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# Dialing for dollars

The brother of a paid-up subscriber farms a land mass in the upper Midwest even larger than Central Park (the standard by which New Yorkers measure plots of ground on which skyscrapers don't grow). On a recent visit to his local John Deere dealer, the farmer noticed that there were fewer machines parked in the lot. "Business on the upswing?" he asked. "Things have been going a lot better since the first of the year, particularly on leases," the dealer replied. "I've leased a lot of tractors and combines. That happened when Deere raised the residual value on its leases."

*Raised* residual values?

Now in progress is an update to our bearish thesis on the giant farm-and-garden implements manufacturer (*Grant's*, March 11). We revisit this subject on the strength, first, of the just related conversation, and, second, of some suggestive though—admittedly—inconclusive telephone contacts made by our enterprising and indefatigable associate Evan Lorenz. In summary, we judge that there is reason to suspect that Deere is overestimating the future value of its used equipment.

You can understand the temptation to estimate high. Farm income has halved since 2013, and corn prices have fallen by 57% from their 2012 peak. To move its green iron in these difficult times, Deere has increasingly turned to leases. In the quarter ended Jan. 31, operating leases generated 15% of revenue, up from 12% in fiscal 2015—and 6% in 2013.

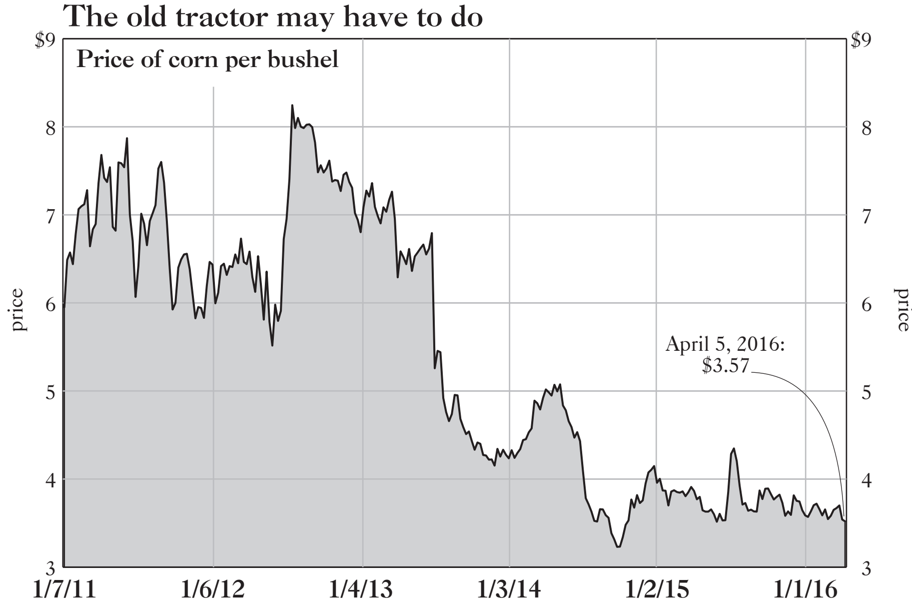
You can likewise understand why prudent management would choose to estimate low—to move heaven and earth to get in front any looming residuals-related problem. Recall that plunging values for used autos materially contributed to Ford Motor Credit Co.'s aggregate $14.4 billion operating loss in 2008. Ford Credit, the automaker's captive finance unit, had charged off $2.1 billion of residual values in the same year, which knock to equity value the accountants ran through the parent's profit and loss statement. In the nature of things, these moments of residual-related truth come to light not at the top of the cycle, but at the bottom.

Deere & Co.'s own captive finance subsidiary, John Deere Capital Corp., operates at a profit, though its book equity has been dwindling: to $4.3 billion as of Jan. 31, from $4.8 billion in the fiscal year ended Oct. 31, 2014. Recapitalizing the Capital Corp. would be an expensive proposition for the parent, though one it could hardly shirk (we are speaking hypothetically here). You need strong and flexible financing options to move the tractors.

As a reminder, an operating lease gives a farmer the right to use a tractor, combine or harvester for a short, fixed term, say two or three years. At the end of the term, Deere takes back its property to sell it. The value thereupon received—the residual value—importantly determines the value of the lease.

