm Credit Bank of Texas, 2012

Speaker and Panel Member, Farm Credit Borrower Rights, AgFirst Compliance Conference, 2012

Matt Ormiston is a Senior Attorney at the Farm Credit Bank of Texas. He is a 2003 graduate of Texas A&M University, from which he received a B.S. in Agbusiness and a Minor in economics. After graduating from Texas A&M, Matt was a Loan Officer in the Shreveport office of the Louisiana Land Bank, which is part of the Farm Credit system, until July 2005. He then attended St. Mary's University School of Law, from which he received his Juris Doctor in May 2008. While in law school Matt was a Staff Writer for *The Scholar: St. Mary's Law Review on Minority Issues*, and a member of Phi Delta Phi, St. Mary's Legal Honors Fraternity. His comment, *Parental Choice and School Vouchers: A Viable Facet of Texas Public Education Reform?*, was published in 2007.

Following law school, Matt worked for a large tax consulting firm in Austin, Texas, where he litigated state and local tax disputes before administrative agencies. In October 2011, Matt joined a boutique business and commercial law firm in Austin that focused on state and local tax litigation and appeals. He has extensive experience representing Fortune 500 companies in state and local tax matters before agencies and courts throughout Texas, Ohio, Illinois, Florida, New York, New Jersey, Pennsylvania and California.

Matt is married to Leslie Warford, and is the proud father of a 5-year old daughter, Morgan, and a 2-year old son, Jacob. He is a member of Riverbend Church in Austin, Texas, and serves on the board of an Austin non-profit, Side-By-Side-Kids. When not spending time with his family, Matt enjoys reading and playing golf.

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TRENDS IN AGRICULTURAL FINANCE – 2016

I. INTRODUCTION

The interesting times for both agriculture and finance continue. The prices of many commodities remain depressed, and many segments of the agriculture industry are beginning to feel the impact of the prolonged period of low commodity prices. While price volatility appears to have tapered, the general consensus is that commodities will remain low, with some moderate increases possible in 2017. As a result, the national net farm income will continue to hover around half of what it was a few years ago, and at levels unseen since 2002, the result of which is beginning to be reflected in declines in farm real estate values.

Financial markets are still in a state of flux, with some major key interest rates moving lower, but yet others increasing. Inflation remains relatively low, and the dollar has continued to strengthen against foreign currencies. Further, global factors, such as the stability of economic unions and changes in import and domestic production policies, continue to affect the agricultural pricing environment.

All of these factors have combined to paint a varying picture for agriculture, with some segments of the industry performing well, some stuck in neutral, and others continuing to struggle, which in turn creates a variety of financing needs within each segment. Fortunately, many segments of agriculture are counter-related to a degree, so when one segment is struggling, another segment is typically doing well.

Consequently, it is impossible to have a broad discussion of trends in agricultural finance. It is more appropriate to analyze segments of the industry individually to get an idea of what is going on with respect to the financing activity within that segment.

A. Structure of this Paper

This paper will discuss the segments of agriculture most prevalent in and important to the State of Texas. These segments include:

- Grain and row crop producers (corn and cotton)
- Protein producers (beef and poultry)
- Dairy
- Timber

In this paper, we will evaluate some of the factors affecting these segments, the financing activity seen within these segments, and, if applicable, provide some examples of credit features and structures seen during the prior 18 months, as well as expectations for the next 12 months.

1. <u>Market Factors Affecting Agriculture</u>

On its own, agriculture is subject to a number of external factors beyond the control of the farmer, rancher or producer. Some, such as weather, have a direct impact on the agricultural producer and affects every segment to one degree or another. However, agricultural producers are subject to microeconomic factors such as simple supply and demand for their products, and macroeconomic factors such as monetary and fiscal policy, inflation and the strength of the dollar, all of which may have a direct or indirect effect on the prices the farmer or rancher receives for their product. To complicate matters, market factors often impact different segments of agriculture in different, or sometimes, opposite ways. Furthermore, the full impact of some market factors may take years to fully develop, making it difficult to analyze using just a moment in time.

