Case Study

Consolidation in the Farm Credit System: The Case of AgCountry and United

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Abstract
Agricultural lenders provide an important service in America's agricultural economy. In recent years, consolidation has occurred in many aspects of agriculture, including agricultural lending. This educational case study examines consolidation in the Farm Credit System (FCS), which is a system of cooperatively owned agricultural lending associations. The merger between AgCountry Farm Credit Services and United FCS illustrates some drivers of consolidation in the Farm Credit System and provides opportunities to consider the advantages and disadvantages of a merger. The perspectives of the associations' leaders, member-owners, and employees are explored, allowing students to offer tactical and strategic advice to these stakeholders. This case study is intended for undergraduate students taking courses in agricultural finance, agricultural lending, or cooperatives.

1 Introduction

In fall 2016, farmers across the upper Midwest were busy harvesting their crops and preparing for the next growing season. At the same time, leaders at AgCountry Farm Credit Services and United FCS were also reflecting on past efforts and planning for the future. Bob Bahl, the chief executive officer (CEO) of AgCountry, and Marc Knisely, the CEO of United, had identified and evaluated strategic opportunities throughout their careers in the Farm Credit System (FCS). Now they were considering another key question: whether AgCountry and United should become a single association. If a merger were to occur, the new association would conduct business with approximately 18,000 borrowers in 65 counties in eastern North Dakota, western Minnesota, and north central Wisconsin (Vinje 2017). A merger had the potential to alter the business relationships of thousands of borrowers and the work lives of hundreds of employees.

FCS associations make loans to farmers, ranchers, and other entities related to agriculture. In recent years, many FCS association mergers have occurred. For example, AgCountry expanded its lending territory through a 2008 merger with its neighbor to the north, Farm Credit Services of Grand Forks. Likewise, United was formed through a 2002 merger of Farm Credit Services of Minnesota Valley and Farm Credit Services of North Central Wisconsin. Both Bahl, who worked for Grand Forks and then AgCountry, and Knisely, who worked for Minnesota Valley and then United, learned valuable leadership lessons during these mergers. Yet other lessons were learned by AgCountry and United's borrowing customers—member-owners who elect their association directors. These customers experienced the benefits and challenges presented by FCS mergers.

Initial merger discussions within a working group of select directors from AgCountry and United highlighted the two associations' important similarities. Specifically, both associations were committed to paying patronage to member-owners, both embraced operating in a strong agricultural region, both maintained strong balance sheets and credit quality, and both supported offering a wide range of services to member-owners. Given their experiences with previous mergers, stakeholders from AgCountry and

United understood that the advantages of merging would be weighed against several disadvantages of merging. Skillful guidance was needed as AgCountry and United searched for the best path forward.

2 Agricultural Lending in the United States

The agricultural lending industry serves farms, ranches, and other businesses related to agriculture. America'a farms and ranches have more than $400 billion of debt (U.S. Department of Agriculture 2020). Borrowed funds are critical because agricultural output is reduced in the absence of adequate credit (Briggeman, Towe, and Morehart 2009; Nadolnyak, Shen, and Hartarska 2017). Farms and ranches use operating loans for purchases of crop and livestock production inputs and term loans for purchases of assets such as machinery, equipment, and farmland. In addition to lending directly to farm and ranch operators, agricultural lenders make loans to agricultural cooperatives and a host of other agribusinesses.

Commercial banks, FCS associations, the Farm Service Agency, implement dealers, credit unions, and individuals all make loans to agricultural producers. These lenders are not always competitors because the agricultural lending market is somewhat segmented by borrowers' characteristics and needs (Dodson and Koenig 2004). Although there are many sources of agricultural credit, commercial banks and the Farm Credit System currently hold the vast majority of U.S. farm debt.

Commercial banks hold roughly 40 percent of U.S. farm debt (Figure 1). These institutions use customer deposits and other funds to make loans to many individuals and businesses, including those in agriculture. Commercial banks are familiar to the many Americans who use bank products or services on a daily basis. In 2019, Wells Fargo had a greater volume of agricultural loans than any other commercial bank (American Bankers Association 2019). Although Wells Fargo and several other major banks have retreated from this area in response to a weakening agricultural economy (Bunge and Maltais 2019), the loan portfolios of hundreds of small rural banks remain highly concentrated in agriculture.

