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Ratings

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Compeer Financial, ACA

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Table Of Contents

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Major Rating Factors

Issuer Credit Rating
BBB+/Stable/--

Strengths:	Weaknesses:
• Very strong risk-adjusted capital ratio • Access to favorably priced funding through AgriBank • Solid track record of profitability	• Exposure to cyclical commodity prices and unpredictable agricultural conditions • Limited geographical footprint, although it has expanded through a merger

Outlook

The stable outlook reflects that although we expect the current downturn associated with the coronavirus' impact to weigh on Compeer Financial, ACA's operating performance, we do not expect outsize losses. We also see Compeer's very strong capital position as withstanding the fallout from the pandemic and from low interest rates and oil prices.

We could lower our ratings on Compeer if we expected the RAC ratio to decline from 16.7% at year-end 2019 to lower than 15% (10%-15% is considered strong) on a sustained basis, credit quality metrics weakened substantially, or funding and liquidity worsened and compromised Compeer's ability to lend.

We do not expect to raise the ratings over our two-year outlook horizon, given Compeer's limited geographical and product diversification and higher concentrations in the agricultural industry relative to those of higher-rated peers.

Rationale

S&P Global Ratings' 'BBB+' long-term issuer credit rating (ICR) on Compeer, a member-owned association, balances the company's very strong capital, solid credit risk track record, and the low cost of funds it receives as a member of the Farm Credit System (FCS) against its concentration in the cyclical agricultural sector and limited geographical diversification. We also view favorably Compeer's funding agreement with AgriBank, one of the four banks at the top of the government-sponsored FCS that lend to associations like Compeer, which are owned by farmers. The three-year running agreement provides a low-cost, stable, primary funding source.

While the rating incorporates the ongoing funding benefits that the association receives as a government-related entity (GRE), we believe that there is a low likelihood that the U.S. government would provide extraordinary support directly to Compeer in the event of financial distress. Therefore, the ICR does not incorporate any uplift for extraordinary government support, as it may for other FCS entities we rate.

Our belief that there is a low likelihood that Compeer would receive extraordinary government support in a stress scenario is based on our assessment that:

- Compeer's individual role is of limited importance to the government. We believe that a larger GRE could take over Compeer's operations if the company ceased to exist.
- Compeer has a limited link to the government. It is privately owned, and the government has no track record of providing extraordinary government support directly to associations like it.

At the time of this writing, our growth expectations for U.S. banks have changed sharply (see "U.S. Financial Institutions Face A Rocky Road Despite A Boost From Government," published April 8, 2020, on RatingsDirect). We now expect lower growth will negatively affect the earnings of the U.S. banking sector. We expect Compeer will face overall reduced earnings capacity in 2020 as well, but to a lesser extent than for some U.S. regional banks. In terms of asset quality, we will closely monitor Compeer's loan portfolio and we expect some asset deterioration, albeit the company does not lend to the industries most affected by the downturn. The agricultural sector, which Compeer lends to, is expected to see manageable impact from the difficult conditions, although should exports become strained, it would likely experience some hardship. While Compeer is experiencing some client draws to assure liquidity, including within its large capital market syndications, it has not had material drawdowns of note, according to management. Growth in loans, according to management, remains robust. Farm credit spreads, in general, have widened on the risk-averse fixed income markets; however, the decline in absolute rates has kept borrowing rates low although cost of funds has slightly increased recently, which is modestly affecting Compeer. We believe that the company has strong capital ratios to weather the downturn as well as liquidity levels because we see little risk that it would lose access to AgriBank funding. Funding remains strong and business remains as usual. The Funding Corp. continues to see a more constructive tone to the funding markets as funding and liquidity measures have been put in place by the Federal Reserve. This tone carried into the agency debt segment of the market and is spurring good participation from all the government-sponsored enterprises: Federal Home Loan Banks, Freddie Mac, Fannie Mae, and the System (Federal Farm Credit Banks).

Anchor: Adjusted to reflect regulated status, low competitive risk, and favorable funding

Our starting point--or anchor--for our rating on Compeer is 'bb+', in line with that for other U.S. companies that we rate under our nonbank financial institutions criteria. Because of Compeer's public policy role, access to 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 (FCA) regulatory oversight, the company's favorable funding through its position in the FCS, and its strong competitive position.