2. <u>Financial Factors</u>

The close relationship between farmers, ranchers, and agricultural producers and their lenders is almost universal. The high capital costs and risks of production agriculture make such a relationship necessary. So, in addition to the myriad market influences on production agriculture discussed above, the dynamics of the financial markets affect the agricultural producer, its relationship with its lender, and its financing needs.

3. <u>Global Factors</u>

Finally, the agricultural economy is truly global in scope. Production in one part of the world affects agricultural producers here in the United States, as do the export, import, and domestic production policies of foreign countries. Further, instability and political change across the globe, not to mention here in the U.S., can ultimately impact the bottom lines of domestic farmers and ranchers.

B. Key Takeaways

Despite the numerous challenges agricultural producers and their lenders face, each of them has the ability to take certain steps to minimize against risks and try to promote a lasting relationship that is beneficial to both.

First, lenders should be sure that they understand their borrowers' business and the agricultural segment in which they operate, while borrowers should choose a lender that meets their unique and short- and long-term financial needs. Producers and their lenders should be candid with one another and try to take steps to support the continuing viability of the producer's operation to the extent possible because agricultural production is capital intensive and should typically be viewed as a long-term endeavor. Producers should try to work with lenders who understand agricultural cycles and market trends to try to stabilize against short-term influences that might dissuade other lenders from financing their operations.

Second, diversity is paramount for both lenders and producers. Lenders can spread risk by loaning to borrowers that operate in as many segments of agriculture as possible. This allows the lender to take advantage of the oftentimes counter-cyclical nature of related agricultural segments. Producers can manage risk by diversifying operations as much as practical, and engaging in hedging activities. A producer can choose to diversify horizontally, for example by producing a variety of agricultural products, or vertically by getting into other segments that add value to the agricultural product or products he or she already produces.

II. TRENDS IN AGRICULTURAL FINANCE

A. In General

Over the past 18 months or so, agricultural commodity prices have remained relatively low after having gone through turbulent price cycles that had historically taken several years to develop. The general consensus is that prices for most commodities are going to return to more normal levels and cycles, with slight increases over the next several years. However, the strength of U.S. dollar has continued to make U.S. agricultural products more expensive relative to foreign products, which has continued to contribute to historic inventories of a number of products, maintaining negative pressure on prices.

At the same time, some foreign governments are changing import policies that led to high prices for some U.S. agriculture products over the past couple of years. Moreover, some countries are eliminating domestic price supports for certain crops and are shedding, or have announced that they intend to shed, stockpiles accumulated over the past several years, all of which apply even more negative pressure on the price of U.S. agricultural goods. In short, commodity prices have continued to negatively impact producers of those commodities, but have continued to benefit those in subsequent segments, such as protein producers.

During the last 18 months, the U.S. financial market has been dealing with near-zero key interest rates. However, in December 2015, the Federal Reserve finally made good on its promise to begin raising interest rates, with a 0.25% increase in the key interest rate. The full impact of this interest rate increase has yet to be determined, but the U.S. has continued to grow, albeit at a slow pace, and is driving the global economic recovery. Uncertainty surrounding the Federal Reserve's plans for raising the key interest rate remains high though, as the agency remains committed to monitoring economic indicators and slowly raising the interest rate as needed. Indications are that the Federal Reserve may raise rates as many as two more times during 2016, with a possible 0.25% raise each time. Whether this happens will primarily depend on job growth and inflation. While the Federal Reserve's "wait-and-see" approach is applauded by some, many market participants wish the agency would establish a rate increase schedule with small incremental increases so that uncertainty will be eliminated from an extremely jittery market.

Although it is almost universally accepted that interest rates in the U.S. will climb, the persistent uncertainty around when the increases will occur continues to encourage a number of agricultural producers to seek and obtain credit with comparatively longer tenors. Low interest rates have also perpetuated the hordes of cash available to be lent.