The Farm Credit System commands an agricultural lending market share similar to that of commercial banks. The system is comprised of 68 associations that focus on lending to specific territories

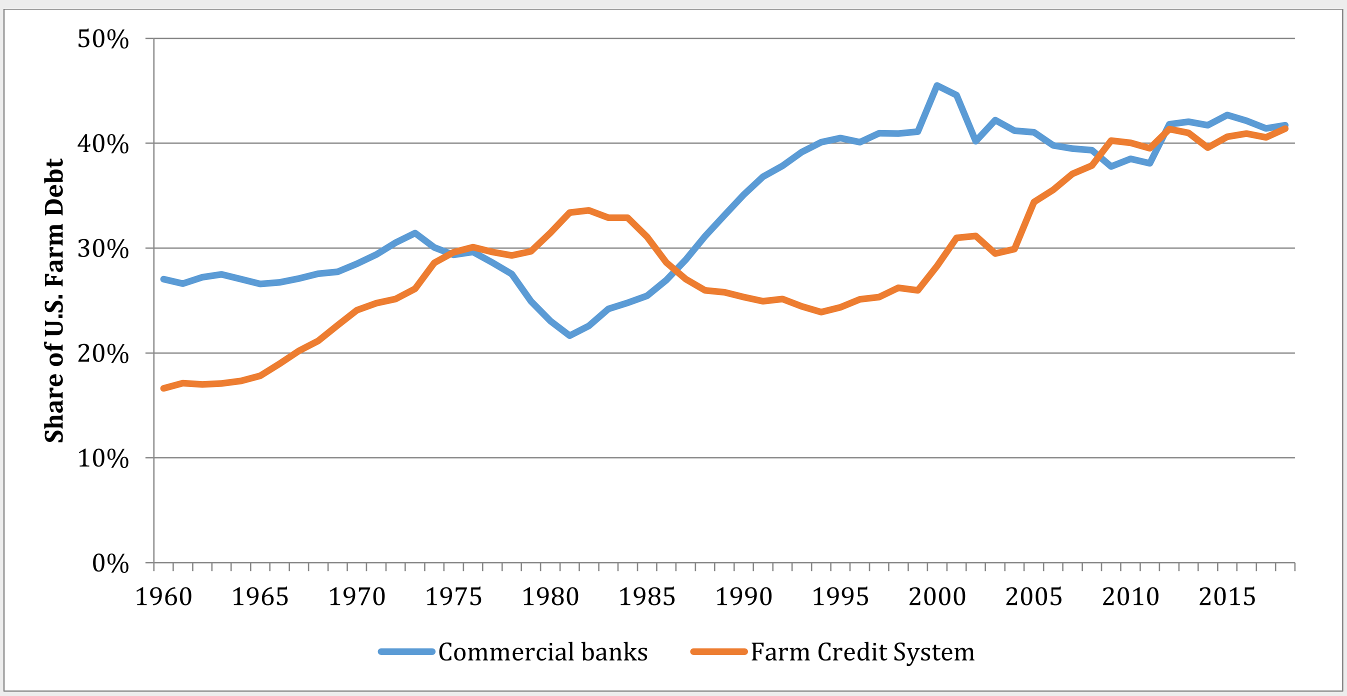

Figure 1. Share of U.S. farm debt held by commercial banks and the Farm Credit System

Source: United States Department of Agriculture, 2020.

within the United States (Farm Credit Administration 2020a). In addition to making loans, many associations offer other services, including crop insurance, farm record keeping, succession planning, and tax accounting. However, FCS associations do not accept deposits or offer many other traditional banking services offered by commercial banks. Associations acquire loanable funds by borrowing from their district bank, which is owned cooperatively by the associations it serves. The four district banks acquire funds from the Federal Farm Credit Banks Funding Corporation, which generates capital for the Farm Credit System by selling debt securities to investors. In total, the system has more than $300 billion in assets and serves more than 500,000 borrowers (Farm Credit Administration 2019a).

