Factors to Consider When Evaluating Loans to Contract Growers

The evaluation and classification of loans to contract growers must consider a number of factors, including: the degree of interdependence between the grower and the integrator, the ability of the grower to transition to another integrator, and the integrator's financial condition. When an institution downgrades an integrator's loans to a criticized classification, it should also perform a borrower-specific classification evaluation of the grower loans affiliated with the integrator. One of the first steps is to evaluate the degree of interdependence that exists between the grower and integrator. The following categorizes the grower's level of dependence on the integrator and how that impacts loan classifications:

- ***No Dependence on the Integrator:*** These contract growers have sufficient resources to make loan payments without income from the integrator. Additionally, they would still have an adequate financial position and cash flow even if the grower contract could not be replaced with another integrator. In these cases, contract growing operations may be secondary to the overall operation, significant off-farm income may exist, or the seasoning of the loan is such that remaining principal is minimal. Loans in this category can be classified based on their own merits.

- ***Some Dependence on the Integrator:*** For this category, nonperformance or cancellation of the grower contract with the integrator would cause at least a limited degree of financial stress to the grower, assuming the contract could not be easily replaced with another integrator. Unless a government guarantee is in place, these loans would generally need to be maintained within one UCS classification of the integrator's loans (e.g., if the integrator loan was classified Substandard, the grower loan would be classified no better than Special Mention). A high degree of judgment is needed when determining the appropriate classification in these cases, and a thorough, borrower-specific evaluation is warranted.

- ***High Dependence on the Integrator:*** These growers are highly dependent on income from the integrator. As such, the grower loan should be classified no better than the integrator loans. This is particularly true when the level of dependence is so high that regulatory attribution is required (refer to FAQ #10 for additional information on attribution). There can be exceptions to this approach if the grower has reasonable contract replacement alternatives (that are sufficiently documented by the institution) or a valid government guarantee is in place.

A classification better than the integrator can be supported if the institution sufficiently documents the grower has minimal or no dependence on the integrator or could readily align with another integrator. To determine if a grower can easily transition to another integrator, the institution should evaluate the following factors:

- ***Age, Size, Technology, Condition, Location, and Management of Facilities:*** These factors can significantly affect a grower's ability to affiliate with another integrator. Smaller, older facilities with outdated technology are usually not very attractive to integrators and may not meet minimum integrator specifications. The grower's management ability will also have a significant impact on the ability to replace a contract. Even if facilities meet an integrator's specifications and are in a good location (e.g., close to the integrator's feed mills and processing plants), integrators may not be interested if the grower has a record of average or below average production management. If integrators are not actively seeking new growers in an area, the condition of the facilities and the grower's management ability may need to be especially favorable.

- ***Industry Structure and Dynamics:*** The hog and poultry industries are becoming increasingly concentrated, leaving growers fewer options if they need to replace a contract. The poultry industry is particularly concentrated. Often, only one poultry integrator will be operating in a region, especially in areas outside the southern United States. If that integrator becomes stressed, growers may face extreme difficulty finding a replacement contract. Additionally, while numerous swine integrators operate in the Midwest, fewer operate in the South, making it potentially difficult for contract growers to find replacement contracts there. Furthermore, growers operating contract farrowing or hatchery units will likely find it more difficult to find replacement contracts compared to grower units that focus on raising market hogs and broilers.

  A swine contract grower that cannot find a replacement contract may have the option of purchasing animals to populate their facilities. However, this represents significantly higher risk than a contract grower operation, so the borrower must have a satisfactory financial position. Similar opportunities for poultry growers generally do not exist. Large integrators typically control the hatcheries and production is not sold on the open market.

- ***Industry Profitability and Capacity and Performance of Integrators:*** If an industry is experiencing extremely weak profitability, many integrators will simply not be interested in taking on additional growers. Also, even if the industry is profitable as a whole, an integrator that is dominant in a particular area may not have the ability to add additional growers because of financial capacity or production issues. Furthermore, an integrator may be capable of adding growers in a location but may choose not to for various reasons.

Note: *The above guidance applies to UCS classifications only. Assigning the performance category requires further judgment. For example, if an integrator loan is in nonaccrual, the same performance category may not be required on a highly dependent grower loan if the integrator shows no imminent signs of defaulting on the contract or reducing payments to the grower.*