B. Grain and Row Crop Producers

1. <u>Factors Affecting Grain and Row Crop Producers</u>

a. Corn

The past two years have had record-setting corn crops, which have led to a steep drop in corn prices. In 2014, the United States produced 14.2 billion bushels of corn, resulting in a season average farm price of \$3.70/bu.[1] 2015 saw the United States produce 13.7 billion bushels of corn, a slight drop from 2014, with a slightly reduced season average farm price estimate of \$3.40 - \$3.80/bu.

The 2015 corn crop was the third largest, which along with continued low prices, added to the record-large corn inventory, which will have a lingering effect on the 2016 corn crop. Despite this, the USDA forecasts that corn plantings will be up approximately 6% in 2016, to 93.6 million acres, mainly due to higher expected returns compared to other crops. Not surprisingly, current estimates put 2016 corn selling in the \$3.40 - \$3.60/bu. range.

Another factor that will impact corn prices is the recent announcement by China that it is eliminating its domestic corn minimum price support and that it will begin releasing some of its stocks, which, according to some estimates, accounts for 50% of the world's corn stock. However, several important questions about the Chinese corn situation remain unanswered, namely when the country will release some of its corn stocks, and the quality of the corn in those stocks. While the likely loss of domestic Chinese corn production may open up export opportunities, both the strong U.S. dollar and China's vast stockpile of corn will likely ensure that there will be little impact on U.S. exports of corn to China.

[1] All historical and forecasted price and production statistics are from the United States Department of Agriculture ("USDA") and other reputable industry sources.

Finally, it should be noted that corn and other row crop producers are beginning to see some relief in their production costs as fuel, fertilizer, and pesticide prices have begun to come down. Forecasts have total input prices falling about 4% in 2016.

Similar to last year, and as will be discussed below, low corn prices continue to be good for other agriculture segments, particularly protein producers who rely on corn as their main feed ingredient.

b. Cotton

Similar to corn, cotton has receded from recent record-high prices, but it appears that prices have leveled out, with the 2016 crop season average farm price estimate hovering around $0.60/pound, which is roughly the same price as the 2015 crop. Much of the drop in cotton prices was the result of global events, chiefly the decrease in cotton imports by China, which still holds a majority of the world's cotton stocks. However, for the second year in a row, cotton consumption is expected to outpace production by about 5 million bales, so the global stock of cotton should begin decreasing and exerting less of a negative influence on prices.

In addition, there is some uncertainty about an ongoing anti-dumping investigation in Turkey. Turkey initiated a probe into pricing of U.S. cotton in late 2014 and recently announced that it determined that U.S. cotton damaged local cotton production and is weighing whether it will impose anti-dumping tariffs.

Some of the drop in cotton exports has been offset by slight growth in mill demand, but sustained low oil prices has made alternative fibers, such as polyester, even cheaper by comparison. As a result, it does not appear that mill use will relieve the negative pressure exerted by large stockpiles of cotton.

Despite the numerous challenges facing cotton producers, both structural and political, the USDA forecast that planted cotton acreage will increase by 11% in 2016 to approximately 9.56 million acres. In Texas, planted acreage is expected to rise nearly 500,000 acres, or 10%, compared to 2015. The increase in acreage in Texas is likely attributable to predictions of normal rain amounts this spring, compared to excessive rain and cooler temperatures during the planting season in 2015, as well as the relatively low returns for alternative crops such as corn.

2. Financing Activities

a. Over the Past 18 Months

For the most part, grain and row crop producers have maintained average levels of financing activity while enduring a prolonged period of depressed commodity prices. Most producers obtained normal levels of operating loans to get a crop in the ground and to harvest that crop later in the year. There was very little activity with respect to purchasing new farm land or equipment, as many producers were taking a "wait-and-see" approach, with the main goal to make it through relatively low, but more normalized commodity prices.

b. In the Next 12 Months

Absent serious weather or global events, there is no expectation that commodity prices will move up much in the next year. Beyond that, most forecasts do indicate a gradual rise in commodity prices, but without the volatility of recent years. The prolonged period of lower commodity prices has made its way into farm real estate values, and the next year could see some producers, particularly the larger ones who can take advantage of scale, adding farm land as farm real estate prices have begun to soften. The decrease in farm real estate values is extremely important in gauging the health of the agriculture industry as farm real estate represents more than 80% of total farm assets in the U.S.