Farmers, ranchers, agribusinesses, utility companies, and rural homebuyers are all eligible to borrow from the Farm Credit System. Table 1 shows that real estate loans to farmers and ranchers are a large portion of the system's combined loan portfolio. Historically, the system has made more real estate loans than commercial banks. Although it lags behind commercial banks in non-real estate lending, it makes many production loans and intermediate-term loans to farmers and ranchers. Loans to cooperatives, ethanol plants, and other agribusinesses are a growing part of the FCS loan portfolio.

3 History and Structure of the Farm Credit System

The Farm Credit System serves a unique and important purpose. In the early twentieth century, credit for agricultural real estate purchases was generally available in limited supply or at unreasonable terms (Farm Credit Administration 2019b). The Federal Farm Loan Act of 1916 addressed this problem by establishing a government-sponsored system of agricultural real estate lenders. The Farm Credit Act of 1933 added short-term and intermediate-term lenders to this system, which would become known as the Farm Credit System. The Farm Credit Administration was also created in 1933 to regulate FCS associations and banks. The Farm Credit System eventually included hundreds of federal land bank associations (FLBAs) and production credit associations (PCAs) that operated in distinct geographic territories. All told, the FCS has long been a "reliable source of credit to finance agriculture and rural America" (Farm Credit 2019a).

FCS associations have always been owned cooperatively by their borrowers. Cooperatives are defined by several principles related to the users of the business' goods or services. In the case of FCS associations, the users of the business are its borrowing member-owners. One principle of cooperatives is user ownership, which means that associations are owned by their member-owners. In order to borrow from an association, member-owners are required to own association stock equal to the lesser of $1,000 or 2 percent of their loan amount. This ownership gives member-owners a claim on the association's profits, which are redistributed to member-owners through patronage dividends that are paid in proportion to a member-owner's loan size.

Another principle of cooperatives is user control, which means that an association's stockholders elect a board of directors to govern each association. Each stockholder is entitled to one vote, regardless

Table 1. Gross loans outstanding for the Farm Credit System (in millions of dollars), 2014–2018

Loan type	2014	2015	2016	2017	2018
Long-term real estate	100,811	107,813	114,446	119,450	124,876
Production and intermediate-term	46,305	49,204	50,282	51,724	53,447
Agribusiness	32,935	36,595	39,628	42,210	46,113
Rural utility	21,568	25,798	27,440	27,965	29,160
Rural home	6,754	7,117	7,148	7,261	7,308
Other	8,681	9,363	9,824	10,167	11,040
Total	217,054	235,890	248,768	258,777	271,944

Source: Farm Credit Administration (2019a).

of that stockholder's volume of business with the association. The board of directors hires a CEO and supports that person in developing organizational strategy. Compared with investor-owned firms, many of which have a narrow focus on creating returns for stockholders, cooperatives are more likely to craft strategy around other goals of their member-owners (Boland, Hogeland, and McKee 2009). In fact, many cooperatives were designed specifically to satisfy unique needs in an industry or geographic region.

A final principle of cooperatives is user benefit, which means that users should benefit from an association's services and benefit financially from the redistribution of profits. Although associations are for-profit businesses that retain some earnings to fund business operations, other association earnings may be shared with member-owners through patronage dividends. Patronage dividends effectively lower the interest rate paid on loans.

4 Consolidation in Agricultural Lending

Consolidation is occurring across many industries. For example, large agricultural operations have become increasingly important to U.S. agriculture. Farm and ranch consolidation may be caused by technological advancements or more efficient labor use (MacDonald, Hoppe, and Newton 2018). Likewise, the number of agricultural cooperatives in the United States has declined markedly, causing the remaining cooperatives to do more business than before (U.S. Department of Agriculture Rural Development 2018). In addition, several major input supply companies have merged in recent years.

The financial industry is also characterized by consolidation. From 2003 to 2018, the number of U.S. commercial banks decreased by 41 percent (Federal Deposit Insurance Corporation n.d.). Over the same period, the number of U.S. banks with over one-quarter of their loan portfolio devoted to agriculture decreased by 24 percent. Commercial bank mergers have been spurred in part by relaxed regulations on activities such as interstate bank branching (Barry and Ellinger 2012).