All figures are as of Dec. 31, 2019, unless otherwise specified.

Table 1

Compeer Financial, ACA -- Key Figures

	--Fiscal year-end Dec. 31--				
(Mil. $)	**2019**	**2018**	**2017**	**2016**	**2015**
Adjusted assets	22,184	20,754	19,545	8,981	8,362
Customer loans (gross)	19,931	18,772	17,779	8,216	7,646
Adjusted common equity	3,719	3,513	3,319	1,215	1,127
Operating revenues	722	687	351	279	257
Noninterest expenses	288	264	138	135	126
Core earnings	390	397	185	122	117

Business position: Limited by concentration risk

Our view of Compeer's business position is based on its solid market position as an agricultural lender in its three-state territory and its role as an association operating within the FCS. Its concentration to agricultural loans, with large exposures to cash grains, dairy, swine, and real estate, within a limited geography, offsets these strengths and constrains the business position score to moderate.

Compeer is structured as a cooperative and owned by the client stockholders (70,000 member-owners) to whom it provides loans and other services ($22.2 billion in assets). The company operates its retail operations through 44 office locations in 144 counties in Illinois, Minnesota, and Wisconsin. We believe that the added geographical diversification from the merger with two associations in 2017 has enhanced the stability of earnings over changing market and weather-related conditions. Lending to a number of uncorrelated industries helps its concentration to agriculture loans as well.

We expect the Capital Markets Group (CMG) and Agri-Access will continue to fuel Compeer's growth and improve diversity. CMG focuses on generating revenue and loan volume for the financial benefit of three participating associations, which include Compeer. The business arrangement provides additional means for diversifying each participant's portfolio, helps reduce concentration risk, and positions the participants for continued growth. In tandem with certain financial institutions, Compeer also provides correspondent lending programs under the trade name Agri-Access. Agri-Access focuses primarily on purchasing participations in agricultural real estate loans and leases. It also services loan portfolios for other institutional investors. These financial services firms are dispersed throughout the U.S.

Compeer's revenue stream consists of net interest income, which represents 67% (compared with a peer average of 83%) of revenues and other fee income derived from its capital markets business; Agri-Access provides some revenue diversification.

In terms of the agriculture industry and commodity prices, ethanol is being hit the hardest as its price is tied to oil prices, which have fallen, and so has gasoline demand; however, Compeer's direct exposure to ethanol is only $400 million. Corn prices also are under pressure, as corn is used to produce ethanol. Strong ethanol use looks likely once the U.S. economic recovery begins. Farm income should remain at historical averages, although it is dependent on the duration of the pandemic. Should weather and trade problems continue to affect the grain industry in 2020, most producers still have sufficient equity that provides flexibility, if needed. Although land tends to be the greatest fixed asset of most grain farm operations, it is not a major area of risk currently because Compeer is highly secured, even in declining scenarios. The dairy industry remains the most susceptible to a long-term COVID-19 shutdown. Although the sector was on the road to improvement in late 2019 and early 2020, some logistics disruptions and the recent decline in milk prices have made the recovery more precarious. Recent enactment of Dairy Revenue Protection and Margin Coverage could offset short-term price weakness, but longer-term disruptions could prove problematic for weaker producers. Pork and beef producers are pressured as demand has dropped substantially due to government-imposed curfews on road use and some packing plants are closing due to the pandemic. This will stress swine prices; however, a high percentage of Compeer's customers have long-term contracts and actively employ hedging strategies. We view positively the recent signing of the U.S.-Mexico-Canada Agreement, which will help support farmers. We also view positively the U.S.-China phase 1 trade agreement, where China is expected to purchase $80 billion in agricultural products over two years.

Table 2

Compeer Financial, ACA -- Business Position

	--Fiscal year ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Return on average common equity	10.82	11.66	8.16	10.46	10.82

Capital, leverage, and earnings: Capital ratios expected to come under pressure; however Compeer is well positioned to withstand the downturn

We expect prudent growth and for profitability to come somewhat under pressure from the downturn; however, we do not expect a material impact on Compeer's operating performance. The company maintains a very strong capital, leverage, and earnings score, in part supported by a RAC ratio of 16.7% (above 15% is considered very strong). Because of the cyclical nature of agricultural lending, Compeer tends to maintain strong capital levels to absorb losses.