As a result, the operating financing trends for this segment are expected to be about the same as they have been for the last year and a half, but there could be an increase in financing for acquisition of farm land by larger producers. However, we may also see an increase in workouts, restructurings, and foreclosures involving marginal producers, who have burned through their capital weathering this prolonged period of depressed crop prices.

C. Protein Producers

1. Factors Affecting Protein Producers

a. Beef

It appears that the roller-coaster ride for ranchers is coming to an end, as the cattle herd is being replenished following the drought-induced selloff of a couple of years ago. In September 2014, live cattle prices were in the $160/cwt range. Prices peaked in the first part of 2015, and then fell to around $130/cwt by the end of 2015. As of March 2016, prices have rebounded to approximately $145/cwt and are expected to linger in that range for the remainder of the year and into 2017.

The leveling of prices signals that the nation's cattle herd is returning to normalized levels. It should be noted that the herd is growing faster than previously expected, as the current forecast prices for the remainder of 2016 are anywhere from $3 - $10/cwt less than the forecast from a couple of months ago. Some predict that the herd replenishment and its effect on production may exert negative pressure on prices through the end of the decade.

Breeding and retention decisions by the cow-calf producers will impact the growth rate of the nation's cattle herd. These decisions will be driven by the expected return for cow-calf producers, which, analysts predict, will be about $200/head in 2016. While this rate of return is less than the prior two years, it is well above historical levels and high enough to induce expansion but likely not at the rates seen over the past year.

While the supply of cattle is heading towards historically-normal levels, feeders are anticipating a much better climate in 2016. The high price of live cattle during 2015 resulted in high losses per head for feeders. However, lower prices beginning in late 2015, due to increased supply, are making 2016 look much better for feeders, as many feeders are approaching breakeven on a per head basis. The higher-priced cattle should make their way through the feedyards completely by the end of April 2016, so feeders may begin seeing positive margins at that time. In addition, low feed costs resulting from the continued low price of commodities (discussed above) should enable feeders to increase margins and have a better year than last year. As a result, it is anticipated that margins will remain at or slightly above breakeven for the duration of 2016.

The increase in cattle supplies will benefit packers and processors, who faced difficulty with excess capacity in 2015, the main causes of which were low supply of fat cattle and decreased demand by retailers. As cattle supplies increase, packers and processors should begin seeing some relief during 2016. However, demand, both domestic and foreign will remain an uncertainty for beef packers and processors. Although retail beef prices are higher for the end consumer, the retailers are retaining a majority of the increase, and not demanding as much boxed beef from the packer and processors. There will be a seasonal increase in domestic demand for beef because of the grilling season, but it is unclear whether overall domestic demand will increase or remain static. In addition, relatively lower prices for pork and chicken, which compete with beef in the meat case at grocery stores, make beef a relatively expensive source of protein. Moreover, while U.S. beef exports are expected to increase slightly in 2016, the strength of the U.S. dollar will dampen any major shifts in export demand. Despite these negative and uncertain factors, beef packers and processors should have a decent 2016 when compared to the issues they had in 2015.

b. Poultry

As discussed above, low input costs, particularly the cost of corn, have led to good margins for those involved in protein production. Poultry producers are no exception. 2015 turned out to be a fantastic year for poultry producers, despite sweeping import bans because of Highly Pathogenic Avian Influenza ("HPAI") and the strength of the U.S. dollar. However, domestic supplies are beginning to grow, which has put negative pressure on prices, but margins remain at or above long-term trends.

The main issue facing the poultry segment is supply. Fears over HPAI appear to have been overblown, yet many countries have maintained blanket bans on U.S. poultry products. Efforts are being made to eliminate or narrow the scope of these bans, which should be successful given the effectiveness of protocols initiated by the USDA. A more realistic burden on the poultry segment and exports is the U.S. dollar, which is forecasted to remain strong relative to foreign currencies, thus limiting the ability to grow exports to foreign countries.