Note that the residual value must be determined as the lease is signed. Not knowing—being no more capable of seeing two or three years into the future than the rest of us—Deere must make an educated guess. The higher the estimated value, the easier it is for the

The old tractor may have to do



source: The Bloomberg

lessor-farmer (a higher residual value means lower monthly payments) and the riskier it becomes for Deere. You can see that the company's margin for error isn't unlimited. Compared with the $3.6 billion in residual value that Deere carries on its books (as of Oct. 31), the Capital Corp. shows the aforementioned $4.3 billion worth of equity (as of Jan. 31).

In the just ended calendar quarter, prices for used farm equipment actually nudged higher, despite a jump in the number of used-machinery auctions, according to the leading authority on the subject, Greg Peterson, who does business as MachineryPete.com. Be that as it may, used-equipment prices dropped by 32% between the first quarter 2013 and the fourth quarter 2015. Has Deere not reflected that decline in the residual values it assigns, and has assigned, to its operating leases?

Lorenz put the question to Deere. There was to be a telephone call to discuss it. At the last minute, the company cancelled the call, just it had done on the verge of a call we had scheduled a couple of weeks earlier.

AGCO Corp. (AGCO on the Big Board), another manufacturer-cum-financier of ag equipment, did respond to a *Grant's* inquiry via email. Have you, we asked, adjusted your residual values in new leases given the softness in used-equipment prices? "[T]here have been a few reductions in [residual values] on specific makes/models," Greg Peterson, the head of AGCO's investor-relations team (and not, confusingly, the proprietor of MachineryPete.com), replied.

Deere does disclose that its financing business has lost its snap. Thus, in the quarter ended Jan. 31, net income attributable to Capital Corp. fell to $129.4 million from $156.8 million in the same quarter the year before. The company partially blamed losses on reduced residual values. But those residual values related "primarily" to construction-equipment operating leases, which account for only 15% of Deere's finance book, not farm-implement operating leases, which substantially drive results. Adverse movements in foreign-exchange rates, less favorable financing spreads, and higher provisions for credit losses also figured in the tale of woe.

Deere chose not to take the occasions of its conference call or 10-Q report to disclose the dollar amount it lost from falling residual values. "We continue to closely monitor the leasing portfolio," Joshua Jepsen, head of Deere's investor relations, unhelpfully noted on the Feb. 19 earnings call, "adjust residual values on the existing portfolio as needed and take appropriate actions on new contracts to ensure we are mitigating future risk."

Thwarted at company headquarters, Lorenz dialed dozens of John Deere dealers across the Corn Belt to put the question to them directly. Not every single one was glad to hear from him. "There ain't no agriculture in New York City, is there," an Indiana man pointed out. Out of these dozens, seven stayed on the line to talk. Those few conversations have done nothing to allay our suspicion that the residual values which Deere is carrying on its books will eventually come in for downside adjustment.

One dealer in Kansas did, in fact, report that Deere is raising residual values in some of its leases. "Is there a concern, that with all this stuff going on lease, that in two or three years' time you might have all of this stuff coming back used," Lorenz asked him. "Not as a dealer," the man replied. "No, that is going to be Deere's problem. Once it leaves here it is John Deere Capital's combine, sprayer, whatever."

A dealer in Illinois also cited higher residual values in leases funded by John Deere Capital Corp. but blamed the increase on dealers rather than on Deere. He said that dealers like himself have always had the option to push for higher values when negotiating with farmers for a lease. In the past, our contact went on, dealers pushed for lower residual values to tempt farmers to purchase the equipment at the end of the lease. "Right now," our interlocutor continued, "in order to help move equipment we have a higher residual lease. At the end of that three-year lease, it is going to be a pretty high-priced piece of equipment. It is either going to be re-leased by the customer or it might go back to John Deere [Capital Corp.]."

Four dealers reported no major change in residual values, which, if true, would also be concerning, given the nearly one-third decline in used-machinery values in the three years through 2015.

"Residual values seem to be high," a dealer from Ohio, who reported no real change in those values, told Lorenz. "I think that it is a given in this kind of atmosphere that farmers don't have any desire to own like they once did. It is kind of a new wave out there. They are perfectly happy to lease for three, four or five years and turn it back in and figure out from there what they will do."

One standout—a dealer in Nebraska—reported that he hadn't put a farmer into a lease in the past 12 months. Still, he said, Deere is getting more financially creative. "They are definitely more aggressive now than they were three years ago, of course," the salesman from the Cornhusker State told Lorenz. "They've always offered pretty good deals, but the discounts are getting better and they are more apt to work with the guy on individual purchases."

For example? "Well," the salesman replied, "zero percent [interest rates] for five years. You don't see that a lot on anything, but it is being offered now."

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