We expect Compeer's RAC ratio will decline but remain within our very strong range. We expect the decline to reflect higher risk-weighted asset growth and patronage allocations, and weakness in asset quality. Compeer's regulatory Tier 1 capital ratio was 15.5%. In addition, the company has $100 million in preferred stock.

Our expectations for the RAC ratio also include:

- Loan growth around low to mid-single digits and the continuation of drawdowns on lines of credit
- Net interest income to benefit from volume growth
- Operating expenses to remain around the same level
- Provisions for loan losses to increase materially due to weakness in credit quality metrics from the impact of the downturn
- Only modest compression on net interest margin in a declining rate environment because the company is mass funded with AgriBank

Compeer benefits from a low cost structure with operating expenses to operating revenues of 40%, materially lower than that of the average regional bank, although higher than the peer average of 30%. Similarly, profitability, as expressed in core earnings to operating revenues of 54%, is much stronger than that of a typical regional bank although less favorable than the peer average of 63%.

Patronage distributions are paid in two forms. They are based upon a distribution of 25% (increased from 20%) of Compeer's adjusted earnings in cash. In addition, the association has in place an Allocated Equity Redemption Plan. Generally, this plan annually retires allocated equities designated with an intent to distribute an equal amount over 10 years. Each payment is subject to board approval. The total payout ratio increased from 41.2% in 2018 to 48% in 2019. The board is free to change amounts and timing as the environment warrants. We expect the payout ratio to remain at the current level for 2020.

In a stress test mandated by the FCA, Compeer's capital would be slightly below the board's operating range after a three-year downturn assuming no management mitigating actions. The stress test produced for the FCA incorporates the concepts of the Dodd-Frank Act Stress Test (DFAST), but also includes an agricultural element, which DFAST does not. The ratio would remain above that of many regional banks under DFAST.

Table 3

Compeer Financial, ACA -- Capital And Earnings

	--Fiscal year-end Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Tier 1 capital ratio	15.47	15.19	14.74	N/A	N/A
S&P Global Ratings' risk-adjusted capital ratio before diversification	16.70	16.90	19.07	19.39	19.25
Adjusted common equity/total adjusted capital	97.38	97.23	97.08	92.40	91.85
Net interest income/operating revenues	66.78	69.16	67.75	74.01	76.91
Fee income/operating revenues	10.20	9.48	9.50	15.66	15.34
Market-sensitive income/operating revenues	0.53	0.57	0.50	0.00	0.00
Noninterest expenses/operating revenues	39.82	38.44	39.31	48.31	49.18
Preprovision operating income/average assets	2.02	2.10	1.50	1.67	1.63
Core earnings/average managed assets	1.82	1.97	1.30	1.41	1.46

N/A--Not applicable.

Risk position: Notable concentration and market risks in agricultural lending

Compeer's loan portfolio is highly concentrated, because it consists primarily of agricultural loans although the concentration of individual client exposure remains minimal. Also, asset quality metrics are less favorable than peer averages with the exception of net charge-offs (NCOs). These aspects limit the risk position score to moderate. We expect the impact from the downturn will translate into higher loan losses; however, Compeer is not exposed to the sectors that are most affected by the pandemic.

