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AGVIEWS

– BY LYNN PAULSON

Bell Bank Director of Agribusiness Development

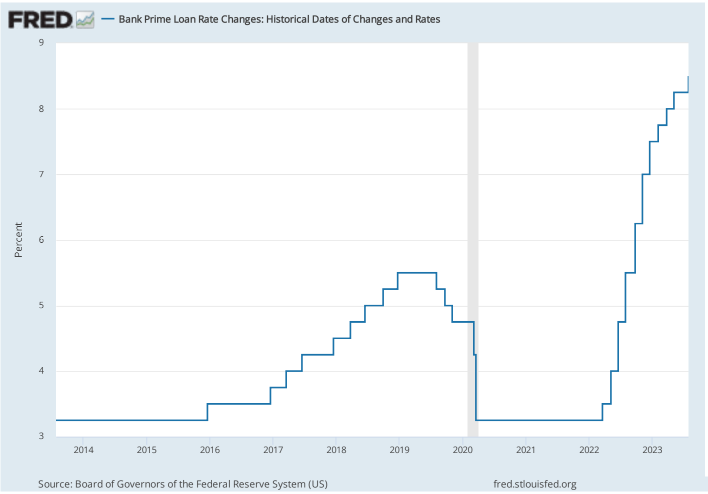
High Interest Rates and the Impact on Lending

The rapid rise in interest rates over the last 20 months has been well documented. Although the Federal Reserve has taken a “pause” in additional increases recently, they have raised the interest rate 11 times since March 2022 – the steepest hike in four decades.

What do the continued high rates mean for lending? And how will farmers and ranchers be impacted in the months and years to come? > > >

When it comes to interest rates, there are a couple of different indexes or indicators that are used to track rate changes. One is the Effective Federal Funds Rate. Another is the bank prime rate – sometimes known as the Wall Street Journal (WSJ) Prime Rate. The latter is an index often used for loan rates. The general rule of thumb is the WSJ rate is 3% over the current fed funds rate.

As seen in the chart below, the prime rate is now 8.5% – up from 3.25% not that long ago. The last time the prime rate hit 8.5% was back in 2001. Are the current rates historically high? Maybe as compared to the last decade or two, but it's helpful to remember the prime rate reached 21.5% back in December 1980. Currently, we're actually closer to historical averages in terms of interest rates than we might think.



The fact that we've had extremely low rates the last decade or two sometimes clouds our historical perspective. Also, the amount of dollars borrowed is much higher today, so the increase in interest rates we're now experiencing from a pure dollar outlay perspective is much higher. There are a lot more commas and zeroes in today's numbers to consider.

What does this all mean for producers who borrow money to fund their farm/ranch operations? What does this mean for folks with no debt but plenty of investable cash? What does this mean for the farmland market? What does this mean for banks that are paying a lot more for the deposits they gather and need to, in turn, lend money back to producers?

A REAL LIFE EXAMPLE

To illustrate the potential impact of these higher rates, let's put this into a real-life dollars and cents example: A producer has an opportunity to purchase a nice parcel of land he's been looking at for several decades and wants to finance $2 million of the purchase. Not that long ago, he probably could have financed it for 4% interest or less. Now it's probably doubled to 8%. How does that affect his annual payments?

Assuming a 20-year amortization, $2 million at 4% would require an annual payment of about $147,000 – or $2.9 million in total payments over the life of the loan, assuming interest rates stayed at 4%.

At today's 8% interest rate, that same $2 million 20-year loan would require annual payments of about $203,000 – or just over $4 million in total payments, an increase of over $1 million.

WHAT ARE THE RAMIFICATIONS OF HIGHER RATES?

For starters, there may be some deals that worked at a 4% rate that simply don't work at 8%.

Most producers that borrow are just now starting to feel the impact of higher loan rates as they begin making their first payments on their operating loans or on their new equipment or land loan that were made at the higher rates. Much more of their payments will now go to pay the higher interest rate.

Relatively speaking, the cost of capital (borrowing) has been extremely cheap over the last 15 years. As noted previously, and as Bell Bank's Wahpeton President Rick Steckler recalls later in this newsletter, it hasn't always been that way. Interest expense as a share or percentage of agricultural production was well over 15% in the mid-1980s. In recent years it's been well under 5%. That percentage will likely start trending back up with the higher rate environment.

WHAT DOES THIS MEAN FOR FARMLAND?

