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Rabobank's Offer to Purchase Farm Credit Services of America – A Case Study

Cole R. Gustafson*

The entire world of agricultural finance shook July 30, 2004, when Rabobank announced its offer to purchase Farm Credit Services of America (FCSA) for $600 million. The offer was such a surprise because few people ever envisioned: 1) fragmentation of the Farm Credit System and/or 2) a foreign lender gaining large market share of U.S. agricultural financial markets.

Although FCSA formally rejected the offer on October 19, 2004, the action generated intense public debate about cooperative dividend policy, capital adequacy standards, government sponsored entity (GSE) status of the Farm Credit System, and credit gaps in rural America.

The following discussion provides a brief overview of FCSA, Rabobank, and motivation for the purchase offer. Next, the actual deal and timeline for implementation are described, had the offer to buy been accepted by FCSA. Finally, lingering issues raised by the offer are discussed. These issues will likely be important topics of deliberation in forthcoming federal farm and agricultural credit program legislation.

Farm Credit Services of America (FCSA)

FCSA is the second largest association in the Farm Credit System (FCS), an 88-year old, $117 billion nationwide network of agricultural lending institutions, dating back to 1916. The federally chartered, but privately-owned cooperative lender was created to alleviate credit gaps in rural America. At the time, farmers had few financing options and great difficulty obtaining reliable and fairly priced credit.

At the time of the offer, FCSA had 57,500 customers in the four-state region where it operated (IA, NE, SD, and WY). FCSA had total assets of $7.8 billion. Financially, it was one of the strongest associations within FCS as it had earned $114 million net income in 2003 and retained $1.3 billion in equity capital at the time of the offer.

FCSA's strong financial position was part of the reason existing directors considered Rabobank's offer. As a cooperative, existing directors felt that some of FCSA's equity capital was theirs and should have been paid out in the form of patronage dividends. FCSA had a policy of retaining all earnings and not paying dividends. In addition, existing directors were interested in being provided with a broader set of financial services, especially in the area of risk management and export finance. Producers in the region are undertaking more value-added activities, many of which involve exports and require letters of credit and foreign currency. Some existing directors also felt that Rabobank could increase financial efficiency of FCSA through greater economies of scale and scope.

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Rabobank

Rabobank is also a cooperative lender with agricultural roots dating back to the 19th Century in the Netherlands. At present, it has 9 million customers worldwide with offices in 34 countries. Total assets exceed $500 billion. Rabobank is considered one of the world's strongest financial institutions. In fact, it is the only financial institution to be rated AAA by both Moody's and Standard and Poor's.

Although Rabobank had always had a sizeable portfolio of agricultural loans in Europe, it made a corporate decision roughly a decade ago to expand agricultural lending operations worldwide. Table 1 summarizes the steady entry and expansion of Rabobank's agricultural lending in select countries.

Table 1. Worldwide Expansion of Rabobank's Agricultural Lending

Agribusiness Lending	
Australia	1994
New Zealand	1998
Alberta, ATB	2001
California	2002
Iowa, Agriculture Services	2003
Poland	2004
MN/ND Red River Valley	2004

To illustrate the commitment Rabobank has when entering a new market, consider the map of Rabobank's present agricultural lending operations in Australia as shown in Figure 1. The size and strength of Rabobank's financial base permitted rapid expansion across the country in a time span of less than a decade.

As a formidable competitor, many wonder how quickly Rabobank's expansion in the United States will occur. Historically, Rabobank has been a major financier of agribusiness at the wholesale level. It is one of four major agribusiness lenders (Cobank, Harris, and U.S. Bank being the others) that operate at the national level and provide credit through sophisticated loan participation and syndication arrangements. Because of the magnitude of lending risks involved, lenders to agribusiness rarely retain whole loans in their portfolios, but instead choose to partner with other firms in an effort to spread and diversify lending risks. As in other markets and countries, Rabobank is highly regarded as both a lender and agribusiness lending partner.