In all, the poultry segment is in really good shape financially, as companies have enjoyed record margins for a couple of years, which has left them flush with cash. The biggest issue for these companies is what to do with the profits they have accumulated.

2. Financing Activities

a. Beef

(1) Over the Past 18 Months

Most of the financing activity in the past 18 months has centered on addressing liquidity issues with feeders and packers caused by negative margins. The borrowing bases governing the amount of credit available under several borrowers' revolving lines of credit had to be adjusted or restructured to address the effects of tighter margins of feeders and packers. Further, some lenders were forced to consider whether and how to address certain compliance covenants as borrowers tried to work through the higher-priced cattle that were being fed and processed during most of 2015.

(2) In the Next 12 Months

It is unlikely that this segment will continue to see the volatility in prices and margins experienced over the last couple of years, so the next 12 months should see normal types of financing activities, such as increases in lines to accommodate growth. With the expected normalization of prices and the market environment for beef, some participants in this segment may look to expand by acquiring operations that are limping out of the difficult times of the past year.

b. Poultry

(1) Over the Past 18 Months

Lower input costs and increased demand caused by relatively more expensive protein substitutes have been a boon for poultry producers and processors, resulting in higher profits. Last year we saw a number of major poultry companies, such as Pilgrim's, pay out a substantial dividend and make large capital investments.

Other than a few minor modifications to accommodate payment of large dividends, financing activity in the poultry segment was nearly non-existent over the past 18 months. In fact, many of the major poultry companies have little to no usage on their revolving lines of credit.

(2) In the Next 12 Months

Conditions for the poultry segment will likely continue to be favorable. Input costs are expected to remain low, and there is no indication that HPAI is going to rear its head again until wild bird migration season picks up in the fall. The strong U.S. dollar will continue to hurt exports, but relaxing fears over HPAI should eliminate bans on U.S. poultry products and offer some relief for the supply stockpile. It is likely that some poultry companies will decide to reward shareholders through dividend payments, but it appears that a portion of this segment is content in having a substantial "rainy day" fund for when the market turns negative.

D. Dairy

1. Factors Affecting the Dairy Segment

Dairy, like the other agriculture segments, have seen prices begin to level off following recent turbulence. In Texas, Class III milk prices went from nearly $25/cwt in September 2014, to an average of $15.80/cwt for 2015. Currently, Class III milk is hovering in the $13.70 - $13.80/cwt range, with an expectation that prices may fall slightly throughout 2016 but rebound in 2017.

While input costs and drought have subsided in the last year or so, dairy prices remain depressed because of oversupply. While Australia and New Zealand continue to feel the effects of drought, Europe, which eliminated its dairy quota system, is driving the growth in global milk production. Production in Europe is also impacted by the decision of the European Union to delay, until September 30, 2016, elimination of its price intervention program for purchasing skim milk powder.

The oversupply has caused milk prices around the world to approach, or fall below, the cost of production, so it's safe to say that the record margins seen in 2014 are now a distant memory. And while spot prices for cheese and butter remain high, they are at such a level that imports from Europe and Australia are looking favorable, especially given the strength of the U.S. dollar.

The loss of nearly 6,000 head of dairy cattle during Winter Storm Goliath may be an unfortunate correction to the supply problem facing the Texas Dairy industry, but it appears that production overall will remain on par with 2015 levels.

The key things to watch for in the dairy segment during 2016 include:

- Effects of drought in Australia and New Zealand;
- The European Union's decision to delay shuttering its price intervention program for skim milk powder until September 30, 2016; and
- Growth in China's domestic milk production.