Consolidation has happened throughout the Farm Credit System in recent decades. The Agricultural Credit Act of 1987 allowed FLBAs and PCAs in the same territory to merge into a single agricultural credit association (ACA). In addition to this consolidation across association types, considerable geographic consolidation has transpired within the Farm Credit System. Although 1,000-plus associations existed as recently as the early 1970s, there have been fewer than 100 associations for the past 15 years (Farm Credit Administration 2019b). Consequently, the typical association has changed from a relatively small organization that served just a few counties to a much larger and more sophisticated organization.

Mergers have also occurred among FCS banks. There are now just four district banks: AgFirst, AgriBank, CoBank, and Farm Credit Bank of Texas. CoBank is an agricultural credit bank (ACB) with authority to fund associations in its district as well as to make loans to cooperatives and other specified entities. The three other district banks are FCBs.

5 Drivers of Consolidation

Consolidation often occurs when one or more of the merging organizations is at a crossroads. Recent or anticipated changes in leadership may influence consolidation. According to Featherstone (2017, 80), "generational transitions provide an impetus for consolidation, whether it be in production agriculture, agribusinesses, or lending." Because mergers are inherently a time of transition, they may be used to initiate operational or cultural change efforts. These efforts can help organizations that wish to build on recent successes as well as those looking to reverse poor performance.

In a variety of industries, increasing returns to scale and economies of scale are among the most common reasons for consolidation. Many banks exhibit increasing returns to scale because outputs such as revenue and profits increase more rapidly than inputs such as assets when expansion occurs (Wheelock and Wilson 2018). Similarly, large FCS associations tend to operate more efficiently than smaller associations (Dang, Leatham, McCarl, and Wu 2014). As financial institutions grow in size, they may become more efficient in their spending on corporate overhead, information technology, and data processing (Kovner, Vickery, and Zhou 2014). Mergers may also allow for cost reductions stemming from the elimination of some duplicate positions or business locations (Kowalik, Davig, Morris, and Regehr 2015).

Consolidation may diversify an organization's business activities. Financial institutions are interested in diversifying both their loan portfolios and their other business activities in order to make their profits resilient to downturns in particular geographic areas, industries, or business lines. Diversification achieved through a merger is most successful when the merging institutions' income streams are uncorrelated or negatively correlated.

6 Challenges of Consolidation

Despite the possible advantages of organizational changes sparked by consolidation, there are several obstacles to creating change. Even well-intended change efforts frequently fall short of expectations (Kotter 1995). The efforts may be particularly difficult if the acquired organization's employees are resistant to the acquiring organization's culture (Nahavandi and Malekzadeh 1988). Leaders with strong communication and change management skills can navigate employees' sensitivities to change and cultivate positive employee attitudes regarding new cultural or operational emphases (Kavanagh and Ashkanasy 2006). Furthermore, because change typically occurs through a long process, leaders can increase the likelihood of success by clearly identifying the benefits of the change and by instilling receptive attitudes among the next generation of stakeholders in their organization (Kotter 1995).

New leadership may be unsettling to some employees or customers who appreciated an organization's previous direction. Furthermore, when a merger occurs, leaders' responsiveness to individual concerns may be reduced due to the demands of representing an enlarged contiutency. Representation is a key issue in the Farm Credit System because member-owners cooperatively own each association. Freshwater (1997, 225) notes that, eventually, "the incremental benefits of larger scale may be more than offset by losses in loyalty and shared values." Maintaining a shared strategic vision is particularly important in cooperatives with heterogeneous membership (Boland, Hogeland, and McKee 2009).

Although eliminating staff or business locations after a merger may reduce costs, customer loyalty can be damaged if customers are forced to interact with unfamiliar staff or to travel to inconvenient locations after a merger. Indeed, loan volume is negatively associated with the distance between borrowers and agricultural lenders (Witte, DeVuyst, Whitacre, and Jones 2015). Efforts to counteract these challenges and retain customers may create new or unforeseen costs.

Finally, diversified income streams are desirable from a risk management perspective, but expanding geographically or across business lines may expose shortcomings in a firm's existing knowledge, services, or products. The acquiring institution must understand the risks of the new areas in which it is becoming involved (Kowalik, Davig, Morris, and Regehr 2015). To maintain or gain expertise in a wide variety of areas, an organization may need to make investments that mitigate cost savings realized elsewhere in a merger.

