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AgriLIFE EXTENSION
Texas A&M System

Agriculture and the 2008 Credit Crisis

Surviving the Cycle of Economic Crisis

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"Success is not final, failure is not fatal; it is the courage to continue that counts."
– Winston Churchill

Since the fall of 2008 we have seen an endless stream of headlines describing a struggling economy. Consumer pessimism, prominent business failures, financial bailouts, and never-before-seen market volatility have been constantly discussed and debated over the last few months. Many experts have concluded that the three-fold crises among the housing market, financial institutions, and the stock market coincided to form the "perfect storm" that has resulted in a severe recession.

Some point to outright greed over poorly backed securities as the ultimate cause of our problem, others to consumers who save too little and borrow too much. Regardless of its cause, the current financial crisis has left businesses with less access to debt capital and their customers cautious about purchases. Highly leveraged businesses operating on narrow profit margins are especially vulnerable at this time. Customers are looking for bargains, which puts even greater pressure on the profit margins of wholesalers and retailers. For cooperatives and other agribusinesses, failure may seem imminent and growth impossible.

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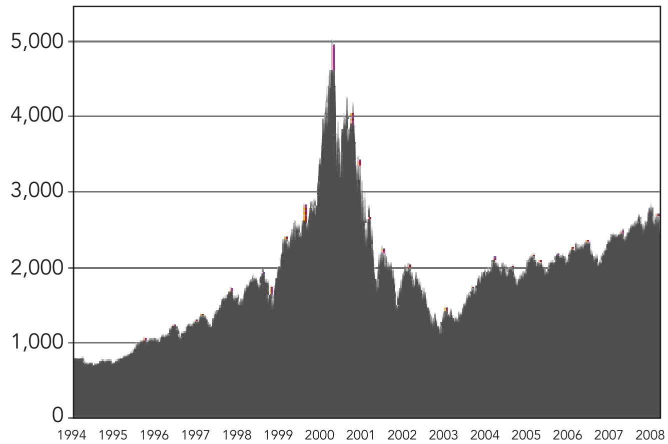
Even so, there may be a few bright points, especially for firms in the agricultural sector:

- Provisions in the Farm Bill still give farmers some access to the guaranteed loans they need for continued or expanded operations.
- High commodity prices have kept producers in operation; this large base of producers supports cooperatives and other agribusinesses.
- Remembering the financial crisis of the 1980s, agriculture did not over leverage this time, and now has solid balance sheets and firm lending standards to help it withstand the current crisis.
- Cooperative banks in the farm credit system remain strong and somewhat insulated from Wall Street.
- Regardless of the economy, people still like to eat.

It is significant that many outside of agriculture are looking to it as an example of resilience and efficiency. Because they participate in a seasonal industry, agricultural producers know how to deal with price variability and manage risk. Many of them see the value of cooperative business during difficult economic times. In fact, when times are difficult, the cooperative business model allows for business development that might not otherwise be possible, which may lead to renewed development of cooperatives in the coming years.

The Cycle of Crisis

Although the current crisis is severe, this is not the first time business has been challenged by a volatile market. As recently as the late 1990s there was rapid growth in the new Internet sector and related fields. During this time, the technology-heavy NASDAQ index grew sharply and peaked at a value of more than 5,000 in March 2000. However, rapid growth and speculation in stocks led to decisions that were not based on sound business principles. The dot-com bubble burst in March 2000, with the NASDAQ falling more than 60 percent over the next year and bottoming out with a 76 percent decline from its peak value (the NASDAQ trades at about 1,600 today). That sounds fairly catastrophic, and for some it was. However, during this period we saw AOL purchase Time Warner, the world's largest media company. We also saw the birth and survival of Amazon.com, eBay and Google, among others that today we consider some of the very best companies in their industry.



NASDAQ Composite Index, 1994-2007.

The point is that business, especially in a capitalist economy, tends to move in cycles. Times of economic crisis are also times of economic opportunity. There is always the potential that someone else is better able to derive value from available capital than you are. Whether it's through a better business model, better management, or new technology, there are firms that are able to grow from (or even cause) the destruction of others. Famed economist Joseph Schumpeter called this characteristic of capitalism "creative destruction" in his book Capitalism, Socialism, and Democracy (1942). In his words,

"The essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process… . Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary."

Change in itself is not bad. The question is: "Does my business keep pace with changes in the business environment?"

