By Harve Light

M&A Activity in Agriculture: Is It Time to Harvest?

Harve Light
Conway MacKenzie
Birmingham, Mich.

Harve Light is a managing director with Conway MacKenzie, a part of Riveron, and leads the Agriculture Advisory Services Team. He works with healthy and distressed agribusinesses throughout the value chain across the U.S. He also serves on the advisory board of ABI's Central States Bankruptcy Workshop.

M&A activity in the U.S. has been strong for the last several years, especially in the middle market, and transaction multiples remain at record highs. Unfortunately, these multiples vary widely by sector, especially in agriculture. It has seen neither the volume nor the multiples that are evident in the rest of the market. Here is a look at several of the components (good and bad) that are affecting this market.

The U.S. Economy: A Historic Run

Since the Great Recession, the economy has been steady and improving. Home prices have recovered, and unemployment is under control and has declined to almost full employment. Interest rates have been at extremely low levels for an extended period, and gas prices have been relatively affordable. Major stock market indices, including the S&P and Dow Jones, have more than tripled since the Great Recession.

Exhibit 1 shows the huge U.S. historic domestic product growth rate. The gray bars indicate a recession, which is typically recognized as two quarters of negative gross domestic product (GDP) growth. (Recessions are officially declared in the U.S. by a committee of experts at the National Bureau of Economic Research.) We are well above the mean time between recessions for over the last 75 years. According to this survey of professional forecasters, the real GDP growth rate in the U.S. is likely to remain flat.

The Current Economic Environment

When looking at valuations for any company, it is important to understand the current economic environment. If you look at where the U.S. economy is today, there are several factors that have differing effects upon valuations in the agriculture sector: GDP at 2.1 percent with an outlook of 2.1 percent (neutral); the unemployment rate at 3.3 percent and an outlook of 3.6 percent (negative); and the Fed Funds rate at 1.75 percent and an outlook of 1.75 percent (positive).

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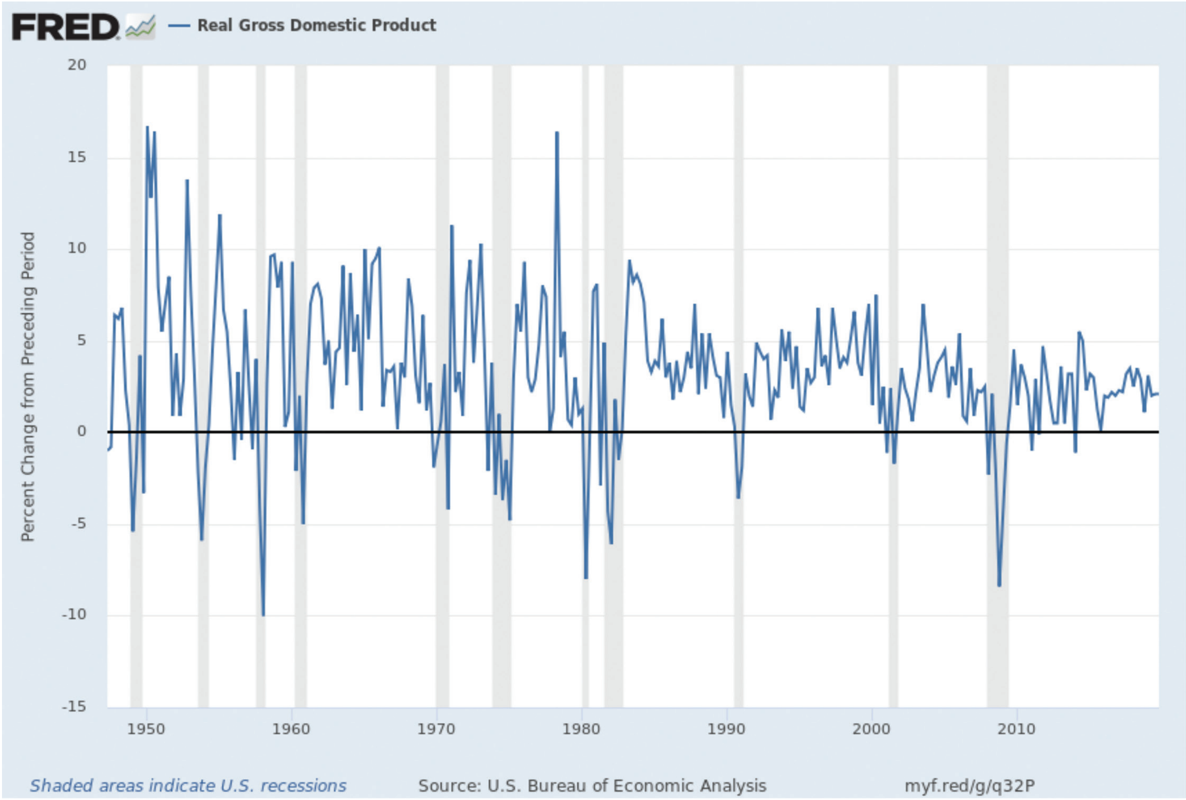
Exhibit 1