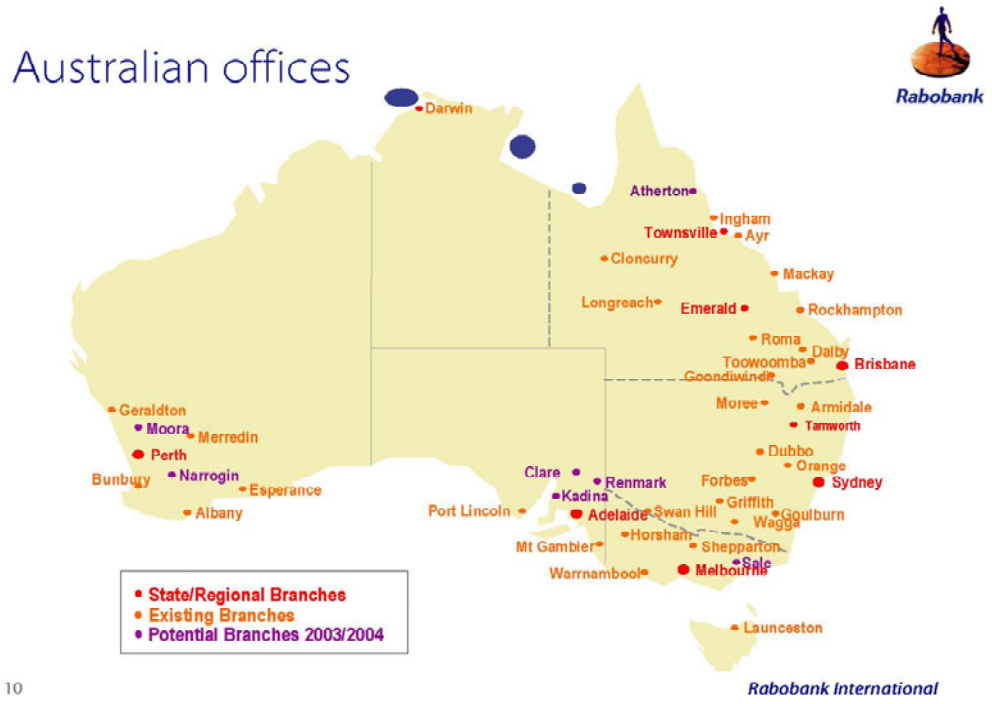

Figure 1. Rabobank's Present Agricultural Lending Operations in Australia

In many regions of the United States, Rabobank was already increasing direct loans to farmers at the retail level, even before its announcement to buy FCSA. For example, in the Red River Valley of Minnesota and North Dakota, Rabobank has been lending to some of the area's largest and most creditworthy farmers for several years. But, a distinct change in Rabobank lending activity was noticed in spring 2004 when it became much more active in expanding retail agricultural lending operations. For the first time, Rabobank advertised its agricultural lending programs in local farm papers and tradeshows in an effort to solicit additional agricultural loans.

In addition to its sheer financial strength, Rabobank is able to rapidly gain market share because of the unique financial products and services it provides customers. Moreover, Rabobank offers a full range of risk management products to farm customers in addition to traditional farm loans. Some of these products are derivations of unique loan provisions offered to agribusinesses that provide interest rate caps/spreads, warrants, and options. Although not permitted in the United States due to more strict regulation of financial institutions, Rabobank does offer commodity risk management (hedging, options) and insurance products in other countries. International financial services such as letters of credit and exchange rate management are also available. Finally, as a full service bank, Rabobank offers a full range of deposit, saving, and investment services. Rabobank's size enables it to quickly develop and

deliver the most progressive financial services, including electronic data processing, payroll, and point-of-purchase programs.

Rabobank also has a strong commitment to both its customers and the communities where it operates. Other than a few senior managers, Rabobank has a commitment to hiring local management and staff when it establishes operations in a new region. Moreover, profits earned reside in that area and are not siphoned off overseas. A final indicator of commitment relates to growth and education. As a cooperative, Rabobank realizes that it is only as strong as its customers. In order for it to grow and develop, its customers must do so likewise. Therefore, Rabohank has instituted formal programs of educational development for its customers. In Australia, for example, farm customers attend a one-week course before their production season begins and select a year-long project. Through the year, customers work on their selected project and then report findings during a second one-week course at the end of the season.

FCSA directors had keen interest in Rabobank's range of financial services and borrower commitment. Given Rabobank's interest in gaining U.S. farm lending market share, both parties had mutual interest in the deal.