Interestingly, the higher interest rates seem to have had less of an impact than expected on the farmland market in terms of sales prices. There may be a couple of reasons for this.

First, after 3 to 4 really profitable years, there's simply a lot of cash in the agricultural sector. A lot of the land being purchased is likely being bought either entirely, or mostly, with cash. As a result, higher rates have less of an impact than anticipated.

Secondly, there's still a limited amount of land on the market. In many areas, demand for farmland still exceeds supply. Given that you may only have one chance in a generation to purchase a strategically located piece of land, you may be pretty aggressive in buying. Most buyers are playing the long game.

The rising rates have maybe had the biggest impact and influence on the non-farm "investor." For many of these potential buyers, there's less emotion attached to the purchase and much more of a logical or rational return on an investment type of approach. Also, there are considerably more attractive alternative investment returns than a year or two ago.

For example, use the $2 million land finance scenario from earlier. Let's assume this was for two quarters (320 acres) and the purchase price was $2.5 million (about $8,000/acre). If the seller didn't have debt on the land sold – and assuming no income tax consequences as a result of the sale – investing in a safe 5% long-term certificate of deposit (CD) would result in interest income of about $125,000 a year from the land sale proceeds.

If the land was renting for $200/acre, the income from the land being sold would be $64,000 – minus real estate taxes. That's a difference of over $60,000 a year. Simply put, that is what's driving a lot of the next non-farm heirs to sell.

It'll be interesting to see where the price trends on farmland go in the coming months and years. Likely, the biggest unknown may be the historical appreciation of owning farmland.

THE IMPACT OF HIGHER RATES ON BANKS

Lastly, how do the rising interest rates affect banks or lenders? Granted, not a lot of folks feel sorry for banks, but the reality is their margins have been squeezed significantly in recent months as deposit costs have risen sharply. It wasn't that many years ago when many banks had net interest margins (basically the difference between loan/investment rates and their cost of funds) of 4-5%. That has been reduced significantly.

As a result, many banks are starting to focus less on growth and more on taking care of their existing customers and being more cautious and less aggressive with new loans.

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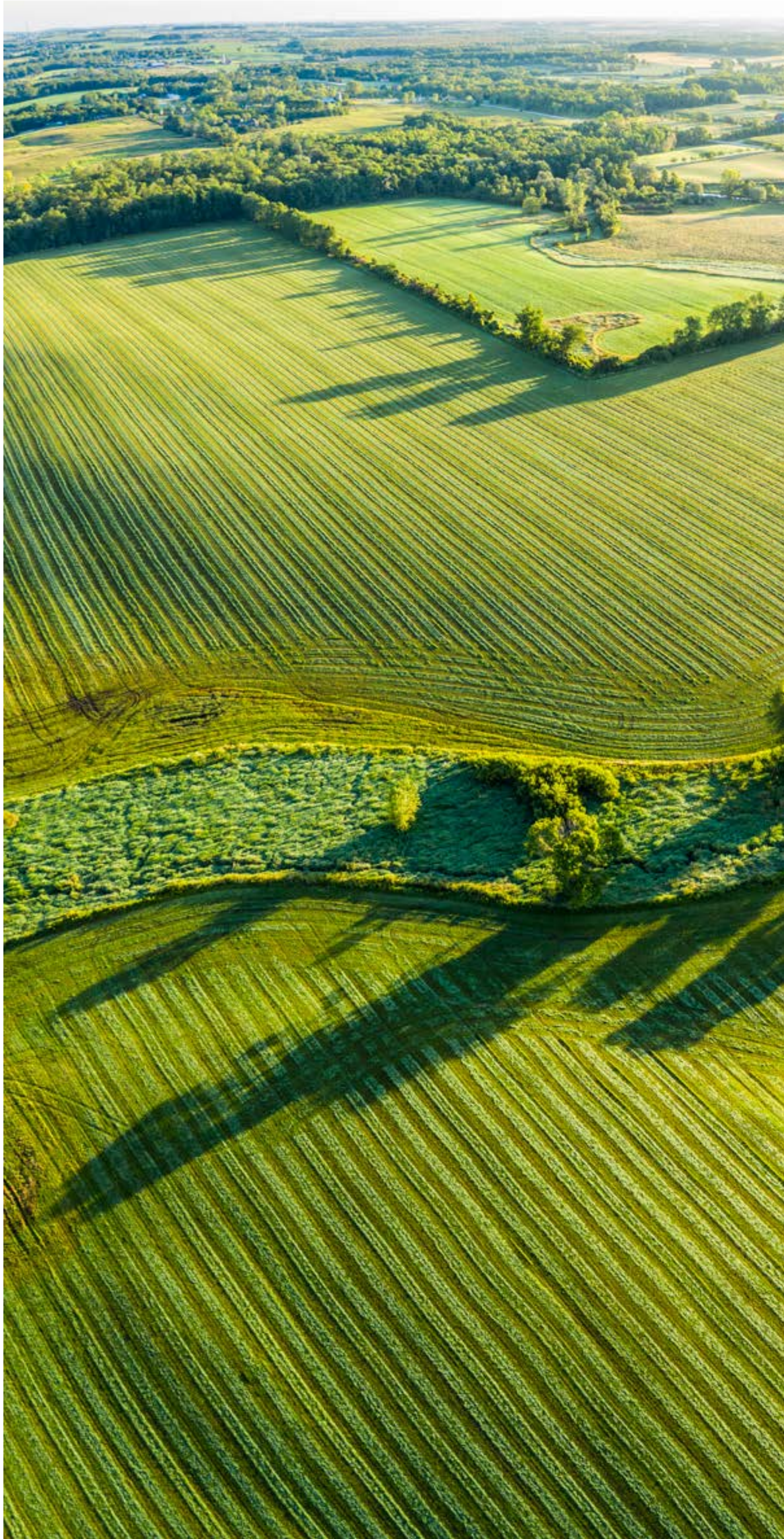


