Niche Lending in Agriculture

by Charles B. Dodson and Steven R. Koenig

The century-long consolidation of U.S. farm production will continue well into the next century, shrinking the farm customer base for lenders and changing the demand for agricultural credit. The greatest changes in agricultural credit are in production financing, especially for enterprises, like hogs, that are experiencing the most consolidation. The effects of structural change on farm mortgage credit is more gradual because farm ownership changes at a more moderate pace.

Despite past consolidation, a diverse group of nearly two million farmers remains. Farm operators range from the small or part-time to large integrated farming operations with annual sales in the millions. The diversity of farm operations suggests niches exist with unique needs and varying potential for lending growth or decline. Understanding these niches will help lenders develop profitable farm lending programs, especially as technological changes and regulatory reforms transform rural credit delivery.

Using averages from USDA's Farm Costs and Returns Survey (FCRS) for 1991-93, we identify 15 mutually exclusive lending niches. These niches are categorized by measures of farm sales, net worth, nonfarm income, and operator age (Table 1). Farms were first categorized into small and commercial categories.

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Included in the small category were all farms with less than $50,000 in annual sales and farms with $50,000-100,000 in sales where the operator's primary occupation was not farming. All remaining farms were classified as commercial. Within these broad groups, operators were then classified by either net worth or off-farm income and finally by operator age.

The 15 niches were then assessed on their credit needs, credit risk, and lending competition. The data measures farm business term used for farm purposes and excludes landlord debt. This represents about 60% of total outstanding farm debt as reported by USDA.

Financing Small Farms

Small farms, those with under $50,000 in annual farm sales, makeup nearly 1.5 million of the 2 million U.S. farms. While they represent three-fourths of farms, they account for only 10% of total annual farm sales. To some, this minimal production suggests that small farms are poor prospects for farm loans or financial services. Our analysis suggests otherwise, because these farmers still own over half of total farm assets and owe 29% of total farm operator debt, much of which is for real estate purposes (Table 2).

Within the small farm group exists market niches with good off-farm incomes (greater than $15,000) and excellent credit risks. Two such niches are the "Country Gentlemen" and the "Part-timers," which together owe a fifth of total farm operator debt. Both groups have low debt burdens and significant off-farm incomes. Country gentlemen average over $80,000 in off-farm income and part-timers average $25,000. These two niches are also attractive because of their large numbers, which total one million – about 400,000 of which have debt.

For many small operations, farming is valued more for its lifestyle than its economic returns. Therefore, nonfarm economic and demographic factors have more of an influence on these operations than farm economic factors. For example, further gains in employment growth of metro

Table 1. Defining Farm Operators

	Off-farm income	Age (years)
Small Farms:[1]		
Subsistence farmer	<$15,000	<60
The American gothic	<$15,000	>60
The part-timer	$15,000-40,000	NA
Country gentlemen	>$40,000	NA
Commercial lifestyle[2]	NA	NA
	Net worth	**Age (years)**
Commercial Farms:[3]		
Large and affluent:		
Corporate farms	NA	NA
Wealthy young farmer	>$500,000	<40
Top producer	>$1,000,000	40-60
The land baron	>$1,000,000	>60
Traditional:		
Aspiring young farmer	$150,000-500,000	<40
The American farmer	$250,000-1,000,000	40-60
The Un-retiree	$250,000-1,000,000	>60
Low resource:		
Struggling young farmer	<$150,000	<40
Troubled family farmer	<$250,000	40-60
The unprosperous retiree	<$250,000	>60

NA = Not Applicable.
1 *Less than $50,000 in annual farm sales.*
2 *Annual farm sales between $50,000 and $100,000 and farming is not their primary occupation.*
3 *More than $50,000 in annual farm sales.*

regions in the Corn Belt, northern plains, and mountain states would contribute to stability in the size of these groups. Already, about 40% of country gentlemen reside in metro counties.

The credit needs of country gentlemen and part-timers tend to be small and irregular, and so credit products and servicing schemes need to minimize fixed lending costs. Average debt owed by indebted country gentlemen is only $65,214 and $42,263 for part-timers. With roughly three-quarters of their total debt being real estate debt, mortgage products are essential to serving these farms. A large share of this debt is for financing the operator's residence. Thus, home mortgages and home/farmland equity loans can be popular products. Only a limited amount of agricultural lending knowledge is necessary to finance these operations because repayment is usually dependent on off-farm income.