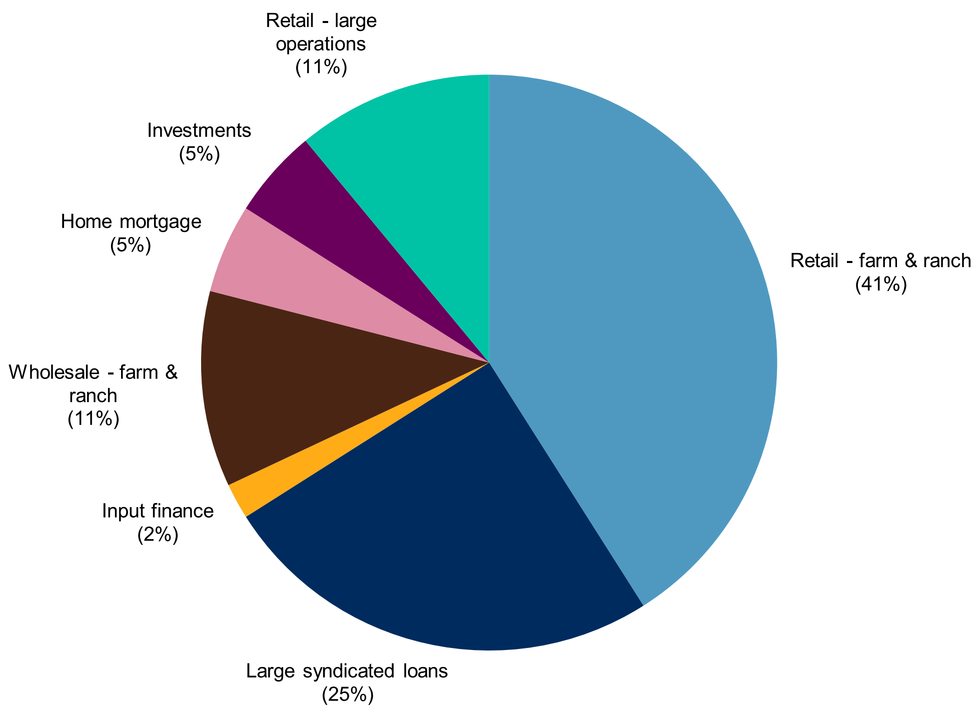
Portfolio quality remains strong in and outside Compeer's territory; however, some deterioration continues, which may be accelerated by the impacts of the pandemic. We expect non-accrual and adverse assets may rise but remain manageable.

The ratio of nonperforming loans to customer loans rose to 83 bps from 71 bps and is weaker than the peer average of 51 bps, although we still consider it acceptable for the moderate risk position score. The ratio of reserves to nonperforming loans at 47% also is weaker than the peer average of 93%. NCOs are very low at 1 bp and in line with the peer average.

We view Compeer's lending practices as prudent, reflected in the association's extremely low loan losses and conservative loan to value ratios. Compeer's conservatism is a component of prudent underwriting parameters built in at the onset of loan origination. For instance, while the FCA allows real estate mortgage loans up to 85% of appraised value, Compeer's underwriting standards generally limit lending to no more than 65% of sustainable value.

Chart 1

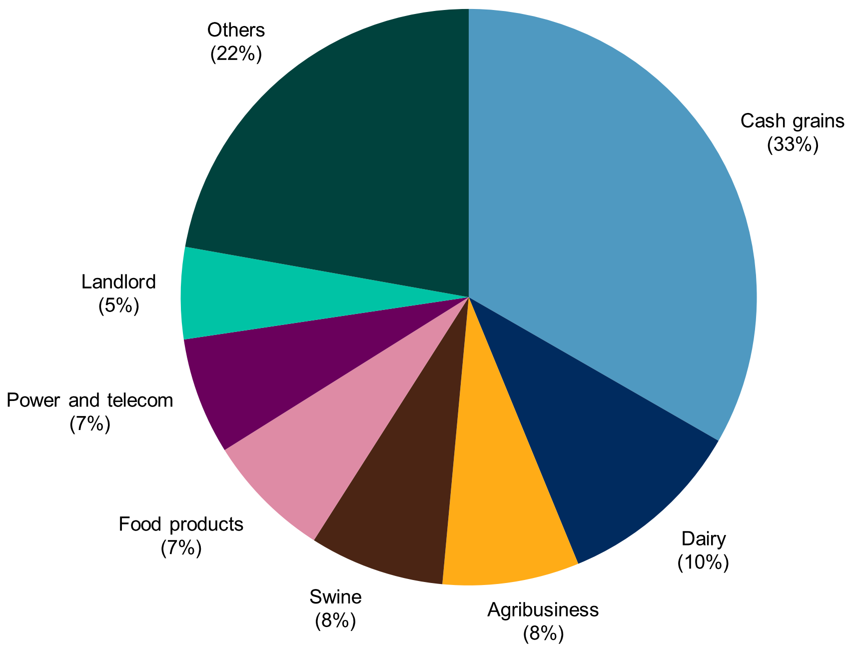
Compeer Financial, ACA -- Loan Portfolio Breakdown
(As of Dec. 31, 2019)



Source: S&P Global Ratings.

Chart 2

Compeer Financial, ACA -- Industry Concentration
(As of Dec. 31, 2019)



Source: S&P Global Ratings.

