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Brain H. Schmiesing
South Dakota State University

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Editor: Donald C. Taylor

Economics Department SDSU, Box 504A Brookings, SD 57007 Tele: (605) 688-4141

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Brian H. Schmiesing
Assistant Professor
Grain Marketing and
Agribusiness Management

During January 1987, the SDSU Economics Department conducted its third South Dakota Agricultural Lender survey. Declining input costs, strict cost controls by producers, favorable conditions in the livestock sector and government payments appear to have enabled many agricultural producers to decrease their total debt levels during the past year. South Dakota lenders also indicated that a higher proportion of their loan customers could be classified as representing a "superior" or "good" credit risk. The diversity of South Dakota agriculture was again evident in the economic trends for the three regions specified in the analysis.

In this newsletter, the findings of the 1986 South Dakota Agricultural Lender survey on the financial condition of South Dakota agricultural producers are discussed.

Description of the 1986 Survey

In January 1987, a questionnaire was sent to the senior agricultural loan officers of 343 lending institutions in South Dakota. Included in the survey were commercial banks, Farm Credit System (FCS) offices and Farmers Home Adminstration (FmHA) county offices. Commercial banks and FCS are referred to as "private" lenders, while "all" lenders includes private agricultural lenders and FmHA county offices.

The survey response rate was 56 percent, with 191 of 343 lenders returning a completed survey. This response rate is slightly higher than that for either the 1984 or 1985 Agricultural Lender survey. The lenders should again be commended for their assistance in providing useful and current information to those concerned and involved with South Dakota agriculture. Without their assistance, this type of research is not possible.

Financial Condition of Producers

The percentage of agricultural borrowers in each risk class reported by the private lenders showed an improvement in quality between November 1, 1985 and January 2, 1987 (Table 1). The improvement was large enough to make the quality reported in 1986 higher than that in either 1985 or 1984. Lenders were asked to indicate the percentages of their borrowers in five credit risk classes ranging from "superior" to "inferior." The percentages of producers in the "superior" and "good" risk categories increased from 34 in 1985 to 41 in 1986. The percentages of producers in the "average" and below risk categories declined. However, the inferior risk class only declined from 9.4 percent to 8.0 percent.

West River Shows Major Improvement

The 1986 Agricultural Lender survey shows the distribution of borrowers across risk classes to differ significantly among regions in South Dakota, as it did in 1985. The State was divided into three regions: "West River," and the area east of the Missouri River into the "Northeast" and "Southeast."

In the West River Region, private lenders indicated approximately 60 percent of their borrowers in 1986 to be in the "average" or below risk category. In 1985, 78 percent of their borrowers were in these risk categories (Table 1).

The Northeast Region had an average distribution of borrowers, where rela-

Table 1: Comparison of the Average Distribution of Producers Across Credit Risk Classes and Regional Differences

Description	Superior	Good	Average	Weak	Inferior
	Percent				
	ALL LENDERS: STATEWIDE ANALYSIS				
A. 1986 survey	16.1	25.2	37.7	13.0	8.0
B. 1985 survey	12.3	21.8	40.9	15.8	9.4
C. Difference	3.8	3.4	-3.2	-2.8	-1.4
	PRIVATE LENDERS: REGIONAL ANALYSIS				
A. West River					
1. 1986	15.3	24.9	37.8	14.8	7.2
2. 1985	8.2	13.5	49.0	18.1	11.3
B. Northeast					
1. 1986	19.6	25.4	31.9	13.1	10.0
2. 1985	14.6	23.4	36.4	16.5	9.3
B. Southeast					
1. 1986	12.2	25.1	44.5	11.9	6.1
2. 1985	10.3	23.6	43.1	14.8	8.4

tively large proportions of borrowers were in relatively strong and difficult financial positions. Forty-five percent were classified in 1986 as being "superior" or "good" credit risks. Yet the 10 percent of Northeast Region borrowers classified as being in an inferior position in 1986 is the highest percentage among the three regions in this category.

In the Southeast Region, a much higher proportion of the borrowers was classified to represent an "average" credit risk. Nearly 45 percent were classified in 1986 as "average" versus 32 percent for the Northeast and 38 percent for West River. Also, the Southeast Region had the lowest proportions of borrowers classified to be in very strong and very weak financial positions.

Debt Reduction Increases

The percentage of producers throughout South Dakota increasing their debt levels was considerably smaller in 1986 (20 percent) than in 1985 (40 percent) (Table 2). In Western South Dakota, 28 percent of the producers increased their total debt during 1986, compared to 53.4 percent last year. This is still higher than in other regions, such as the Southeast, where only 17 percent of the producers increased their total debt in 1986.