10 TAKEAWAYS

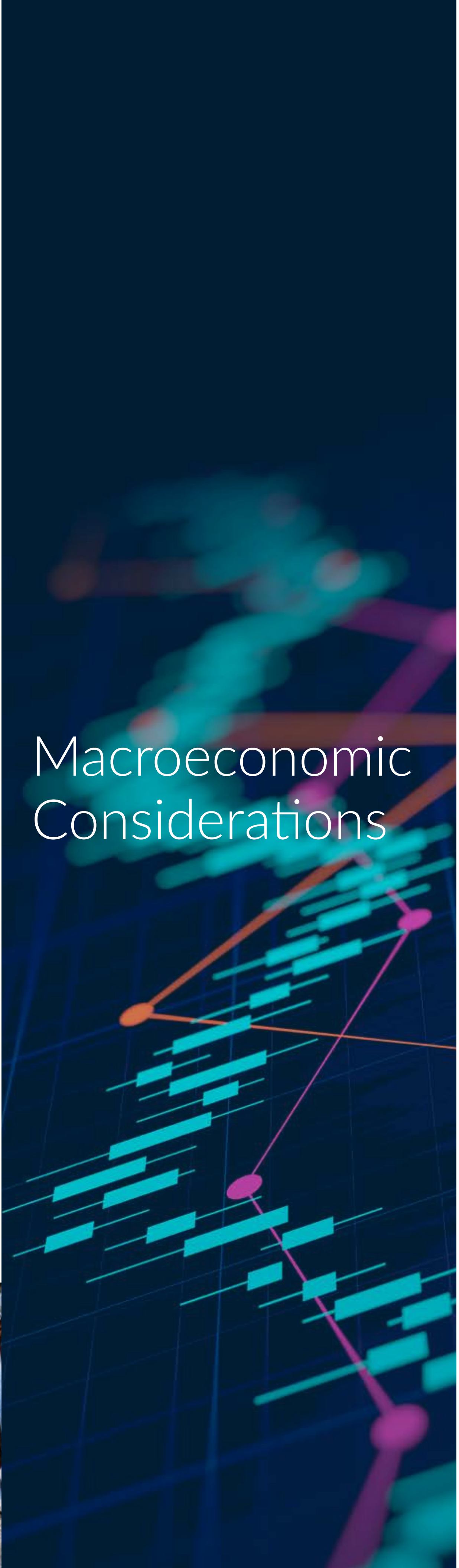
The American Banker Association's Ag Bankers Conference

I recently attended the American Banker Association's Ag Bankers Conference in Oklahoma City. (Side note – if you are ever in OKC, you need to take in and tour the Oklahoma City National Memorial and Museum, the site of the 1995 bombing that claimed 168 lives. It was an emotional and moving place to visit.)