If history is any indication of the future, commercial banks may not experience much competition for these customers. During 1991-93, the Farm Credit System (FCS) held only a 15% share of total outstanding farm debt, while banks captured a 50% share (Table 3). Unlike the FCS, banks and other full service lenders might be better equipped to serve these operators because they can offer a full range of financial services.

A similar lending niche is a group we defined as "Commercial Lifestyle" farms. These 40,000 operators have sufficient sales to be commercial farmers (more than $50,000 in annual sales) yet they do not consider farming as their primary occupation. This transitional group tends to cluster in the lake states and the Corn Belt, and unlike small sized farms they have greater non-real estate financing needs.

In contrast to the higher off-farm income niches are "Subsistence Farmers" and "The American Gothic." These operators have less than $15,000 in off-farm income. The American gothic operator is over 60 years old and averages 71 years of age. Over the next decade these 250,000 farms should contribute heavily to declines in total farm numbers. With an average 239 acres owned and $250,000 in farm assets some will need farm management or trust services. Because of limited farm and nonfarm incomes the 150,000 subsistence farmers also are expected to decline in number. Their weak financial condition is evident in that USDA direct lending programs currently supply 28% of their total agricultural credit needs.

Financing Large and Affluent Farms

Net worth and operator age were used to classify the roughly half million commercial farms with more than $50,000 in annual farm sales into 10 mutually exclusive lending niches. The 10 niches were grouped into three net worth categories: large and affluent, traditional, and low resource.

The large and affluent category represents just 5% of all farms, but accounts for nearly 40% of total sales and nearly a quarter of farm debt. With gross cash income topping $480,000, net farm incomes approaching $100,000, significant off-farm incomes, strong balance sheets, and large capital requirements, they are a top prospect for agricultural lenders. The average size of these operations is likely to increase in the future, mostly displacing smaller less profitable farmers. But with only 70,000 indebted operators, owing an average $381,775 per farm, competition among lenders for this group is keen. Unlike other niches, commercial banks and the FCS can face strong competition from life insurance companies and nontraditional lenders for their business.

While these borrowers are top prospects, lenders with limited lending resources, those unwilling to specialize in agricultural credits, and those not offering flexible loan products will not be competitive. Financial services, such as working capital management, estate and tax planning, and investments, may need to be tendered to meet the needs of these borrowers.

Many of these operations produce specialty agricultural products or bulk commodities on a large scale, requiring special lending expertise. Vertical integration into processing or marketing is also more prevalent with these farms. Thus, providing agribusiness financing in addition to farm production or mortgage financing becomes more important. Because of their size, they often can obtain credit from large regional lenders and from nontraditional sources, such as captive finance companies of input suppliers. Also, these farm businesses can cover larger geographic areas presenting additional problems to localized lenders, such as community banks.

The "wealthy young farmer" may be the most desirable niche among the large operator group because their young average age (34 years) suggests they are good candidates for growth. Also, their credit use is sizable, with 75% carrying debt and which averages $333,575 per indebted farm. Another prized target group are the "Top Producers." These operators are older (40-60 years), but are the largest in size with an average of 3,700 operated acres and gross farm incomes in excess of $550,000. Over 69% of these operators have debt, which averages $443,829 per indebted farm. Less than 60,000 farmers are in these two groups.

Large operators over 60 years old were defined as "Land Barons" because, on average, they own over 2,000 acres. With an average age of 67 years and more than half being debt free they are not top farm loan prospects. These 30,000 operators are top prospects for farm management, estate planning, and trust services if a next generation of operators is not present on the farm.

Farm businesses classified as non-family corporate farms are unique in that incorporation of the farm business is the sole criteria for this classification. Therefore, this niche accommodates a range of farm operators. Despite the public image of corporate farming, these farms are small in numbers – less than 6,000. However,