2. Financing Activities

a. Over the Past 18 Months

Returning to a down cycle in dairy prices, following a very recent spike in prices, many dairy producers sat tight with respect to their financing needs, similar to grain and row crop producers. Most of the activity in the past 18 months was related to the fall in milk prices, with several dairy processing companies reducing their revolving lines of credit after having increased them in 2014. In addition, several producer-owned dairy companies have decided to expand into processing dairy products in an effort to capture as much value from the dairy production chain as possible, resulting in some financing activity. However, at the producer level, the last 18 months has seen very little financing for expansion or capital improvements.

b. In the Next 12 Months

Sustained lower milk prices means that some dairy producers will become distressed again. It would not be shocking to see some of the marginal producers look to restructure their debt or even exit the industry. However, there may be financing opportunities for dairy producers looking to expand into value-added operations.

E. Timber

1. Factors Affecting Timber Producers

The market drivers affecting timber producers are pretty simple – the housing market and consumer packaging. The housing market has continued to improve, as we have seen steady increases in the annualized housing start data beginning in mid-2015, when the annualized rate of new housing starts remained between 900,000 and 1,000,000 units. Currently, U.S. Census data puts annualized housing starts at nearly 1,200,000 units and projects that rate to continue increasing over the next year.

Consumer packaging demand roughly tracks the health of the United States' economy. As consumer spending increases, so does demand for consumer packaging. Most forecasts show that the economy is expected to continue improving at a modest rate of 2% - 3%, which is a positive signal for consumer packaging producers and the timber growers who supply them with raw material.

2. Financing Activities

a. Over the Past 18 Months

During the past 18 months, timber segment financing was fairly active. Following a string of refinancing actions to lock in lower rates, a number of timber and timber-related companies exercised available accordion features in existing credit agreements or went to the market for merger and acquisition and capital expenditure financing.

Loan covenants and terms have remained relatively consistent over the last 18 months and pricing appears to have levelled off over the last few months, with interest rates being set at levels appropriate for the credit quality of the borrower and the structure of the financing.

Merger and acquisition financing continued during the second half of 2015. On June 1, 2015, KapStone Kraft Paper Corporation ("KapStone") acquired Victory Packaging, LP ("Victory"). KapStone produces containerboard, corrugated products, and specialty paper used for packaging. To fund its acquisition of Victory and to refinance existing debt, KapStone obtained a $1.915 billion senior secured credit agreement consisting of a 5-year $940 million Term Loan A-1, a 7-year $475 million Term Loan A-2, and 5-year $500 million revolver. All of the facilities were grid priced, depending on KapStone's total leverage ratio, ranging from LIBOR plus 100 to 200 basis points. The credit agreement also provides for unlimited increases in the credit facilities provided that KapStone's total leverage ratio remains below 2.50x.

KapStone's credit agreement only had two major financial covenants. First, the company is subject to a minimum interest coverage ratio of 3.00x. Second, the company is subject to a stepped-down maximum leverage ratio, starting at 4.50x and decreasing to 3.75x.

Outside of merger and acquisition financing, a number of timber companies are utilizing relatively cheap debt and cash on their balance sheets to secure additional timberland for both production and investment purposes.

b. In the Next 12 Months

Continued increases in the annualized rate of housing starts means timber producers will remain fairly active with respect to financing activity in the next 12 months. Specifically, it is expected that merger and acquisition financing will continue.

The long-term nature of timber production will also mean that companies will continue to refinance debt in anticipation of future interest rate increases.

III. AGRICULTURAL LOAN STRUCTURES

A. Revolving Lines of Credit

1. Term of Loan

a. Over the Past 18 Months

During the past 18 months, the term for revolving lines of credit for operating lines in Texas has remained relatively constant. Often times, such revolving lines of credit are set at 12-month intervals to mitigate and protect against market fluctuations and other factors that affect agricultural borrowers and lenders. Prior to the expiration of each 12-month interval, lenders will evaluate the loan based on the borrowers' most recent financial information and current and historical market information, among other things, to determine whether the loan can be renewed for another set period of time. Prior to the last 18 months, some revolving lines of credit were set at 24-month renewals. However, it was learned that, for most loans, 24-month terms did not allow lenders to keep an appropriate pulse on borrower performance, and lenders and borrowers needed more flexibility to seek adjustments in terms and conditions that would better work under the circumstances, if and when possible.

