



## SMARTER PERSPECTIVE: FARM SUPPLY

# Farm Supply Trends and Key Considerations for the Asset Based Financing Professional

By Stephen D'Aquila and Dustin Miller

In this article, we provide a general guide to lenders to assist in evaluating a prospective borrower or existing portfolio account within the farm supply industry.

### INDUSTRY OVERVIEW

The term “farm supply” can cover a broad variety of businesses. It can apply to companies that supply agronomy products, such as fertilizer seed, and crop protectant sales and services, to commercial farms. It can also apply to those that retail farm-related products, such as livestock feed, feed bins and equipment, animal health and veterinary products, fencing, other light farm equipment, and various products farmers require, such as general tools, workwear apparel, etc.

Some farm supply retailers may carry an inventory mix that crosses over into apparel, sporting goods, home goods and lawn goods, pet products, and other products not directly related to farming. Additionally, some businesses identifying themselves as farm supply retailers may in actuality more closely resemble a big-box home improvement store with a rural customer base, such as Tractor Supply Company – a chain with a wide variety of agricultural and livestock



supplies in addition to tools, sporting goods, apparel, and lawncare products. Businesses such as these would be more appropriately understood as retail, with all associated diligence and underwriting also geared toward a retail approach.

For the purposes of this article, we will primarily focus on farm supply understood as companies generating a material portion of their revenue through the sale of products and services intended for commercial farmers.

As a competitive industry, there are typically several competing farm supply companies offering any number of particular products or services in a region. Some companies focus on one specific product or area, such as fertilizer or seed, while others offer a one-stop shop approach intended to meet all of a farmer's various needs. Companies

operating in this space can range in size from national distributors to small, regional cooperatives. Some may offer a wide suite of services, such as in-depth soil testing and application of products using heavy farm equipment, which individual farmers may not own themselves, while other companies may operate strictly as distributors of agricultural products.

Farm supply businesses generally engage in some form of hedging in relation to commodity products, such as fertilizer and seed, to protect themselves from significant shifts in commodity prices. These strategies may include actual hedging contracts with financial firms, but more likely include prepayment or deposit programs with vendors to lock-in prices for future dates. Prepayment programs generally come with a discount, which can vary

depending on the product and how far in advance the prepayment is made. Farm supply businesses generally offer customers discounts to prepay for products to lock-in pricing as well, and try to balance vendor and customer pricing agreements as much as possible to minimize the impact of market swings on their profitability. Both vendor and customer prepayments typically begin in the late fall for products related to the following spring planting season.

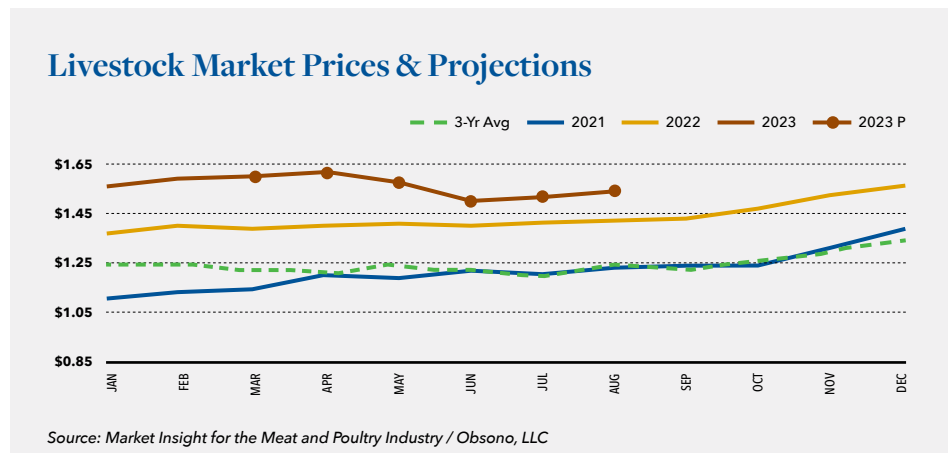
The performance of the farm supply industry depends on both demand from the agricultural sector as well as the price of agricultural inputs. Most importantly, fertilizer and animal feed prices are major determinants of industry performance and market dynamics. These, in turn, are impacted by oil and natural gas prices, which impact both the production cost and transportation cost of these products. The COVID-19 pandemic caused increased volatility in fuel and other input costs, and a generalized increase in agricultural commodity prices from 2020 through 2021. Fertilizer prices experienced volatility in 2022, with no major net increase, and have decreased during the first quarter of 2023. Prices for livestock, which are a major factor in driving demand for animal feed, have increased steadily from 2020 through early 2023.

