FINANCING AND SUPPLYING INPUTS TO THE 21ST CENTURY PRODUCER

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Preface

The U.S. agricultural industry is in the midst of major structural change — changes in product characteristics, in worldwide production and consumption, in technology, in size of operation, in geographic location. And the pace of change seems to be increasing. Production is changing from an industry dominated by family-based, small-scale, relatively independent firms to one of larger firms that are more tightly aligned across the production and distribution chain. And the input supply and product processing sectors are becoming more consolidated, more concentrated, more integrated.

Agriculture in the 21st century is likely to be characterized by: 1) adoption of manufacturing processes in production as well as processing, 2) a systems or food supply chain approach to production and distribution, 3) negotiated coordination replacing market coordination of the system, 4) a more important role for information, knowledge and other soft assets (in contrast to hard assets of machinery, equipment, facilities) in reducing cost and increasing responsiveness, and 5) increasing consolidation at all levels raising issues of market power and control.

These profound changes in the agricultural industry present new challenges and new opportunities that require new ideas and concepts to analyze and implement. They require new learning and thinking. Some of those new ideas and concepts are presented here, not as empirically verified truths, but as “thoughts” to stimulate different and better thinking. They have been developed based on observations, analysis and discussions with numerous managers and colleagues in agribusinesses in North America and Europe. This series focuses on Financing and Supplying Inputs to the 21st Century Producer; companion series are also available on Farming in the 21st Century (Staff Paper 99-9), and Value Chains in the Food Production and Distribution Industries (Staff Paper 99-10).

Our purpose in sharing these “thoughts” is to invite discussion, dialogue, disagreement — in general to encourage others to develop better “thoughts”.

Keywords: technology platforms, agricultural finance, marketing strategy, input suppliers, grower segments, financial markets

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Evolution of the Agricultural Financial Markets

The agricultural financial markets are undergoing dramatic changes. The evolution of these markets is expected to involve five phases. Some segments of the market will transition through all of these phases, whereas others will not, but the changes in the competitive environment for most agricultural lenders have been profound in the last twenty years, and the rate of change is not expected to abate in the next twenty. The result of this evolution will be new financial and risk management products, new credit delivery systems, and new competitors.

The first phase of development in the agricultural financial markets is the origination of the traditional agricultural debt service provider. In the U.S., this phase occurred earlier this century with the formation of specific institutions such as the Farm Credit System and agricultural loan division of commercial banks and insurance companies, and the development of unique terms including longer maturities to serve the farm production sector. These institutions and their new financial instruments served the agricultural sector well throughout most of this past century.

For those financial institutions who had the authority to do so, over time a broader set of financial products and services were also offered to farm borrowers including trusts, estate planning, insurance, savings and deposit, and other services. For many commercial banks, this offering of a broader set of financial products and services to farm customers was a logical extension of their charter as well as a response to increased competition in the market. For the Farm Credit System which did not have the regulatory authority to offer broader financial products and services, strategic alliances and other arrangements were introduced to make some of these services available to their customers. This broadened offering of financial products and services to farm borrowers was the second phase of the farm financial market evolution.

In the early 1980s when traditional lenders encountered significant financial losses in their agricultural loan portfolio and became more restrictive in extending credit to farmers, captive finance companies aggressively entered the market. Thus began phase three of the evolution of these markets. This phase was characterized by significant growth in non-regulated financial institution lending to the agricultural sector. Finance companies associated with input supply firms initially entered the market to enhance product sales and meet competition. Captive finance companies used both credit as well as leasing arrangements to deepen the customer relationship and broaden the product service offering in increasingly competitive markets. But many of them found that extending credit or lease financing to farmers could also be a profitable business venture. These profits existed because many of these companies could source relatively inexpensive funds from the commercial paper and secondary markets through securitization; they could use asset based lending and credit scorecarding procedures to dramatically lower the cost of credit extension; and the higher cost and consequently rates of traditional agricultural lenders provided them an opportunity to lend money to farmers at higher rates and profit margins than might occur otherwise.

The agricultural financial markets are now entering a fourth phase of the evolutionary process. This phase is characterized by non-agricultural financial companies such as General Motors Acceptance Corporation Mortgage Division, and other non-regulated, non-agricultural finance companies entering the market to serve the sector. In some cases financial institutions are considering total financial services to include equity as well as debt capital. This phase also includes the more complete integration of the financial and risk management markets with traditional lenders frequently requiring and selling insurance products as part of the financial products-service package. And in some cases financial service and risk management providers have been integrated into single institutions such as the merger of Travelers Insurance Company with Citibank to form Citigroup.

The fifth and final phase of the evolution of the financial markets for production agriculture is just now unfolding in the form of a broader integration of the input, finance, risk, and product markets. Companies such as Koch Industries and Cargill are experimenting with product service offerings to farmers that include an optimized set of fertilizer, seed and chemicals; the financing to acquire this optimized input bundle; a risk management program including product warranties, options and forward contracting arrangements, and insurance products; and finally a contract or other arrangement to buy the finished product from the producer. Thus, financing is integrated as part of a total product/service bundle — a total systems solution. And in this arrangement the product flow relationship is dominant and is used as a carrier to provide the risk and financial services components of the package.

This final phase of evolution of the financial markets to be part of a total product/service package offered by value chain integrators has the potential to profoundly change not only the financial markets for production agriculture, but also the entire relationship that farmers have with their financial services provider. In essence, the once dominant relationship of the lender with his farm customer would be replaced by a dominant relationship between the farm customer and the value chain integrator.