7 Comparison of AgCountry and United

AgCountry and United were neighboring associations located in the AgriBank district. In 2016, AgCountry had more than 12,000 customers and 400 employees, roughly doubling United in these categories. AgCountry had 27 offices and United had 12 offices. Table 2 shows that AgCountry's balance sheet was more than three times the size of United's balance sheet.

Due to their different lending territories, which are illustrated in Figure 2 and Figure 3, the associations had lending activities concentrated in different upper Midwest states. These varied geographies meant that AgCountry's member-owners and United's member-owners were influenced by different conditions. Associations have a limited authority to originate or purchase loans from outside of

Table 2. Financial summary for AgCountry and United (in thousands of dollars), 2016

	Total assets	Total equity	Net interest income	Return on assets	Return on equity
AgCountry	$5,462,470	$1,168,716	$131,193	2.00%	9.40%
United	$1,727,586	$305,474	$44,090	1.40%	8.10%

Sources: AgCountry Farm Credit Services (2017); United FCS (2017).

their territory, so both associations made roughly one-fourth of their loans to member-owners outside their lending territories.

As described in Table 3, AgCountry and United also had different loan concentrations. Although both AgCountry and United made many loans to fund cash grain operations producing corn, soybeans, and wheat, these loans were a larger part of AgCountry's loan portfolio than of United's loan portfolio. In contrast, United's presence in Wisconsin resulted in many loans to dairy farms. Both associations made loans for sugar beet production, which is a relatively uncommon enterprise in other areas of the United States. However, many of the smaller lending concentrations for AgCountry and United were very different; AgCountry was highly involved with the ethanol industry, whereas United was involved with unique crops such as cranberries.