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The unemployment rate is considered a negative factor because the agriculture industry is facing a labor supply shortfall. The Fed Fund's rate is a positive factor because low interest rates are supporting the high levels of debt that farms and agribusiness companies are currently carrying. In addition to these three factors, the value of the U.S. dollar is currently stable and is expected to remain so for the next year. This has a positive impact for the agribusiness industry in allowing it to continue to export. Unfortunately, there are several issues that are negatively affecting the U.S. agribusiness industry:

- African swine flu in China has wiped out nearly half of that country's pork production, which has resulted in weak feed demand;
- Weather in the U.S. has had a major impact, including the delays in corn and soybean planting that contributed to a roller-coaster for prices in 2019; and
- Geopolitics have had a negative effect on the industry because tariffs will continue, as a full trade deal is unlikely.

If tensions do not increase again, the U.S. economy should not fall into a recession — but that's a big "if." Overall, the U.S. economy is stable, and while it has had a historic run, some industries are surviving but not thriving. Several industries have raised concerns about the true overall health of the U.S. economy, including automotive, trucking, oil and gas, retail, health care, real estate and agriculture. A serious downturn in any one of these industries could push the U.S. economy into a recession. Many of these positive economic factors also have a negative impact on agribusiness valuations.

Agribusiness Headwinds

In addition to the economic environment, it is important to look at the headwinds that agribusinesses specifically are facing. This includes labor, global trade wars, technology needs and customer preferences.

First, minimum wage increases across the nation continue to place a heavy burden on company margins without providing the benefit of a stable workforce. The lack of a reliable workforce continues to strain many operations, as workers are hard to find despite higher wage rates. There is a bright spot in that proposed federal legislation might alleviate some of these labor issues. Unfortunately, timing and final terms remain unclear.

Second, trade wars on several fronts will increase the uncertainty around global demand for U.S. food products. Small wins will occur, but a comprehensive trade deal with China is unlikely to occur quickly. The impact of tariffs will be amplified by improvements in other global markets, reducing demand for U.S. products.

Third, technology is still a major headwind, and internet access to rural communities remains a significant issue. This lack of internet access hampers the ability of an agribusiness to implement technological solutions that will improve efficiency. New technologies are also needed as food safety requirements continue to expand. Traceability requirements to improve overall recall speed and success are increasing. Technology protocols, specifically in blockchain, will require capital investment and changes to the way that data is collected.

Fourth, changing customer preferences continue to challenge growers and processors with a shift toward organic products. A new customer focus on sustainability will require additional investment, and product innovation will be required for smaller companies to survive.

In addition to these industry shifts, agribusinesses are facing significant issues at the company level. The biggest of these is input-vs.-output prices. Input prices have remained steady over the last several years, but commodity prices have steadily declined, as shown in Exhibit 2. The weaknesses are supported by three datapoints: farm income, farm debt and farm bankruptcies.

According to the U.S. Department of Agriculture, farm income is projected to reach $88 billion this year. This is the highest level in several years, but it remains below the record set in 2013. Unfortunately, more than one-third of this income is from some sort of assistance or insurance payments.

Farm debt is expected to finish up 2019 at record levels of nearly $415 billion. Of this amount, $255 billion is related to real estate and $160 billion is related to non-real estate debt. Also concerning are the average loan maturities, which are at an all-time high. Most troubling are the maturities for operating expense loans at 11.5 months. Non-real estate loans are also getting bigger, as banks made more than $800 million in new non-real estate farm loans in the second quarter of 2019 alone. Loans greater than $1 million were a significant contributor.