Table 2. Profile of Farm Operator Niches

	Farms	Farm production	Farm assets	Farm debt
		Percent of total[1]		
Small Farms:	75	13	53	29
Subsistence farmer	8	2	5	4
The American gothic	12	2	8	2
The part-timer	31	4	19	9
Country gentlemen	22	3	19	12
Commercial lifestyle	2	1	2	2
Commercial Farms:	25	87	47	71
Large and Affluent:	5	39	24	25
Corporate farms	–	6	1	1
Wealthy young farmer	1	9	5	7
Top producer	2	15	10	11
The land baron	1	9	7	5
Traditional:	14	36	20	33
Aspiring young farmer	3	7	3	7
The American farmer	7	20	11	20
The un-retiree	4	8	6	6
Low Resource:	6	12	4	14
Struggling young farmer	2	3	1	4
Troubled family farmer	4	7	2	8
The unprosperous retiree	1	2	1	2

– = less than 0.5 percent.
Source: 1991-93 Farm Costs and Returns Survey.
[1] Numbers may not total due to rounding.

they are large producers, accounting for 6% of total farm sales. Because of their small numbers and their ability to attract equity capital, corporate farms are not top lending prospects. Only 43% of corporate farms carry debt.

Financing Traditional Farms

Traditional farms total 275,000 and are most likely to fit the public image of the "family farmer." Within this group, three niches were identified using operator age and net worth: "Aspiring Young Farmers;" "The American Farmer;" and "The Un-Retiree."

Most traditional operators are fully employed in their farm operation, but off-farm incomes average $20,000 for the group. Across all age groups, operators are generally financially strong and profitable with most reporting positive net farm incomes. Traditional operators account for a little over one-third of total farm sales and total farm debt. Average annual farm sales are about a third the size of large and affluent operators.

Of all the 15 lending niches, "The American Farmer's" 20% share of total farm operator debt is the largest. Most of these 140,000 operators are financially sound and profitable. Only 1 in 20 of these farm operators were considered to be vulnerable to failure with negative incomes and debt-to-asset ratios greater than 0.40. Consolidation of production, especially in the livestock industry, will likely cause a reduction in their number. Yet, they will remain a solid component of production agriculture for some time.

The financial condition, size of operation, and farm income levels of American farmers and aspiring young farmers are very comparable. But, because of a low average age, the aspiring young farmer niche offers more potential for credit demand. The 60,000 young aspiring farmers own less than half as much farm real estate (about 200 acres). Many of these farmers will demand credit for future farmland purchases, although some might need special financing terms, such as a government guarantee.

The "Un-retirees" are commercial operators over 60 years of age with sufficient net worths to retire, but that continue to operate full-time. Like their richer land baron counterparts they carry less debt, with only 50% owing any debt. Some of these 80,000 farms lack sufficient size to operate economically and will contribute to future declines in farm numbers. With average farm net worths exceeding $500,000 they do represent a significant market for trust and financial services. The FCS has been the primary supplier of credit to un-retirees, holding 37% of un-retiree total debt, perhaps because much of this group's debt was acquired during the late-1970s and early-1980s when the FCS dominated farm real estate lending.

Financing Low Resource Farms

Low resource operators represent the highest credit risk because of low net worths, low farm and nonfarm incomes, and high debt burdens. They account for 6% of operators and 14% of total farm operator debt. This group could experience significant declines in farm numbers and in debt utilization, especially if government support for agriculture falls. USDA direct farm loans account for 26% of low resource operator debt.

Despite their high credit risk, low resource operators have historically provided commercial banks with considerable loan volume. Combined they represent about 13% of all commercial bank lending to farm operators and banks have a 41% market share. It is unclear from FCRS data how much of commercial bank debt is guaranteed by USDA, but it is likely that commercial banks' strong presence in this market is a reflection of high bank use of USDA's guaranteed loan programs.

Two low resource niches that provide volume for banks are "Struggling Young Farmers" and "Troubled Family Farmers." Both groups have high credit demands with over 80% reporting debt. Credit risk is evident with indebted operators having average debt-to-asset ratios above 55%.

Lending to these operators means higher servicing costs and a unique expertise in agricultural lending. To effectively control risk, many require a USDA loan guarantee, increasing needed expertise and overhead expenses. These higher costs might deter some lenders from serving this market. But maintaining expertise in guaranteed lending could also lead to missed opportunities to shore up weak credits during downturns in the farm economy.

Implications for Lenders

Production agriculture is still undergoing rapid change resulting in the consolidation of production agriculture into fewer and larger units and the growth in industrialization of production. These trends will continue well into the next century. This means a much smaller customer base and stable to declining credit demand for traditional agricultural lenders. Lenders will need to adapt credit programs to these changes or risk losing volume and market share. Top producers and wealthy young farmers, because of their strong financial position, economics of size, and growth potential are emerging as the top lending prospects (Table 4). To competitively serve these customers requires a commitment of resources by lenders. However, competition for these credits is intense and many smaller commercial banks will lack the resources to service this clientele.