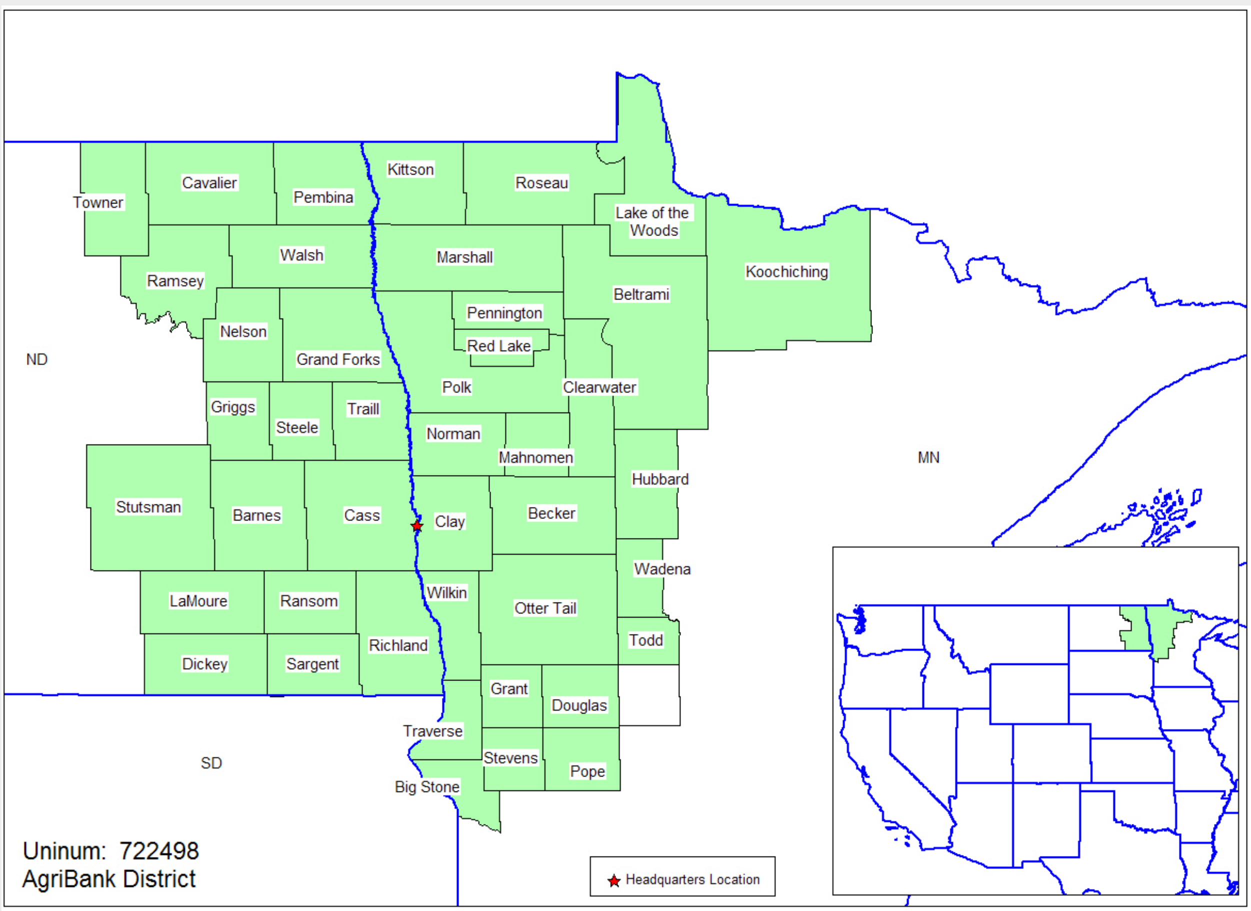

Figure 2. Lending territory of AgCountry, 2016

Source: Farm Credit Administration (2020b).