## DUE DILIGENCE

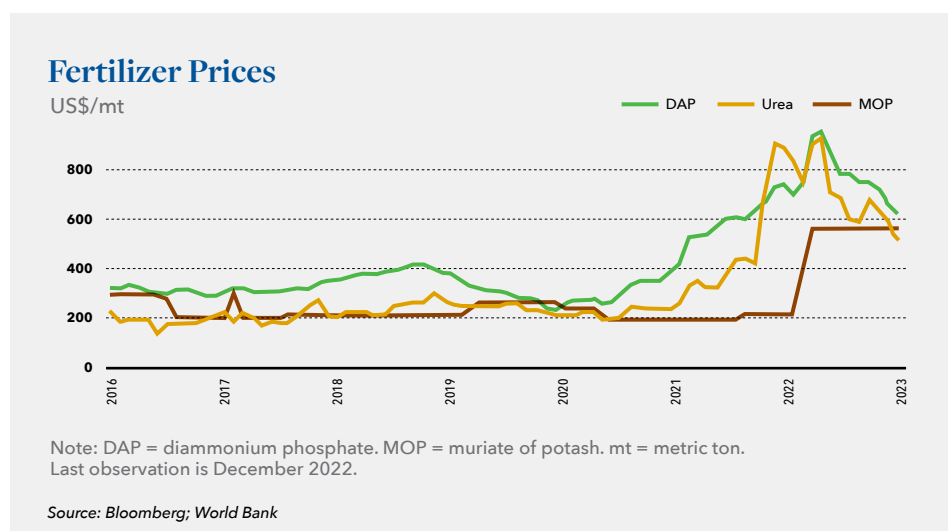
**Below are a series of recommended discussion topics that should be thoroughly explored as part of a farm supply business diligence process:**

### Nature of the Business

It is critical to understand the specific nature of the farm supply business as early as possible in the diligence process. Is it, for example, a high-volume distributor of agronomy products to commercial farms? Perhaps, instead, it is a big-box or hardware store-adjacent retailer targeting rural demographics with significant amounts of home improvement, apparel, and sporting goods inventory, in addition to lighter



**Livestock prices are projected to continue increasing in 2023. Livestock prices are a major factor in driving demand for animal feed.**



**With the exception of MOP which has remained relatively flat, fertilizer prices have been on a declining trend in recent months after more than doubling since 2020.**

amounts of farm-related products. The fact is that many companies offer a mix of these commercial and retail components. Understanding the concentrations in these areas of a farm supply business early in the process will help direct the diligence process to further explore relevant topics. Farm supply businesses that fall into the latter category of being a retailer adjacent to a big-box or hardware store would be more subject to typical retail diligence concerns, and less subject to the farm-specific factors discussed in this article.

### Sales Seasonality

Lenders should have a general

understanding of the company's sales seasonality. Key areas include understanding what crops are being grown in the regions served, what the planting seasons are for those crops, variation in planting season between different geographic regions and crops served by the company, weather factors that may impact the timing of the planting season, and what types of crop applications and other products farms require throughout the growing season and into the harvest season. It is also important to understand what the company's sales mix is between agronomy products, which will be highly correlated to this seasonality,







Many, but not all, business described as "farm supply" generate a material portion of their revenue through the sale of products intended for commercial farmers.

and livestock and other farm supply products, which may not correlate to the planting season and may even show seasonality contrary to the crop cycle.