There has been a strong demand for credit from small "lifestyle" farmers and this market is expected to remain significant. Three small farmer niches that offer small lender opportunities are country gentlemen, part-timers, and commercial lifestyle. These farms have small debt demand per farm, and so credit programs need to minimize delivery cost. Commer-

Table 3. Farm Operator Credit Use

	Share of total operator debt held by: Banks	FCS	USDA	Individuals	Total[1]	Average debt per indebted farm	Farms carry debt	Average D/A ratio[2]
	Percent					Dollars	Percent	
All Farms	40	22	11	14	100	98,285	45	20
Small Farms:	44	19	13	13	100	60,144	36	17
Subsistence farmer	33	14	28	16	100	46,641	38	18
The American gothic	34	38	15*	–	100	46,044	14	12
The part-timer	51	15	11	12	100	42,263	33	15
Country gentlemen	47	16	–	15	100	65,414	45	15
Commercial lifestyle	37	25	18	13	100	90,308	69	20
Commercial Farms:	39	25	9	13	100	218,377	72	24
Large and Successful:								
Corporate farms	44	9*	–	17*	100	413,584	43	28
Wealthy young farmer	33	22	4*	17	100	333,575	75	22
Top producer	39	30	3	13	100	443,829	63	19
The land baron	35	37	1*	14*	100	333,470	46	14
Traditional:								
Aspiring young farmer	40	20	19	17	100	141,844	81	32
The American farmer	39	28	10	14	100	182,721	74	26
The un-retiree	36	37	13	7*	100	163,129	50	23
Low Resource:								
Struggling young farmer	43	7*	34*	10*	100	157,064	88	70
Troubled family farmer	38	16	23	11	100	168,159	80	55
The unprosperous retiree	39	11*	19*	13*	100	168,594	56	56

*– = sufficient data not available. * = Coefficient of variation between 25 and 50 percent.*
Source: 1991-93 Farm Costs and Returns Survey.
[1] Total includes other categories of lenders not listed.
[2] Ratio was calculated for only those farms reporting debt.

cial banks are well-positioned to maintain their dominance in these markets, because of their broad range of financial services and high market shares.

Industrialization of agriculture means a greater reliance of farm operators on vertical integration. Production contracts were especially prevalent among commercial sized lending niches. Currently, almost 30% of all farm production is produced under some form of contract. Growth in contracting often means declining demand for production financing, but could lead to growth in the financing needs of the contracting agribusiness firms. The traditional operators are more likely to feel the impacts of consolidation and industrialization, which is currently happening in livestock production.

The major source of nonequity capital for farmers is not lenders, but landlords. The FCRS data shows that through cash or share rent of real estate landlords supply 3 times as much capital to farmers as lenders. Growing farm firms increasingly are using farmland leasing over ownership to expand production. Thus, a good trust/farm management division could serve as a marketing tool to obtain loan volume.

Commercial banks will also need to be concerned about competition from nontraditional lenders. Merchants and dealers were an important source of nonreal estate credit to commercial farming operations, providing from 6% to 8% of total nonreal estate credit. Merchants and dealers are providing growing competition through leasing arrangements and captive finance companies. Among commercial-sized

Table 4. Summary of market growth, credit risk, and lending competition by lending niche.

	Market Growth	Credit Risk	Lending Competition
Small farms:			
Subsistence farmer	-	+	-
American gothic	-	0	-
The part-timer	+	-	-
Country gentlemen	+	-	-
Commercial lifestyle	+	-	0
Commercial Farms:			
Large and Successful			
Corporate farm	0	-	+
Wealthy young farmer	+	-	+
Top producer	+	-	+
The land baron	0	-	+
Traditional:			
Aspiring young farmer	0	0	0
The American farmer	0	0	0
The un-retiree	-	-	-
Low resource:			
Struggling young farmer	-	+	-
Traditional family farmer	-	+	-
The unprosperous farmer	-	+	-

- = low or declining
0 = stable
+ = high

niches, an average of 20% of all farms reported leasing some machinery. The marketing of leasing services might be an option for some commercial banks. ▲

Additional Reading

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