Table 4

Compeer Financial, ACA -- Risk Position					
	--Fiscal year-end Dec. 31--				
(%)	2019	2018	2017	2016	2015
Growth in customer loans	6.18	5.59	116.39	7.46	10.03
Total managed assets/adjusted common equity (x)	5.96	5.91	5.89	7.39	7.42
New loan loss provisions/average customer loans	0.11	0.08	0.08	0.13	0.08
Net charge-offs/average customer loans	0.01	0.02	0.01	0.01	0.03
Gross nonperforming assets/customer loans + other real estate owned	0.83	0.71	0.51	1.06	0.93
Loan loss reserves/gross nonperforming assets	47.19	44.80	53.36	41.47	38.05

Funding and liquidity: Concentrated funding sources are offset by very stable access

We consider Compeer's funding and liquidity adequate. The association is not authorized to take retail deposits from customers. Its primary funding source is a wholesale credit agreement with AgriBank, one of the four farm credit banks. The $22 billion ($18 billion was advanced) line of credit with AgriBank is renewable every three years. The association has the ability to tap capital markets for supplemental funds via preferred stock and subordinated debt, but it relies overwhelmingly on AgriBank. We recognize that there is a very low probability that Compeer would lose access to AgriBank funding.

We believe that these low-cost funds reflect the implicit government support that the FCS receives as a GRE and the joint and several support shared among AgriBank and its three counterparts. Compeer is seeing modest pressure on cost of funds and expects this trend will continue or improve, not worsen materially. As part of its cooperative structure, and to preserve this funding advantage, AgriBank requires Compeer to maintain an investment equal to 2.5% of the average quarterly balance of its note payable, with an additional amount required on association growth above a targeted growth rate, if the geographical area is also increasing above a targeted growth rate. To the extent Compeer chooses to participate in AgriBank's asset pool programs, it also is required to hold AgriBank stock equal to 8.0%-14.0% of the balance of loans in them. In addition, Compeer's agreement with AgriBank incorporates covenants related to performance, credit quality, and capital levels, such that should these deteriorate, the cost of Compeer's funding would increase. As of this time, the company significantly exceeded those thresholds. Our calculation of Compeer's stable funding ratio is 74%, indicative of a shortfall in matched funding for term assets and which is weaker than the peer average of 81%, although that also is showing a shortfall.

We view Compeer's on-balance-sheet liquidity as limited by the design of the FCS structure. The company does maintain a modest investment portfolio ($1.1 billion) made up entirely of government-guaranteed securities. The company's broad liquid assets do not cover short-term wholesale funding at 0.20x, which also applies to the peer group at an average of 0.50x. The shortfall is largely due to Compeer's small securities portfolio. Nevertheless, we view liquidity as adequate because we see little risk that Compeer would lose access to AgriBank funding.

Compeer is expected to follow the market in terms of LIBOR migration to Secured Overnight Financing Rate (SOFR). A Farm Credit workgroup, on which Compeer has two representatives, is working toward the migration; however, farm organizations are not mandated to transition to SOFR before early 2023.

Table 5

Compeer Financial, ACA -- Funding And Liquidity					
	--Fiscal year-end Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Long-term funding ratio	72.78	72.45	17.64	14.77	15.91
Stable funding ratio	74.43	74.03	18.25	15.39	16.50
Short-term wholesale funding/funding base	33.00	33.44	100.00	100.00	98.73
Broad liquid assets/short-term wholesale funding (x)	0.20	0.17	0.05	0.06	0.06
Short-term wholesale funding/total wholesale funding	32.82	33.24	99.38	98.70	97.35

Additional rating factors:

No additional factors support this rating.

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: Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies, Dec. 9, 2014
- 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of April 20, 2020)*	
Compeer Financial, ACA	
Issuer Credit Rating	BBB+/Stable/--
Preferred Stock	BB+
Issuer Credit Ratings History	
05-Jun-2018	BBB+/Stable/--
19-Jul-2017	BBB/Positive/--
02-Jul-2015	BBB/Stable/--
Sovereign Rating	
United States	AA+/Stable/A-1+
Related Entities	
Agribank FCB	
Issuer Credit Rating	AA-/Stable/--
Preferred Stock	BBB+
CoBank ACB	
Issuer Credit Rating	AA-/Stable/--
Preferred Stock	BBB+
Farm Credit System Banks	
Senior Unsecured	A-1+
Senior Unsecured	AA+
Senior Unsecured	AA+/Stable

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