S&P Global
Ratings

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Research Update:

American AgCredit ACA Assigned 'BBB+' Rating; Outlook Stable

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Overview

- American AgCredit ACA, a lender within the U.S. Farm Credit System, has a long history of good earnings, low loan losses, strong capital ratios, and uninterrupted access to low-cost funding from CoBank.
- However, the company has concentrated exposures to agricultural lending and real estate mortgages.
- We assigned a 'BBB+' long-term issuer credit rating to American AgCredit ACA.
- The stable outlook indicates our expectations that over at least the next two years, the company's loan credit quality will be solid, capital ratios will remain strong, and funding and liquidity provided by CoBank will remain ample and uninterrupted.

Rating Action

On May 19, 2021, S&P Global Ratings assigned its 'BBB+' long-term issuer credit rating to American AgCredit ACA. The outlook is stable.

Rationale

Our 'BBB+' long-term issuer credit rating on American AgCredit (AAC) balances the company's solid credit history, robust revenue growth, strong capital ratios, and substantial funding and borrowing capacity that it receives as a member of the Farm Credit System (FCS), against its concentration in the cyclical agricultural sector and high growth rates compared with peers.

Our starting point--or anchor--for our rating on AAC is 'bb+', in line with other U.S. companies that we rate under our nonbank financial institutions criteria. Because of AAC's public policy role, access to government-related entity (GRE) funding, and regulated status, we raise its anchor to 'bbb+', three notches above our anchor for other finance companies and equal to that of U.S. banks. This is to account for the Farm Credit Administration's regulatory oversight, the company's favorable funding through its position in the FCS, and its strong competitive position.

Our view of AAC's business position is based on its solid market position as an agricultural lender in seven states, and its role as an association operating within the FCS. AAC is the fourth-largest association in the FCS and the largest in the CoBank district. However, its concentration in agricultural loans--with large exposures to vineyards and wineries, field crops, tree fruits and nuts, dairy, and other agricultural commodities--somewhat offsets these strengths.

In addition, AAC's loan growth, spurred in part by its shift to an increasingly digital lending platform, has been high at an average of 14% annually over the past five years. We view the increase in the association's market share to 28% from 25% as a result of this growth favorably. However, we also see such outsize growth as a sign of increased risk appetite. That said, AAC's management has extensive experience in the agricultural lending industry, and it has solid risk management, illustrated by its record of strong asset quality, supported by conservative underwriting.

Our assessment of AAC's capital, leverage, and earnings incorporates the company's high regulatory capital ratios, combined with low credit loss provisions and satisfactory retention of earnings after patronage payments. However, outsize loan growth has weighed on capital ratios. The association's common equity Tier 1 ratio fell to 10.63% as of March 31, 2021, from 15.4% at year-end 2017, while its total capital ratio decreased to 10.86% from 15.6% over the same period. We calculated a risk-adjusted capital (RAC) ratio of 14.0% as of Dec. 31, 2020, which is toward the upper end of the 10%-15% range we consider strong. Although we think continued above-average loan growth could further lower capital ratios, we expect AAC's RAC ratio will remain within this range. If the company issues subordinated debt and preferred stock in the near term, such issuance would likely benefit capital ratios.

The company pays a patronage, or refund, to its members, of approximately 57% of earnings annually. We expect the company to continue to pay a similar percentage, allowing capital to slowly rise.

Despite the potential for lingering economic headwinds from the COVID-19 pandemic, we expect AAC's profits to increase in 2021, with increased net interest income stemming from loan growth, continued low provisions given low net charge-offs (NCOs), and slightly improving efficiency measures. Noninterest revenue typically contributes more than 20% of total revenue. AAC's revenue growth has outpaced expense growth in recent years, indicating improving efficiency at the association.

AAC's loan portfolio is somewhat more diversified by product and geography than many other associations' portfolios. The largest exposure is to wine grapes and wine, which make up 17% of total loans, followed by field crops (14%), dairy (13%), tree fruits and nuts (11%), beef (10%), and forest products (9%). The remainder of the portfolio consists of a number of products and commodity types.

Similarly, AAC is geographically diverse, with the largest exposures to California (51%), Kansas (12%), and Colorado (9%) and the remainder spread across the U.S. and Guam. The association actively engages in loan participations to manage risk, with about 25% of total commitments sold to improve portfolio diversification. It has also been a participating lender in the Paycheck Protection Program; as of March 31, 2021, it had originated $159.5 million under this program.