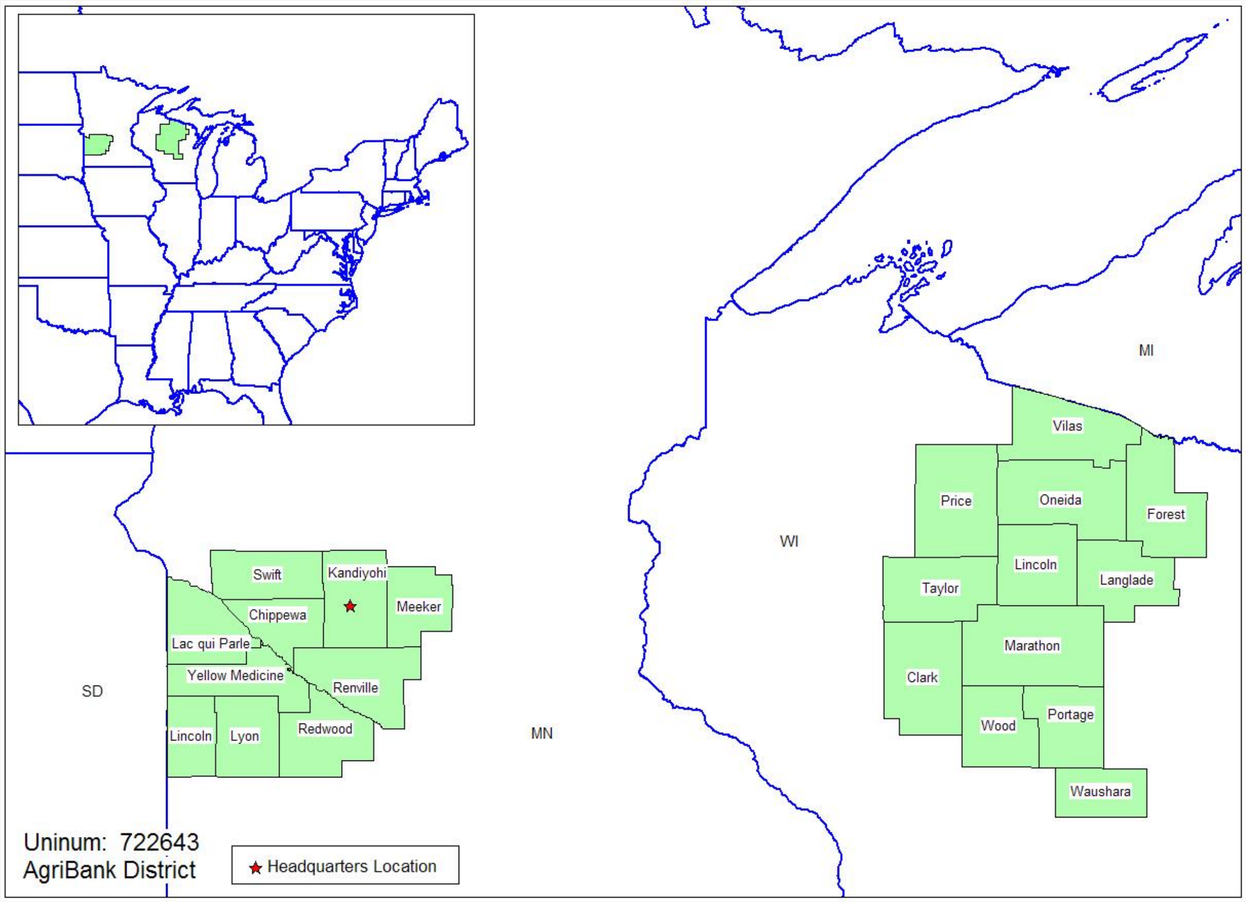

Figure 3. Lending territory of United, 2016

Source: Farm Credit Administration (2020b).

Table 3. Loan portfolio concentrations, 2016

	AgCountry	United
Cash grains	52.7%	36.5%
Sugar beets	11.5%	6.0%
Livestock	6.1%	5.7%
Ethanol	4.1%	0.3%
Dairy	3.9%	12.4%
Other	21.7%	39.1%

Sources: AgCountry Farm Credit Services (2017); United FCS (2017).
Note: Percentages are based on share of loan volume.

8 Details of the Merger

Several approvals would be required to merge AgCountry and United. First, the directors of both associations would need to vote to recommend a merger. Then, AgriBank and the Farm Credit Administration would both need to approve the proposed merger. The associations' member-owners would also need to vote on the proposal. Therefore, for a merger to occur, the concerns of many different stakeholders would be acknowledged and addressed by those crafting merger plans.

If the merger was approved, AgCountry would acquire United, making the new AgCountry the eighth-largest FCS association (Meersman 2017). The merged association would be headquartered at AgCountry's existing headquarters in Fargo, North Dakota. The initial merger plan recommended that all existing business locations for both associations remain open after the targeted implementation date of July 1, 2017. Furthermore, association leaders believed that most of the associations' employees, particularly customer-facing employees, could be retained after the merger.

Future leadership was a key topic during merger talks. Because merging all of the existing directors from AgCountry and United would have created a large board, the associations planned to merge their existing 12-director boards into a new 18-director board. On the new board, nine of the elected directors would represent the former AgCountry territory, six of the elected directors would represent the former United territory, and three outside directors would be appointed. A CEO transition was also part of the proposed merger plan. Bahl would maintain his role as AgCountry CEO from the July 1, 2017, merger date until his planned retirement at the end of 2017. Knisely would then become CEO at the beginning of 2018.

9 Key Questions

On November 11, 2016, Bahl and Knisley were scheduled to attend a joint board meeting with the directors from AgCountry and United. At that meeting, the potential merger would be discussed, and the directors of both associations would vote on whether to recommend the merger. As the CEOs and directors prepared for the board meeting, they had many opportunities and challenges to consider. For the merger to be successful, the CEOs would need to offer sound guidance to the associations' directors as they solidified their strategic plan. Moreover, the CEOs and directors would need to balance the concerns of member-owners and employees from both associations as the merger process unfolded.

Although optimism pervaded many of the initial discussions surrounding the merger, important questions were sure to emerge as stakeholders seriously considered the merger for the first time. These questions would reflect different goals and concerns. The direction of the merger would be determined by leaders' answers to questions such as the following:

1. From an economic perspective and a strategic management perspective, what are the main motivations for approving and main reservations for opposing the merger?
2. What concerns may AgCountry member-owners have with the proposed merger?
3. What concerns may United member-owners have with the proposed merger? Are these concerns similar to or different than those of AgCountry member-owners?
4. How does the proposed plan manage the change created by a merger? Are there additional steps that may ease the transition to a merged organization?

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