It should be noted that revolving lines of credit generally start out as budgeted lines of credit. Over time and with good borrower performance, budgeted lines of credit can become revolving lines of credit. Even though most revolving lines of credit were set at 12-month intervals over the last 18 months, some well-qualified borrowers with long, established histories with their lenders were able to secure multi-year revolving lines of credit; generally, such revolvers did not exceed 24-36 months and did not exceed $500 thousand in amount.

b. In the Next 12 Months

It is anticipated that the trend from the last 18 months will continue over the next 12 months and that the term of a revolving line of credit for an operating line will be the same as it has been over the last 18 months. For many borrowers, that means the term of a revolving line of credit will continue to be set at 12-month intervals, where the loan can be renewed for another 12 months if borrowers meet the lenders' credit standards.

2. Interest Rates

a. Over the Past 18 Months

Over the past 18 months, interest rates for revolving lines of credit have been based on an Index, such as the U.S. Prime Index, and have been set at 50-100 basis points above Prime, e.g., for well-qualified borrowers. As a result, rates on revolving lines of credit for such borrowers have ranged from 4.00% to 5.00% on average. Because interest rates are priced to risk, better credit risks will receive better rates. Some loans over the last 18 months, therefore, were able to qualify for rates equal to Prime.

b. In the Next 12 Months

It is anticipated that interest rates will not dramatically change over the next 12 months. Any change that occurs is currently expected not to exceed 50 basis points above Prime.

B. Term Debt

1. Term of Loan

a. Over the Past 18 Months

During the past 18 months, agricultural term debt loans in Texas have ranged from 10-25 years, with many of those loans being made on 20-year terms. The term of the loan is based on the purpose of the loan, the type of collateral, the borrowers' financials, and the borrowers' goals and preferences, among other things (e.g., shorter term for lower interest rate).

b. In the Next 12 Months

It is anticipated that the loan terms available for term debt will be the same over the next 12 months as they have been for the last 18 months, and the average loan term for term debt is expected to remain about 20 years.

2. Interest Rates

a. Over the Past 18 Months

Over the past 18 months, interest rates for term debt have been typically based on a fixed term. For well-qualified borrowers, interest rates for a 20-year term have ranged from 5.25% to 5.75%, and interest rates for a 10-year term have been 4.75 to 5.00% or better.

b. In the Next 12 Months

If the Prime rate increases by 25-50 basis points, then fixed rates will likely increase by 0.50% or more, depending upon the term of the loan and the borrowers financials, among other things.

C. Financing Considerations

1. Some Important Factors for Lenders

The terms and interest rates for agricultural loans have not changed dramatically during the last 18 months and are not expected to change beyond that indicated above during the next 12 months. However, borrowers can maintain or improve their attractiveness to lenders by demonstrating certain factors and traits that will prove their ability to weather fluctuations in the market and their operations. These factors include: working capital; owner equity; and the amount of term debt the borrowers have.

Working capital is critically important for the borrowers' balance sheet. If borrowers are able to maintain good working capital despite market changes and keep a good amount of cash readily available, then they can weather through market fluctuations and other uncertainties associated with agricultural operations. Working capital allows borrowers to remain in control of their operations and demonstrates good management and control.

Owner equity is also important from a lending and operational perspective; generally stated, owner equity reflects the amount of the borrowers' assets less the borrowers' liabilities. Owner equity allows borrowers to pledge assets to secure their debts. However, owner equity is not as important as working capital to many lenders because borrowers can have equity in their business but no profits to pay towards their term debts, e.g.

The amount of term debt borrowers have is an important consideration for lenders. The less debt, the better. During periods of downturn, when profits are greatly reduced, the fewer challenges and pressures on cash flows, the better, and borrowers will be able to better preserve (and not diminish) working capital. Borrowers with less term debt can withstand the storms a lot better than borrowers with greater amounts of term debt.