### Inventory Seasonality

In relation to the above point, it is important to understand the company's methodology for building inventory leading up to the high season and selling it through during the high season, particularly with agronomy products. It is also important to understand what the inventory trend is for any other products that exhibit sales seasonality. Many farm supply products have seasonal demand. If a company reaches the end of the high season with elevated product inventory related to the planting season, that could be an indication that it has not managed inventory properly and is left with a seasonally inappropriate mix.

### Delivery of Products

Many farm supply retailers and distributors offer product delivery. This can include delivery of retail farm supply products, as well as bulk delivery of agronomy products. It is important to understand what products the company offers for delivery, whether there is a fee charged to customers to cover the cost of delivery, and what portion of sales are delivered versus picked by customers at company locations. In a liquidation scenario for a company with significant delivery operations, it can be expected that continuing delivery would incur additional expenses for the liquidation process, which must be accounted for, while terminating delivery and selling on a customer pick-up basis only would negatively impact customer participation in that liquidation process.

### Services

Many farm supply companies offer a suite of services to customers. These can include installation of grain bins, tanks, fences, and other equipment; soil sampling and testing to determine optimal fertilizer applications; and application of fertilizer, seed, and crop protectant to fields using the farm supply company's equipment. Understanding what services a farm supply company offers, and what portion of inventory sales are generated as part of a service offering is important. Is, for example, a large amount of crop protectant sold by the farm supply company also applied to customer fields by the company as a service? In a liquidation scenario, a liquidator would likely be hesitant to continue this or other such service offerings. Selling inventory without offering the related services, however, may necessitate additional discounting and/or sales to competitors and other market participants rather than to the company's primary customer base.

### Commodity Inventory

Some farm supply products, such as fertilizer, have commodity-like price dynamics. Fertilizer pricing is driven by global markets and can be affected by supply and demand, fuel and other input prices, trade regulations, government policies, and similar market factors. Similarly, livestock feed, crop protectant, and seed exhibit some commodity-like pricing characteristics. Secured lenders should be sure to understand what inventory categories are commodity-like within a farm supply seller's overall product mix. Commodity-like inventory generally has a very large potential customer base in a liquidation scenario, and generally requires relatively minor levels of discounting below market price to incentivize purchasing. On the other hand, rapid decreases in market prices for commodity goods can leave



a company carrying inventory at a high cost basis relative to current market prices. Lenders should closely monitor market prices on any commodity inventory.

### Customer Prepayment

Some farm supply companies offer customers the option to prepay for product. This may appeal to customers for various reasons, including a preference for locking-in discounted prices for commodity goods, which may increase in price closer to a growing season, as well as for tax purposes in order to recognize expenses in an earlier tax year. Farm supply companies may offer customers the ability to deposit funds in a general prepayment account to be spent with the company on any available products at a future date. It is critical to review any prepayment programs, understand both the extent to which customers participate in these programs and what legal recourse they may have to these funds in a liquidation. The lender should also consider that, if customers with deposits were to become unsecured creditors in a liquidation, they could choose not to participate in a liquidation sale with the company. This, in turn, could negatively impact recoveries.

### EPA Regulation

The EPA regulates what fertilizers and crop protectants can be applied to fields, and in what amounts. This can vary from region to region. It is important to understand that any changes in EPA regulation can alter market demand for products, or make them entirely unsaleable. However, when a product is banned due to environmental concerns, typically, a "grandfather" period is implemented, which allows farms to continue using existing product for a certain period of time before the ban takes effect.





*Agronomy products are generally applied to fields as part of crop planting and growing.*

### **Federal Crop Insurance and Agricultural Subsidies**

Federal crop insurance programs provide a safety net to farmers, which allows them to continue investing in agricultural inputs without bearing the full risk of crop failure or other catastrophic events. Additionally, agricultural subsidies protect farmers from bearing full exposure to market price decreases for commodity crops. It is important to understand that changes to either of these programs could impact the purchasing patterns and spending of customers to a farm supply company.

### **Drop-Ship Sales**

Many farm supply products can be drop-shipped from vendors directly to customers. It is important to understand what portion of a company's sales are drop-shipped, which specific products drop-shipping is offered for, whether drop-shipped products are the same as stocked products, and any impact this

may have on analysis of inventory turns and other performance metrics.