Withstanding the Crisis

One thing that is guaranteed about our current economic crisis is that it will happen again. Is your business engineered to keep pace with the dramatic changes from the next downturn in the business cycle? To find out, consider the following questions:

1. Do you conduct an annual strategic planning session, and do you regularly consult your existing strategic plan?
2. Do you maintain adequate working capital compared to your sales and level of risk?
3. Do you actively manage your customer credit?
4. Do board members and management work within the confines of their respective roles?
5. Do you know what motivates your customers and what value they find in your products and services?
6. Does the board of directors faithfully execute its responsibility of "due diligence"?

If your answer to any of these questions is "no" or "I don't know," then your business may be in danger of failing.

Strategic Planning

Do you conduct an annual strategic planning session, and do you regularly consult your existing strategic plan?

Strategic planning is an essential exercise for any business. For a cooperative, it involves the board of directors taking a hard look at the status of the business relative to its competitors to determine the proper actions needed for long-term viability. Sometimes it involves hard decisions that might alter the very essence of the business model. Remember that strategic planning is a process, not a product. It is a culture within a business that leads to constant adjustment ahead of changes in the business environment. Strategic planning can help the board and management feel more confident about their business. During the strategic planning process, invite presentations from your banker, auditor and industry professionals, and don't be afraid to dream big.

Working Capital

Do you maintain adequate working capital compared to your sales and level of risk?

Working capital is the lifeblood of a business. Your working capital represents how much cash you have on hand to fund daily operations. It must be enough to cover short-term debt and upcoming operational expenses. But that's not all. Working capital also can represent the firm's ability to withstand disaster or benefit from opportunity. Many cooperatives and agribusinesses are small to medium-sized firms dependent on debt capital (loans) for growth. In a highly seasonal industry, this can be risky. If you allow your working capital to be depleted, an unexpected problem (like crop loss to hail or drought) could be disastrous. If your business is carrying debt, your banker will show a keen interest in your working capital. Most likely, current bank covenants are somewhat strict in this regard. To lower your need for working capital, focus on increasing your inventory turnover, decreasing risk, and diversifying product and service offerings.

Customer Credit

Do you actively manage your customer credit?

Cooperatives are especially guilty of allowing customers to build up tremendous lines of credit under the assumption that customers need the credit and might not otherwise patronize the business. In effect, the cooperative is providing unsecured loans to its customers. No bank would extend a loan in this way. What's more, no loan is without cost, and if the customer is not paying the cost of the loan, then the business is paying that cost through lost interest and lost use of capital. A business is wise to set policies limiting the size of accounts receivable and defining the proper extension of credit. Such policies, even lenient ones, could include, but not be limited to, a credit application and letter of deposit from the applicant's bank.

Board and Management Roles

Do board members and management work within the confines of their respective roles?

It should be clearly understood that board members are responsible for the strategic direction of the business and management is responsible for carrying out that vision in the manner it deems most appropriate within the bounds of company policy. The general manager is the one individual responsible for the operation of the firm. That includes accounts receivable, payroll, personnel issues and pricing. The board of directors is responsible for setting strategic objectives and general policy, for distributing income, and for protecting the wellbeing of the business. The board is also responsible for hiring the general manager. When board members try to control operations (like deciding what brand of equipment to buy) or managers forget to listen to the needs and desires of members, neither will be making the best decisions for long-term success.

Customer Value

Do you know what motivates your customers and what value they find in your products and services?

In tough economic times it's easy to cut marketing expenses or cancel plans for expansion. While this might be justified, don't mistake reduced expenses for gains in efficiency. Some dollars spent on marketing or expansion might be generating greatly needed income. A more prudent approach is to reassess what adds value for your customers. A cooperative business must also consider whether there is value in ownership. The cooperative retains a portion of the members' income to use as equity capital. This is good–every business needs this equity to fund future growth. However, if that equity is returned without interest and without creating anything of value, members will take their business somewhere else. Growth for the sake of growing is not sustainable.

Due Diligence

Does the board of directors faithfully execute its responsibility of "due diligence"?

Board members are obligated to act in the best interest of the corporation and its shareholders. Personal agendas have no place in the boardroom. Board members are responsible for hiring the general manager, hiring an auditor, holding an annual meeting, entering into contracts and obligations (including the borrowing of money), distributing dividends, amending bylaws as necessary, and perhaps most important, providing oversight to management. Directors are responsible for understanding the complete operation and structure of the business. They are ultimately responsible for the use of corporate assets and funds. Therefore, it is their right to ask direct and pertinent questions about the use of such assets, and to receive timely, detailed answers. Furthermore, it is their right to consult with objective, third-party professionals when deemed necessary. They are the champion of the shareholders and protector of business longevity.

The current financial crisis will not be the last. However, a business that has prepared adequately can survive times of economic uncertainty. The practices outlined here will help your business thrive during good times and bad.

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