For young, beginning, and small farmers, building liquidity on their balance sheets is one of the best ways to build a financially sound agricultural operation and establish a good lending relationship. Such farmers should ease into farming and start at the appropriate level for their experience, being sure to match-pair their balance sheet with their experience and expectations. Growing too big too fast can be a recipe for failure in agriculture and preclude borrowers from developing working capital and owner equity with limited term debt.

2. Microeconomic Considerations

A lot of the published data on agriculture we have considered is macroeconomic-based. However, agricultural markets and economies are often regional or regional-influenced. Lenders, therefore, will consider borrowers' financials, including borrowers' historical data, along with regionalized data, pricing, projections, and markets among other things, when considering borrowers' requests for credit, including loan renewals. In prior years, some lenders relied on income projections more than historical price points when making lending decisions. Such forecasts allowed for increased leverage on borrowers' balance sheets. Credit decisions based on projections alone have largely gone away, and lenders generally analyze both projections, as well as historical data, in making their lending decisions.

3. Loan Terms and Conditions

There are variances in loan terms and conditions; however, for the most part, most loan terms and conditions used by a particular lender are based on the type and purpose of, and collateral for, the loan and the repayment source, e.g., rather than the market or time period in which the loan closed. For example, a revolving line of credit for a dairy operating line may have more covenants and conditions than a 10-year land loan. However, in times of severe fluctuation, or for borrowers involved in more volatile markets, more financial covenants may be required during those times than might otherwise be required.

In Texas, loan terms and conditions did not change dramatically over the last 18 months and are not expected to change greatly over the next 12 months. Although both revolving lines of credit and term debt require certain terms and conditions, revolving lines of credit for operating lines generally will require more terms and conditions than term debt for land loans, all things being equal. However, the size of the loan and the repayment source on term debt may necessitate terms and conditions that are similar to those found in revolving lines of credit. Affirmative covenants on revolving lines of credit and on larger term debt or term debt with a more complicated, or less predictable or reliable, repayment source have often included payment and performance obligations, agreements regarding use and disposition of proceeds, record keeping and reporting requirements, insurance and collateral requirements, including inspections, environmental compliance and indemnities, and notice requirements. Negative covenants on such loans have often included lien, lease, and other encumbrance prohibitions, debt limitations, and limitations on changes in property use, ownership, borrower name, and assets. In short, while operating lines typically have more terms than their term debt counterparts, the larger or more complicated a loan becomes, whether by type, amount, or repayment source, the more terms and conditions will be required.

4. Restructurings

When agricultural loans become distressed, there may be options available to lenders to restructure the indebtedness in an effort to return the loans to viability. When loans are distressed – or are becoming distressed, communication between borrowers and lenders is critical and can make all the difference. Lenders often reach out to their borrowers when they become aware of distress in the loans. However, generally speaking, borrowers will be aware of the distress before their lenders, and addressing distress at earlier stages can prevent unnecessary deterioration and loss. Borrowers, therefore, should reach out to their lenders as soon as possible when they find themselves in such circumstances to see whether any options exist for addressing the distress. Restructure options for loans that are eligible and capable of being restructured may include conversion agreements, reamortization agreements, and forbearance agreements.

IV. CONCLUSION

It should be apparent that each segment in the agriculture industry is in a different economic and financial position than the other segments. Some are enjoying record margins and are utilizing financing to put those record margins to their most economic use. Others remain under negative price pressure and trying to manage their finances so that they can wait out the storm.

Today's agriculture industry is more susceptible to more influences than ever, both domestically and internationally. Consequently, a strong relationship between producers, lenders, and their attorneys, is crucial. All should work together to the extent possible to identify the challenges facing the segment of the agriculture industry in which the producer operates, and utilize financing options that contribute to the producers' long term success. Thankfully, the next 12 months is not expected to be dramatically different from the past 18 months in terms of loan term, interest rates, or structure. However, as history has shown, agricultural borrowers should always be prepared to weather the storms that arise and know that changes will occur – it is only a matter of when.