The Deal and Timeline

Rabobank's offer to buy FCSA can be summarized in three points. First, Rabobank agreed to purchase FCSA for $600 million and then distribute the proceeds to existing and previous customers who had patronized FCSA in the past five years. Second, Rabobank would pay an exit fee of approximately $800 million to Farm Credit Administration (FCA), the regulator of FCS. By statute, this fee must be paid in order for FCSA to depart the system. Finally, Rabobank would assume all assets and liabilities of FCSA and payoff all outstanding FCS liabilities.

It is no coincidence that the sum of the exit fee paid to FCA ($800 million) and amount distributed to FCSA shareholders ($600 million) approximately equals total equity capital of FCSA. In other words, FCSA's existing equity capital base would have been paid to existing shareholders or used to pay the required exit fee. Essentially, Rabobank is simply acquiring FCSA with no direct payment or payment for goodwill or surplus embodied in FCSA.

Rabobank announced this offer on July 30, 2004. On August 3, 2004, FCA received a resolution from FCSA directors requesting termination. Next, after a 30-day wait-period, FCSA would have proceeded to submit a plan for termination to FCA. This plan was never written. Therefore, the process of terminating FCSA was never initiated.

Had the letter been written, FCA would have calculated the specific amount of the exit fee to be paid and then decided whether or not to let FCSA depart FCS within 60 days. If FCA approved the request, an information packet disclosing specifics of the deal would have to be provided to FCSA shareholders 30 days prior to voting, and the actual vote must occur within 60 days of the FCA decision. If the vote to exit FCS was approved, FSCA would terminate operations in 90 days. However, a unique clause permits reconsideration of the shareholder vote.

If more than 15 percent of shareholders disagree with the outcome, they can file a petition for reconsideration which would lead to a re-vote.

As word of the offer spread, two competing bids for FCSA were formulated. The first was a $2.5 billion offer tendered by AgStar, another FCS association headquartered in Mankato, MN. The second offer was being organized by a dissident group of former directors, but never formally conveyed.

The Outcome

Initial public and private reaction to the buyout offer was quite negative. All remaining FCS associations including CoBank condoned the offer. The U.S. House Agriculture Subcommittee held a hearing on September 30, 2004, to obtain more information on the issue. Had the deal proceeded, regional Congressional hearings were being proposed to provide more input on the issue. A website (http://www.rabobankbuyout.org) was created to inform and aid FCSA stockholders in the analysis of their decision.

In order to sway FCSA directors, Rabobank sweetened its buyout offer by raising the amount dispensed to stockholders from $600 million to $750 million. However, this was not enough to counter prevailing stockholder and public sentiment. Stockholders were concerned about the viability of the entire FCS, questioned Rabobanks commitment to dividends given that it does not pay patronage dividends at present, and felt the purchase price was still too low. Therefore, FCSA directors voted to reject both the Rabobank and AgStar offers on October 19, 2004, noting that, "the increasing likelihood that approval for the transaction would be delayed" and because of the risks faced by FCSA because of the delay.

In response to the Rabobank offer, FCSA directors adopted a number of reforms including adoption of a dividend policy. An initial $55 million would be distributed based on 0.75 percent of eligible customers' 2004 loan and lease balances in early 2005.

On Thursday, November 4, 2004, FCSA's board announced that president and chief executive, Jack Webster, resigned in the aftermath of the failed Rabobank deal. He was a strong proponent of the offer.

Issues for Discussion

The resulting outcome leaves a number of unanswered questions for Rabobank, FCSA, and the general public. Rabobank will now have to re-evaluate its decision to expand U.S. farm lending operations and reformulate a strategy if the decision is to continue. FCSA will have to mend a deep internal rift between stockholders who were for and against the buyout offer. Implementation of the new dividend policy and operational reforms will require development of policies that balance stockholder interests with safety and soundness of the institution.

In addition, the buyout offer raises a number of public issues:

FCA Departure Criteria – If FCA would have received a request from FCSA to depart FCS, the decision would have been based on the following criteria (according to FCA policy): Would departure of FCSA "*materially adversely affect*" the rest of FCS? The departure of FCSA could have potentially adversely affected FCS in several ways. First, FCS obtains favorable costs of funds on Wall Street in part because of the volume it brings to the market. Since FCSA was FCS's second largest association, loss of bond sales supporting this volume would probably have resulted in increased funding costs for remaining FCS associations. The amount of increase is an empirical question that would need quantification to determine if it were *"material."* Second, agriculture in the FCSA region is unique and provides important diversification and risk balancing opportunities to FCS. FCS has been able to overcome past periods of financial difficulty by drawing on the diverse strength and political support of regional associations.