The ABA event was a terrific gathering of about 400 ag lenders from across the United States, and a great way to get a feel for what's really going on in the ag lending world. Here are a few takeaways from the conference and from my interactions with bankers:

1. **Overall, the 2023 crop was very good.** The comment heard over and over again was the crop "was better than expected." Good genetics are getting most of the credit.
2. **AI in agriculture was a big topic.** Now, to some of us, AI once meant artificial insemination, but in today's world it of course means artificial intelligence. Discussions touched on what it all means, what it can do, what it can't do and to beware of unintended consequences.
3. **The overall outlook was pretty optimistic, especially with Midwest bankers.** 2024 will see headwinds and significant margin compression, but overall, the ag sector is financially healthy, with the best financial times, at least for a while, being in the rear-view mirror. There are no real credit issues on the horizon with a fair amount of financial runway before any major credit problems occur.
4. **Interest rate increases are a concern.** The increases haven't really impacted the producer all that much yet – but they will.
5. **It's the best of times in the cattle business** – especially for cow/calf producers, and good for them. They deserve prosperity after several challenging years. The general thought is there should be strength in this area for some time, assuming the general economy doesn't tank.
6. **Hogs and dairy areas need to be watched closely.**
7. **Land values have likely peaked,** despite some recent high land sales that are viewed as outliers. Some retraction is possible, but not a lot.
8. **Regulators expect solid credit administration and farm/collateral inspections.** Don't get complacent.
9. **Liquidity in the banking system is being watched closely** – especially as some of producers' excess cash sitting in banks starts to decline.
10. **There's concern over the continued consolidation in all areas of agriculture.**





Macroeconomic Considerations

China seems to be in an economic mess these days, with low economic growth, commercial and residential real estate markets that are in trouble, the U.S. decoupling a lot of our reliance, and young adult unemployment over 20%. In addition, challenges that are coming to light with their population demographics and declining birth rates will only exacerbate over the coming decades. It will be interesting to see how they deal with all of these issues. For the U.S., it's a little bit of a double-edged sword, at least in the short run.

With the farm bill expiring at the end of September, Congress has extended the current bill for another year. In recent years, there seems to have been limited interest in farm bill details. As long as profits were there, crop insurance was left alone and huge ad hoc disaster government payments were coming, there was little interest or concern. So what does a future farm bill look like? For one, there's likely no new money. Additionally, the reality is only about 16% of the U.S. House represents a district considered rural. Further, nearly 150 members of the House and 17 members of the Senate have never voted on a farm bill before. It's getting harder and harder to educate members of Congress and get agriculture's voice heard in Washington, D.C.

There are still a lot of job openings for those who want to work. Many producers and agribusinesses are dealing with worker shortages as well, but that may be changing as the job market is starting to find a more normal equalization. More and more large companies are starting to report job layoffs – especially in white collar or management type of positions.

There are still a lot of people who chose to leave the workforce and simply haven't come back. The labor participation rate is almost a better indicator of job market trends than the unemployment rate. Recent data shows that trend may also be improving.

Interestingly, about two-thirds of Americans say they're living paycheck to paycheck. Even more worrisome is that 50% of folks earning over $100,000 a year also say they're living paycheck to paycheck. That's probably a reason that a reported 25-27% of 25- to 34-year-olds are currently living with their parents.

Americans built up a reported $2.1 trillion in excess savings during the pandemic – mainly due to large government stimulus checks. According to the San Francisco Federal Reserve, that's now largely gone. What does that all mean? Well, many Americans got used to living pretty well off of the government stimulus, and when it was gone, it has proved to be challenging to go back to living on what they were actually making before they received all the government money. It's probably a big reason that 37% of Americans say they lack enough money to cover a $400 expense without credit, family help or selling something.

No doubt, for many, with basic family needs becoming more and more expensive, making ends meet is a huge challenge. As a result, the amount of credit card debt is rising rapidly as many families are putting their living expenses on that little plastic card. The New York Federal Reserve recently reported that credit card balances now exceed $1 trillion – at very high interest rates. As we all know, there comes a day of reckoning to all of this, and it's maybe not a good plan to think the government will always be there to bail everyone out. At some point, as tough as it is, individual financial understanding and responsibility need to come into play.

SPOTLIGHT: RICK STECKLER

A Career in Agribusiness Lending Started with a Trip to the Bank

One day when Rick Steckler was around 10 years old, he joined his dad for a meeting with his dad's banker. It was in the fall of that year, and his dad had payments to make to the banker, named Fred, after selling his calves and crops at the end of the season.