Farm bankruptcies are on the uptick, and chapter 12 cases are increasing at a rapid rate. For the 12 months ending Sept. 30, 2019, there were 580 filings, up 24 percent from the previous year. This will be an interesting trend to watch with the recent increase in allowed debt limits. Lenders now have to take a harder look at whether giving up a significant amount of control for the capital gains exclusion will be worth it.

Exhibit 2: NAV-Invesco DB Agriculture Fund

These factors are being offset by the low-interest-rate environment. It is critical that companies do what they can to improve balance sheets before rates begin to rise again.

How Much Gas Is Left in the Tank?

The effective Fed Funds interest rate had been steadily increasing from 2016-19, which is a good sign for economic growth. In July 2019, it peaked at 2.4 percent, its highest level since March 2008. The Federal Reserve began to take actions with several rate cuts, as it started to see some weakness in the economy. The current interest rate level is expected to remain steady throughout 2020, barring any external impacts. Exhibit 3 shows the 10-year Treasury constant maturity minus two-year Treasury constant maturity. It is a good indicator of economic health.

The yield spread is the difference between the long-term 10-year and short-term two-year interest rates. The curve has flattened, which usually indicates an impending slowdown. Short-term yields equaled long-term yields in August 2019, but a widely expected inversion scenario was averted. An inverted-yield scenario is a strong signal of a possible recession, as the yields are driven by inflationary pressures and high asset prices. The impacts of President Donald Trump's tax cuts and fiscal stimulus are likely to fade by the next presidential election in 2020. The outcome of trade wars with key U.S. economic partners and surging budget deficits are now negatively impacting the spread. It has remained at or near the zero mark, but we will need to see where it goes given the expected short-term impact of COVID-19. It is improbable that the economy with slip into a recession because pent up demand will bring the economy roaring back.

In the interim, producers and processors face very different challenges from the rest of the economy. They are seeing small demand losses but major shifts in product mix as retailers become the dominant customers. These companies are now managing the demand shift and logistical challenges related to inputs and deliveries. On the bright side, workers are collecting overtime in many instances. These companies should be able to weather the storm better than others.

Where Is Private Equity?

One of the common questions asked regarding agriculture industry M&A activity is this: "Where is private equity?" Over the last several years, private-equity firms have had record fundraising levels. Deal flow has been extremely high, and the number of exits has been very low. Transaction multiples have maintained almost 12x over the past three years. However, almost two-thirds of private-equity transactions are add-ons to existing platforms.

There are a limited number of firms that are investing in agriculture, primarily in processors and ancillary service