FCA Timeframe - Many observers felt FCA's timeframe for making a decision was too short given the complex analyses required. FCA and South Dakota congressmen both sought extensions. Although ample time is required to assure complete determination, this must be balanced with responsiveness to stockholders requesting departure. The timeframe selected must avoid the possibility of delay in less complex requests where the analysis can be streamlined.

Domino Effect – If FCA had determined that FCSA's departure from FCS did not materially adversely affect the rest of FCS, at what point would effects occur? Even though all remaining FCS associations disavowed the buyout, it is not inconceivable that circumstances could arise in the future leading to another association requesting departure.

GSE Status – As a GSE, FCSA and the entire FCS are both regulated in the breadth of products they can offer. For example, they are unable to collect deposits or originate loans in towns with population exceeding 2,500. Moreover, FCSA faces a geographic boundary also, its four-state territory of operation.

It is likely that FCS and FCSA will both request greater operating flexibility in terms of financial services offered and geographic territory in order to strengthen the system and insure against take-over bids in the future. However, other competing financial institutions, namely commercial banks, state that FCS needs to be more highly regulated as they are so strong financially at the moment that they are garnering the interest of private-sector financial institutions. Originally, FCS was created to fill credit gaps in rural America, not to compete with other lenders.

Capital Levels – At the time of the buyout, FCSA had 16 percent capital ratio (equity capital/total assets). This capital ratio is relatively high for a financial institution. From a safety and soundness perspective, high capital ratios are desirable. Regulators and most stakeholders view capital positively. High capital ratios enable financial institutions to weather periods of economic adversity.

Some FCSA directors, however, felt they had a claim on a portion of FCSA's capital base. Since FCSA's capital base was comprised primarily of retained earnings, they felt that a portion of past retained earnings should have been paid out historically as patronage dividends, since FCSA is a cooperative. The number of FCS associations paying dividends has increased from 17 to 63 percent in the past decade. Dividend policies of FCS associations will require careful scrutiny in the future in order to balance safety and soundness with stockholder preference for income.

Distribution of Rabobank Proceeds – Originally, Rabobank had proposed to distribute $600 million to existing customers and those that have patronized FCSA in the past five years. An important question is why the distribution was limited to recent patrons? Why not pay a portion to those who patronized FCSA 6, 20, or 50 years ago? Surely, they have some interest in this payout. Again, the capital base was created primarily from retained earnings that have accrued *over the entire life* of the institution.

A second question is whether or not this distribution creates an incentive problem of self-interest. Would FCSA shareholders approve Rabobank's offer for the sole purpose of pocketing cash without considering what is best for the institution?

Moreover, does the federal government have an interest in the distribution? Some argue that since FCSA is a GSE, part of the proceeds should be returned to the federal government. The level of FCSA's retained earnings and capital would have been considerably less had FCSA not been able to borrow at below-market interest rates through the FCS's Funding Corporation.

Exit Fee Payment – A group of former FCSA directors challenged the buyout offer and felt that Rabobank should use its own funds to pay the FCA exit fee instead of raiding FCSA's capital base. In principle, they felt a buyer should be responsible for paying the required fees, instead of the institution being overtaken. Had this occurred, the entire capital base of FCSA would have been available for distribution to shareholders. FCSA president Jack Webster has stated that FCSA capital should be viewed as unallocated reserves, and the directors can choose to allocate them as they wish.

Filling FCSA's Void – Had the buyout occurred, FCS would have had to re-establish operations in FCSA's vacant territory. FCS has a national charter and is obligated to serve the entire nation. If it chose to do so, part of the exit fee collected by FCA could be used to re-establish operations. However, which FCS associations should be eligible for the territory and/or funds? In addition, what quality of loans would remain if Rabobank were to cherry-pick and retain loans of this highest quality? The viability of a new FCS association in the territory would be questionable if its loan portfolio consisted primarily of marginal credits. Philosophically, would any credit gaps remain in the former FCSA territory that would warrant the presence of a GSE lender?

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