### **Agri-Finance**

Farm supply companies often have agreements with agri-finance companies, which offer various credit products to farmers. Some agri-finance agreements require a farm supply company to agree to assume a portion of recourse on defaulted credit used with the company. These programs should be explored in diligence to understand the extent of these credit programs in the company's sales, what recourse lenders have to the company, and the likelihood that these programs could be used by customers purchasing from the company in a liquidation. A lack of access to credit products that customers rely on to make purchases would negatively impact their ability to participate in a liquidation.

### **Rail Strikes or Disruptions**

Although the potential rail strike in late

2022 and early 2023 appears to have been averted by government action, relations between labor unions and railroads remain tense. It should be understood that any disruptions to rail operations caused by labor action could have a significant impact on the ability of farm supply companies to operate, as much of the bulk product utilized by farmers relies heavily on rail transportation for delivery to regions around the country.

### **Costing**

Inventory costing should be thoroughly understood, including the impact related to changing commodity costs. As information on a borrower is gathered, it is recommended that the lender share this information with the appraiser prior to an appraisal engagement. Doing so will facilitate a more efficient process in areas such as initial recovery guidance and general report setup recommendations.



## Glossary of Key Terms

**As with many industries, farm supply and agriculture have their own nuanced language. The below glossary of terms is designed to provide the reader with a high-level overview of key terms that are likely to arise during conversations with a client.**

**Agronomy** The science of soil management and crop production. Agronomy products are generally applied to fields as part of crop planting and growing. These primarily include fertilizer, seed, and crop protectant. Agronomy services include soil testing and other agricultural consulting services to aid farmers in selecting crops and maximizing yields and efficiency.

**Agri-Finance** Credit products specifically offered to agricultural customers.

**Agricultural Supply Cooperative** In agriculture, it is common for farmers to

enter into cooperatives to increase their market power. These can include supply cooperatives, manufacturing/marketing cooperatives, machinery pools, and financial cooperatives. Farm supply businesses may be organized as supply cooperatives, a structure under which the cooperative is owned by member farms.

**Crop Protectant** Products used to manage plant diseases, weeds, and other pests that damage crops. These can include herbicides, fungicides, insecticides, seed treatments, and other similar products.

**Certified Seed** Seed with specific characteristics produced under strict conditions to maintain genetic and varietal purity. Seed certification is an internationally recognized system to preserve the generic identity or crop varieties. Planting certified seed ensures that farms know they are

planting the genetics they intend to, and that there are no other seeds or impurities mixed in with the seed they are planting.

**Hobby Farmer / Gentleman Farmer** A landowner who has a farm as part of their estate, who does not farm for profit or sustenance.

**UAN Solution** A solution of urea and ammonium nitrate in water, which is used as fertilizer. UAN solution can be composed of different ratios of urea, ammonium nitrate, and water, depending on the specific fertilization needs of farms.

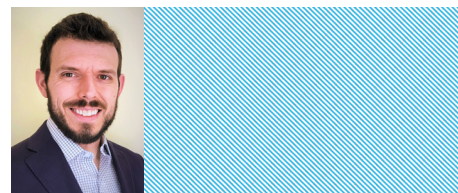
**Animal Health Products** Supplements and medicines for livestock. Some of these products may require a prescription from a veterinarian.

**Hilco Valuation Services** *We are currently engaged in multiple valuations and are having informative conversations with our industry contacts and partners across the farm supply industry on a regular basis. Whether you are working with a prospective farm supply borrower or have current industry exposure within your portfolio, the more you understand about those businesses, the better. This is particularly relevant in the current, uncertain climate. As information on a borrower is gathered, we recommend that lender share these details with Hilco or the selected appraiser prior to a formal valuation engagement. Doing so will facilitate a more efficient and effective process in areas such as initial recovery guidance and general report setup recommendations. To learn more, we encourage you to reach out to our farm supply team at Hilco Valuation Services today. We are here to help!*



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