AAC's loan credit quality is excellent, with NCOs averaging a minimal two basis point (bps) annually in the past five years. Similarly, AAC's nonperforming assets (NPAs) (including troubled debt restructurings) have been stable at a low 44 bps-51 bps of loans and ORE over the past five years. We think these measures indicate that AAC's underwriting and concentration limits are conservative. Although the association's allowance for loan losses, which measured 0.22% of loans as of March 31, 2021, is low on an absolute basis, we think it is appropriate relative to the

low NPAs and NCOs.

Unlike most other FCS associations, AAC manages its funding through a block funding arrangement with CoBank (most associations match-fund through their funding banks). AAC determines its funding strategy and product offerings, and CoBank executes debt issuance via the Funding Corp. on its behalf. Because AAC does not match-fund through CoBank, it manages its own interest rate risk.

Board policies limit sensitivity to a 200 bps shift in interest rates to 10% of net interest income. As of Dec. 31, 2020, management estimated that a 200 bps rise in rates would increase net interest income by 2.1%, while a downward regulatory shock scenario would decrease net interest income by 0.1%. As a part of its arrangement, AAC maintains liquidity coverage consistent with CoBank's requirements for 15, 30, 90, and 120 days of liquidity. CoBank allocates $3.7 billion of its investment portfolio to AAC for liquidity measurement purposes.

In addition, AAC held $61 million of cash on the balance sheet as of Dec. 31, 2020, and had access to the additional liquidity available through its direct note with CoBank. AAC's issuance of subordinated debt and preferred stock, if it occurs, would likely modestly benefit on-balance-sheet liquidity.

We view favorably AAC's long-term general funding agreement with CoBank, one of the four banks making up the government-sponsored FCS, which lends to associations like AAC. The three-year running agreement provides a low-cost, stable, and primary funding source for AAC. The direct note with CoBank provides it with enough funding for its lending activity, up to a maximum borrowing base, which is redetermined every 15-18 months, though it can be renegotiated as needed. Although AAC is dependent on one source of funding, we see little risk that it would lose access to funding from CoBank, based on its long historical funding relationship with the bank since the founding of the FCS. Moreover, the association could obtain additional liquidity, if necessary, through lines of credit at commercial banks, by issuing debt or preferred stock, or through whole loan or participation sales.

While the rating incorporates the funding benefits that the association receives as a member of a GRE, we believe there is a low likelihood that the U.S. federal government would provide extraordinary support directly to AAC in the event of financial distress. Our assessment is that AAC's individual role is of limited importance to the federal government. In addition, we view AAC as having a limited link to the government. Its members privately own AAC, and the government has no history of providing extraordinary government support directly to associations like it. Therefore, the issuer credit rating does not incorporate any uplift for extraordinary government support.

Outlook

The stable outlook reflects our expectation that over at least the next two years, AAC will continue to report good earnings, maintain an S&P Global Ratings RAC ratio of 10%-15%, and have uninterrupted access to funding and liquidity from CoBank. In addition, we expect asset quality will remain solid as the U.S. emerges from the COVID-19 pandemic.

Downside scenario

We could lower our ratings on AAC if capital ratios decline meaningfully from current levels, such that the RAC ratio falls below 10% and remains there, if credit quality metrics weaken substantially, or if we perceive that the association's high growth targets are leading it to loosen

its underwriting standards.

Upside scenario

Conversely, we could raise our ratings on AAC if its capital ratios increase and we believe its RAC ratio will remain above 15% on a sustainable basis, if the pace of balance sheet growth moderates, and if loan and revenue diversification improves. We would also look favorably on an increase in the association's proportion of on-balance-sheet liquidity.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/--

SACP: bbb+

- Anchor: bb+
- Sector-Specific Anchor Adjustment: +3
- Business Position: Moderate (-1)
- Capital, Leverage, and Earnings: Strong (+1)
- Risk Position: Adequate (0)
- Funding and Liquidity: Adequate and Adequate (0)
- Comparable Ratings Adjustment: 0

External Influence: 0

- Government Influence: 0
- Group Influence: 0
- Rating Above The Sovereign: 0

Related Criteria

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Financial Institutions | General: Nonbank Financial Institutions Rating Methodology, Dec. 9, 2014
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Capital Farm Credit ACA, Jan. 12, 2021
- CoBank ACB, Oct. 15, 2020
- Federal Farm Credit Banks, Oct. 2, 2020
- AgriBank FCB, Sept. 29, 2020
- Compeer Financial ACA, April 20, 2020

Ratings List

New Rating; CreditWatch/Outlook Action	
American AgCredit, ACA	
Issuer Credit Rating	BBB+/Stable/--

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