After the meeting, as Rick and his dad walked out of the bank, Rick remembers his dad saying to him, "You're pretty good at math. You should get a job like Fred's when you grow up – you'd be able to get out of the office to make farm visits."

Now, decades later, Rick is nearing the end of a long career in agribusiness lending and community banking. Bell Bank's Wahpeton, N.D., president, Rick is planning to retire in early 2025 after nearly 43 years in banking and 17 years with Bell – a rewarding career that found its roots in that early remark from his dad.

A CHALLENGING START

Rick didn't always plan on going into banking. He studied ag education at North Dakota State University, and was planning to go into that field when, in the spring of 1982, he saw a posting for an ag banking representative position. With his dad's comment in the back of his mind, he decided to interview for the role, and after being offered the job, changed his career plans.

It was a tumultuous time to enter ag banking. The prime interest rate was around 21%, which severely impacted the finances of farmers and ranchers.

"The very first ag loan I ever made was at 18%," Rick said. "And on top of that, land values were going down, farm equipment values were going down and farmers' net worth was decreasing."

And if that wasn't enough, the area was going through a dry weather period, Rick recalls, leading to lower crop yields.

Because of all those conditions, Rick found himself at only 22 or 23 years old needing to have serious – and difficult – conversations with farmers many decades older than him.

"Somehow, I had to tell them what they were doing wasn't working or maybe they needed to try something different," he said. "Trying to deliver bad news to them wasn't easy."

In that rocky beginning to his career, Rick drew on his own experience growing up on a farm and ranch to empathize with his customers.

"Being raised on a farm, I know that farming isn't just a business, it's a way of life," Rick said. "In any interaction with customers, I've always tried to be a good listener, to put myself in their shoes, and to help get them to a common goal."

Even in situations where Rick has had to turn down a loan request, he's always made an effort to thoroughly explain his decision and why he's making it.

"As a community banker, a lot of your customers are members of your church, or you may see them at a school sporting event or at the local café," Rick said. "It's never easy to turn someone down, but I've always tried to help my customers understand the situation and any steps they can take to work through it or other options they could consider."

THE IMPORTANCE OF RELATIONSHIPS

Amidst the enormous changes Rick has seen throughout his career – from advances in farm technology to improved crop productivity – the human element in community and agribusiness banking has remained constant. That's especially evident in Rick's customer relationships that have expanded through multiple generations.

"What has been very satisfying is when that second or third generation comes in, and they say, 'I want to start farming and my dad told me to come and see you,'" Rick said. "It is so gratifying and humbling to know that they have trust and faith in you to allow you to work with that next generation. You can't ask for anything more than that."

And that shows how those customer relationships still matter as much today as they did when Rick started his career.

"What hasn't changed over the years is you still need to get to know your customer, and your customer still needs to get to know you," he said. "That's all as important today as it was 40 years ago."

And, as his dad said, being pretty good at math helps too.

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>
> \- Rick Steckler

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Joe Watzke
218.291.3310
Moorhead, Minn.


Jeff Stanislawski
218.205.0201
Pelican Rapids, Minn.


Rick Steckler
701.672.8601
Wahpeton, N.D.


Katie Grant
701.298.7031
Fargo, N.D.


Jerry Polejewski
218.998.5603
Fergus Falls, Minn.


Jason Bauer
218.291.3309
Moorhead, Minn.


Matt Schenck
218.486.8811
Hawley, Minn.


Bryan Kellerman
320.759.8414
Alexandria, Minn.


Jared Oachs
218.291.3311
Moorhead, Minn.


Jerry Arneson
218.291.3307
Moorhead, Minn.


Nate Hunter
218.844.8318
Detroit Lakes, Minn.


Brett Starr
218.592.4008
Pelican Rapids, Minn.


Nathan Berseth
701.298.1586
Fargo, N.D.


Don Lacey
218.998.5602
Fergus Falls, Minn.


Kelly Hubrig
701.672.8617
Wahpeton, N.D.

www.bell.bank

Lynn Paulson

Lynn is Bell's director of agribusiness development. He writes and speaks about agricultural lending and finance, the global economy and the ag economy.

He has expert knowledge of the ag industry, having worked in ag lending for more than 30 years and as a retired owner and operator of a Benson County, N.D., family farm. His banking experience includes merging several banks and holding companies and growing the new company to $600 million. He has also served on various financial boards.

You can reach Lynn at 701.298.7138 or lpaulson@bell.bank