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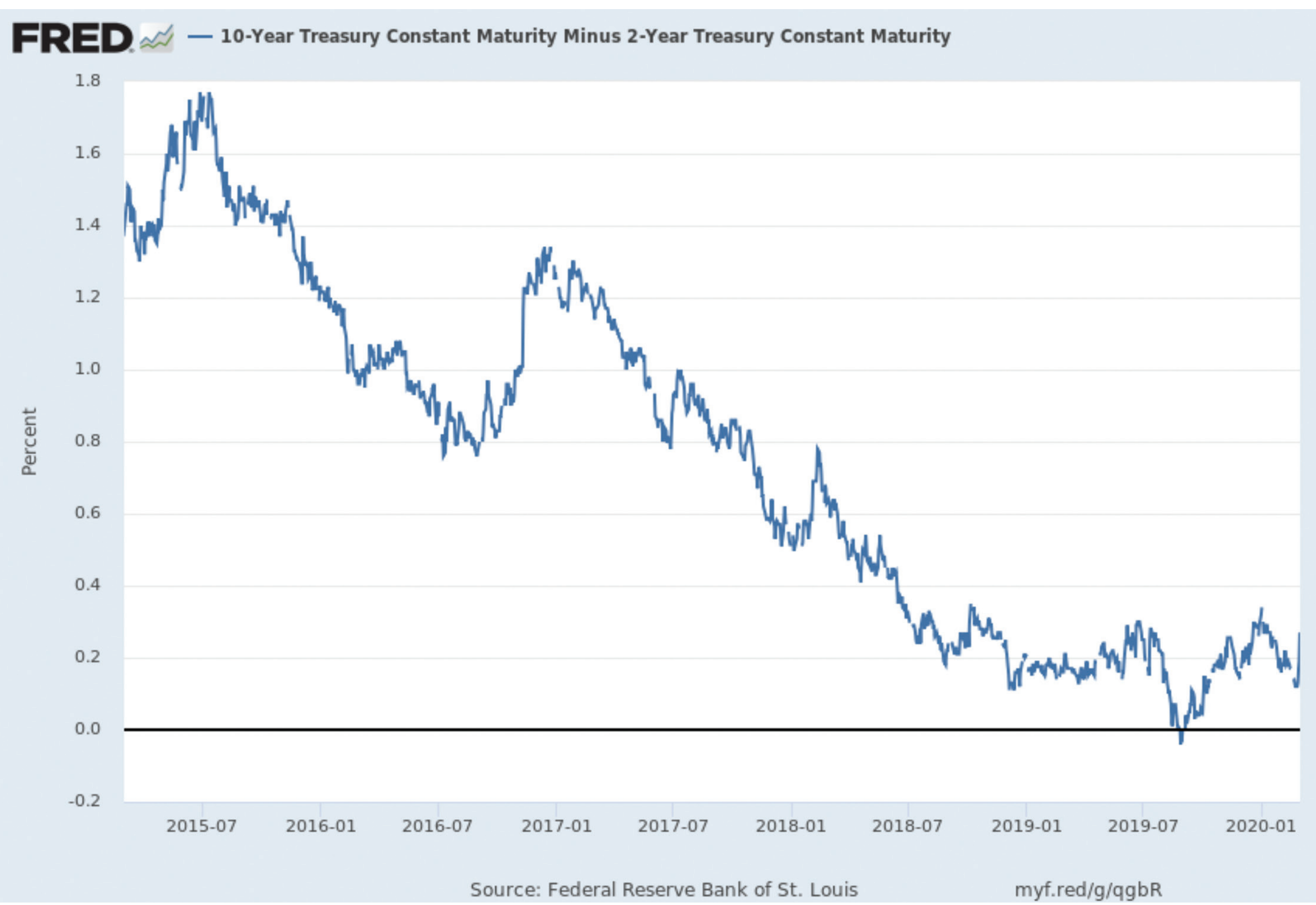
Exhibit 3



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providers. These are niche players with very specific investment criteria. New players might emerge given the level of capital that has been raised and put to work. Given the level of distress in the industry, however, business owners should be mindful that if the negative trends continue, distressed investors will enter the market with the intent of buying at extremely low prices.

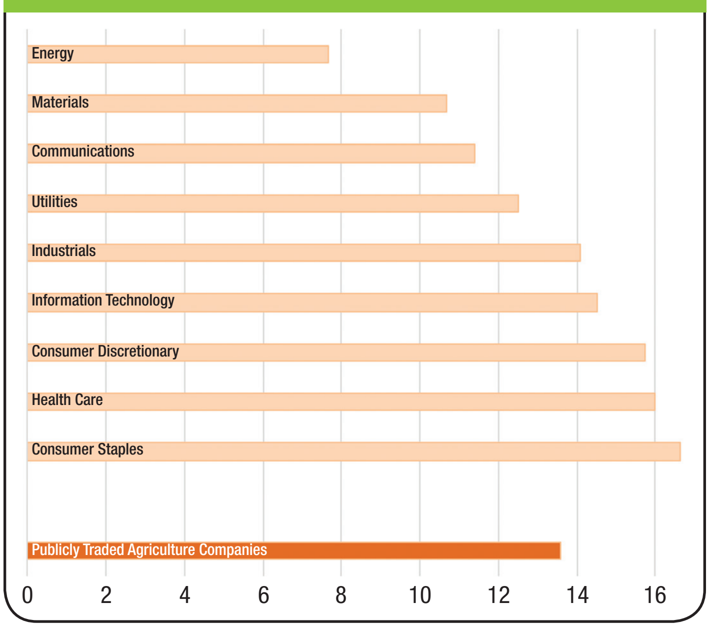
Why hasn't private equity taken a larger interest in the agriculture industry? The fundamental reason is the industry's inability to generate the required investment returns. Returns are negatively impacted by commodity price risk, potential recall exposure and lack of exit strategies (the most significant reason). The existing large companies that dominate the agriculture space generate significant cash flow and have no reason to take investment risks on new technologies and applications, which hampers innovation and access to capital. There does appear to be some hope on the horizon, as companies like Microsoft, Google and IBM are starting to make startup investments in the space. This should lead to potential exit strategies for venture capital and other startup companies down the road, as these heavyweights become more invested and the large existing players realize that they need to keep up.

