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Lending Risk Associated with Hemp Production

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The 2018 Farm Bill legalized hemp and opened the door to a potential new agricultural product in Kentucky. As an Agricultural Lender in a state that has suffered low commodity prices over the past few years, as well as challenges in our dairy and tobacco industries, the potential associated with hemp is certainly an exciting conversation with lenders involved in agriculture across the Commonwealth. As with any new product, we have seen the ups and downs in the hemp industry over the course of 2019.

Moving into 2020, many of the challenges we as lenders saw in the industry are still present today. We are all still waiting on FDA regulations that many feel will set the course for what the hemp industry will be in the future. We continue to see a market adjustment on the processing side as we validate those processors that will be in business for the long haul. On the insurance side, we will have a crop insurance product for 2020 but there is a lot to learn about how the product will work and how it will support our growers. Most importantly, we are still trying to understand the full scope of demand for the product and adjust our production to meet, not exceed, that demand.

As lenders, we discuss these unknowns as Risk: Risk to the borrower and Risk to the Lender. Agriculture relies heavily on Credit due to the cyclical nature of our products and a key piece of evaluating Credit is understanding and evaluating the Risks associated with the production of an agricultural product. Most bankers that I have had an opportunity to talk with this past year are interested in hemp and the financing potential but we all agree that there are Risks that must be evaluated prior to extending Credit to a producer entering the industry.

So, what Risks or potential Risks are the banks considering at this time? While not all encompassing, several areas stand out that the producer and banker should thoroughly understand.

- **Processing Instability**. With full demand currently still undetermined, there is limited reliable processing capability available across the state at this time. We have seen processors enter and leave the market over the past year which should be of concern for the producer and banker alike. As lenders, we want to fully understand the grower's business plan. A key part of the business plan is partnering with a reliable processor who both the grower and lender feel confident can meet their obligations. Obtaining and analyzing grower contracts is an important piece of the overall Credit evaluation for the lender. For the grower, there must be a partnership with the processor which means the grower should understand the current financial strength of the processor with whom they will be doing business.

- **Capacity of the Grower**. As with any Credit decision, the lender seeks to understand how the loan will be re-paid. With the relative newness of hemp, lenders will have minimal historical information in order to make accurate income projections. For now, a conservative approach for both the lender and the grower is to project income at no better than break-even. While this may seem extreme, this helps the lender and the grower make more realistic projections. As lenders, we are also looking at the hemp operation relative to the overall farming operation: in other words, how does the hemp production measure to the other products the farm produces? As lenders, we want to be very careful to offset the potential for loss with other farm outputs. Having an all-or-nothing approach with hemp is not recommended at this time.
- **Collateral**. Lenders require collateral for agricultural loans just like any other loan and hemp production is no different. Two specific concerns around collateral stand out from a lender standpoint in relation to hemp production. First, as lenders, we are neither licensed or registered to grow, process, handle, transport or sell hemp within the state. It is not yet clear under federal or state law if we as lenders are able to obtain possession of hemp in the event of collection or if we can succeed the licenses of the borrower in the event of foreclosure. From a lender perspective, while we may take a lien on the hemp crop, we will also likely look for other collateral to secure the debt against the crop. Lenders will most likely be hesitant to take hemp back in the event of collection due to uncertainty in the legal arena as well as uncertainty of available markets to sell, thus, other more stable forms of collateral (e.g., real estate) will likely be preferred. Second, from an equipment standpoint, there is a great chance that the equipment we use today to plant, cultivate and process hemp will evolve and change over the next several years. Most likely, the cost and value of equipment purchased today will drop over the next few years as new technology emerges and older equipment becomes obsolete. For both the grower and the lender, it is important to evaluate equipment purchases and assure the grower can absorb a loss in value as future equipment needs are considered.

While these are not all encompassing, the stability of processors, the growers' ability to repay borrowed funds and the importance of collateral are major pieces of evaluating Credit for hemp producers within the current state of the market. For the producer, it can be easy to be pulled into a venture that, at times, offers returns that might sound too good to be true. We know the other piece of this though: it probably is too good to be true. Hemp is a product that likely has the potential to increase our state's net farm incomes and there are already success stories around the state that support the potential of the product. For all growers and lenders though, it is important to fully evaluate all of the Risks present in the market at this time and make choices that allow the farm operation to continue to produce in the years ahead. Until we fully understand the potential of the market, we recommend an approach for all growers to only invest what their balance sheets and income projections (without hemp) can afford to lose. While this approach may appear overly safe, it likely supports our farmers and hemp growers over the years ahead.