An internal inconsistency would appear to exist between the the percent of producers reducing debt levels and the distribution of producers across financial risk classes. The Southeast region had 48 percent of the producers reducing their debt levels and the smallest percentage increase in the borrowers being classified as "superior" or "good" credit risks. However, this region of South Dakota has experienced the steepest and largest decline in real estate values. Even though a producer reduces total debt, the leverage position of the operation may actually increase if real estate values drop by a sufficient amount.

A significant proportion (four-fifths) of the producers in 1986 appear to have generated sufficient net income to reduce or hold constant their total debts. Interest rates for operating loans was one of the input prices that decreased during 1986. The average interest rates charged by private lenders declined by approximately 1.5 percentage points for all borrower risk classes (Table 3).

The positive aspect of this improvement is that a significant proportion of South Dakota producers may now have sufficient net income to buy used equipment and real estate. This may stabilize the prices for these assets, or at least significantly slow the rates of price decline.

Assuming a normal crop, and no major adverse changes in input or output markets, producers and lenders may not have to again experience a major decline of farm asset values in 1987. This would imply that many South Dakota producers

Table 2: Comparison of Percentage Changes in Total Debt by Region and Statewide

Description	West River	North-east	South-east	State-wide
1986	----	Percent	----	
A. Increased their total debt	27.6	19.7	16.8	20.3
B. Decreased their total debt	32.8	37.8	48.0	40.6
C. Held their total debt constant	39.6	42.5	35.4	39.1
1985				
A. Increased their total debt	53.4	37.3	36.0	39.9
B. Decreased their total debt	20.5	26.7	27.0	25.6
C. Held their total debt constant	26.1	36.0	37.0	34.5

would again be able to reduce debt levels and strengthen their balance sheets.

What Will Happen in 1987 and 1988?

Although a moderate recovery may have begun in 1986, it should be stressed that any agricultural recovery is extremely fragile. The debt-to-asset ratio for South Dakota agriculture was 32.1 percent on December 31, 1985. Although eventual estimates of the aggregate leverage level will probably be lower for December 31, 1986, South Dakota agriculture is still extremely vulnerable to an increase in interest rate levels. If the rate of inflation increases in the general U.S. economy, interest rate increases are likely. Increased input prices because of inflation and increases in interest rates would reduce producer net incomes and reduce the value of capital assets such as land.

In 1986 South Dakota agriculture has probably increased in its dependence upon government payments as a percentage of net farm income. In 1985, government payments to South Dakota producers ($232 million) represented 40 percent of the State's total net farm income of $584 million. The expectation would be for this ratio to be higher or constant in 1986 and 1987.

The Food Security Act of 1985 contains provisions for a reduction in grain target prices in 1988. Reduced target prices imply reduced government payments. Current cash rental rates for farmland and land values will likely decline if this

Table 3: The Annual Percentage Rates (APRs) for Agricultural Operating and Real Estate Loans by Private Lenders

Description	Superior	Good	Average	Weak	Inferior
AGRICULTURAL OPERATING LOANS					
A. January 2, 1987	10.68	11.25	11.81	12.57	13.20
B. November 1, 1985	12.21	12.77	13.30	14.02	14.71
C. Difference	-1.53	-1.52	-1.49	-1.45	-1.51
AGRICULTURAL REAL ESTATE LOANS					
A. January 2, 1987	10.39	10.82	11.45	12.34	12.92
B. November 1, 1985	12.25	12.66	13.27	13.79	14.18
C. Difference	-1.86	-1.84	-1.82	-1.45	-1.26

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happens. If market prices for grains do not improve above current levels by 1988, cash rental rates for farmland and farmland prices will probably experience a further decline.

Currently the livestock-to-grain price ratios are favorable. The livestock sector is a cyclical industry. Profitability in the livestock sector encourages production expansion by the red meat and poultry sectors. The issue is not WHETHER a downward price trend for livestock will develop, but rather WHEN will expanded meat production cause prices to decline.

Another threat is from within agriculture. Producers could again aggressively bid up farmland, breeding livestock and machinery prices. These higher price levels could become inconsistent with the long-run outlook for agriculture. South Dakota agriculture could again become vulnerable to a major reduction in asset values.

Unless major changes occur in the fundamental trends affecting the agricultural industry, the current recovery should be perceived as being a temporary lull in the storm rather than the passage of the storm.

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