Current M&A Trends

There are three key trends that are dominating M&A activity within the agriculture space: strategic buyer domination, macroeconomic factors, and labor and benefits. Strategic buyers comprised 90 percent of the deals that have closed. Nearly 70 percent of the transactions that have recently taken place have been between private companies. Macroeconomic factors negatively affecting M&A include uncertainty around U.S. trade policies, which are expected to continue and put downward pressure on multiples. This pressure will be compounded by improvements in other global markets, which are causing shifts in global supply. These improvements in global supply are pushing commodity prices down, as evidenced in the earlier commodity price chart.

Finally, labor and benefit issues will continue to put significant pressure on margins. Many agriculture-heavy states have minimum wage increases that will be implemented over the next two to three years, although these minimum wage hikes are having little to no effect on labor supply for agriculture companies. In addition, employers continue to pay significantly higher health care costs, as seen over the last decade. The average cost of employer health care coverage offered to workers rose to nearly $20,000 a year for a family plan. All these issues are having a negative effect on transaction multiples.

Exhibit 4: S&P 500 EV to EBITDA Ratio by Sector



What Does This Mean for Transaction Multiples?

As shown in Exhibit 4, agriculture companies have generated returns below those of the major market indices. Publicly traded agriculture companies are trading at an EV to EBITDA multiple of 13.6x, which is in the middle of the pack. To adjust for the typical agriculture transaction, there are several factors that must be considered, such as a smaller company size, fewer growth opportunities, fewer cost-savings opportunities and smaller management teams (see Exhibit 5). The conclusion is that a company performing to industry standards can expect a transaction multiple of six to nine times EBITDA.

Conclusion

Over the next two to five years, we can expect that low- to mid-market companies will become sellers, and that the anticipated headwinds will cause entrepreneurs and sponsors to sell while they can. The high debt levels and increased labor costs will continue to cause distress and lower valuations. Larger companies will be strategic and opportunistic buyers, and more focus will be placed on operating profits in order to sustain and increase margins. Technology will drive strategic acquisitions. Finally, disruption and distress will drive opportunistic acquisitions.

Disruptions to the economy have very different effects on transaction timing and trading multiples. In today's market, the

Exhibit 5

Publicly Traded Company Multiple	**13.6**	
Deductions:		
Smaller Company Size	3.0	2.0
Fewer Growth Opportunities	2.0	1.0
Cost-Savings Opportunities	2.0	1.0
Management	0.5	0.5
Middle-Market Company Multiple	6.1	9.1

time to close a transaction will likely be longer due to market uncertainty and the disruptions caused by the novel coronavirus in early 2020. This will have negative effects on equipment suppliers and service providers with moderate to weak financial health. These companies are more likely to see a decline in revenue and profitability as purchases are delayed, which will drive the opportunistic acquisitions at lower multiples.

Conversely, current events will have a positive effect on producers and processors due to a short-term increase in demand for food products as more people stay home. This will lead to higher short-term profitability, but the effects of this event will not last. Of greater concern are issues like the continuing water rationing in California, which will have lasting effects on crop production. This is an industry that remembers the drought of 2014 and its lasting effects on commodity pricing.

Regardless of whether an owner is an active seller, it is important to have a sale price in mind, as an unsolicited offer could come at any time. Once the price has been established, owners will need to take a hard look at the validity of that price. Owners tend to overestimate a company's value, but in reviewing the valuation, management teams can look for specific areas to target to increase the overall value of the company. By doing so, there would be no surprises at the start of a transaction. And that leads to a better overall process that maximizes potential value. abi

Editor's Note: *For a prediction of what the COVID-19 situation might bring, please visit abi-org.s3.amazonaws.com/Newsroom/The_Coronavirus_and_Its_Likely_Impact_on_the_Bankruptcy_World.pdf.*