Financial and Business Management
Strategies for Uncertain Times

by David M. Kohl

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Operating a farm business in difficult times is surrounded with many dangers, some which concern a failure to recognize the true nature of the situation and consequently making an inappropriate response to it. While many farm businesses will fail in the next few years, it will be sad if some which could have been saved are not. It will be particularly unfortunate if a farm business liquidates because the management had a poor understanding of the situation and

Financial Profile of American Agriculture

To set the stage for possible strategies and solutions to the financial plight of the livestock farmer, it is important to gain a historical prospective from the financial sector of agriculture. Many farmers and people serving agriculture have never faced an economy other than an expanding one. For example, it was a fairly common practice for farmers in the 1970s to buy land, livestock and machinery at any price demanded and expect to sell them at even higher prices. The main objective of many connected with agriculture was to ride the inflation spiral upward as far as it would go. In the decade of the '70s, farm asset values increased over three times, while the composition of assets shifted from more liquid holdings (i.e., assets that generate cash) to a greater percentage of the value of assets concentrated in non-liquid areas, such as farm real estate and improvements. Farm real estate in 1960 amounted to 60 percent of all farm assets, while currently it represents three out of every four dollars of farm assets. This shift in assets has had two distinct ramifications on the American farmer. Farmers are depending more on borrowed capital for liquidity to meet everyday expenses, and cash flow generation and management are currently keys to a farmer's success.

Analysis of the liabilities side of credit shows that the balance sheet bears out that farmers are using more credit. U.S. farm debt outstanding has increased over 3.5 times since 1970, generally following the inflation rates. However, since mid-1981, farm assets have declined by about two percent nationally while farm debt has increased at over a six percent annual rate. Thus, statistics point out that farmers are depending more on credit for cash flow and subsequently eroding their equity positions.

If one analyzes the income portion of U.S. agriculture, it is obvious that the cash flow crunch has been slowly creeping up on farmers.

Net farm incomes with adjustments for inflation, since the mid-1970s are comparable to pre-World War II levels. Also there has been a scenario of extreme volatility in net incomes from one year to the next as agriculture has been thrust on the international scene and affected by domestic farm policy, market cycles and weather.

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Expenses versus income

The cash flow crunch is more dramatically demonstrated as one analyzes the ratio of farm production expenses to gross U.S. farm income. For example, in 1970 production expenses amounted to 73 percent of gross farm income on farms that produce over $100,000 gross farm income annually. Today these same expenses represent well over 80 percent. Farms that produced under $100,000 gross farm income illustrate a more striking trend. In 1970 it cost 77 cents to produce a dollar's worth of income, while on the same farms today it costs over a dollar to produce the same dollar of income.

Debt outstanding as a percent of net farm income has increased from 91 percent in 1950 to over 1,000 percent in 1982. In other words, a farm with $10,000 net farm income carried $9,100 in debt in 1950, but now has well over $100,000 debt for the same amount of net farm income.

Meeting adverse trends

How are farmers making adjustments to meet these adverse trends? Analysis of net income per farm family shows off-farm income currently represents well over two-thirds of the total income generated. This compares to the early 1960s when off-farm income was less than 40 percent of total farm family income. When the farm enterprise and overall situation allows, we find farm families turning to off-farm income to supplement operating expenses, family living and debt payments.

This quick historical overview of the financial sector of agriculture finds interesting and challenging times and gives us some perspective of agriculture for the remainder of the decade. Volatility in incomes along with the importance of non-farm income appear to be factors that farmers will have to contend with in the financial game plan. Skyrocketing inflation on farm assets that bailed out poor credit and investment decisions in the past by both farmer and agrilender appears to be in remission.

It is obvious that good records along with efficiency, cash flow, borrowed capital and good financial practices will be essential for a profitable farm business.

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Records and their role on your farm

Farm records are key ingredients in any successful farmer's game plan. Record analysis can be the difference between a winner and a loser. Analysis of a summary of Virginia beef farm records over the years illustrates that farms with highest net cash income did not necessarily have the highest cash receipts, but were able to control their cash expenses more efficiently. Analysis of specific cost control items suggests that high income farms generally have significantly lower expenses for fertilizer, lime, land, or interest and purchased feed. Investment analysis finds that lower income farms have a higher investment in machinery and lower investment in livestock.

Analysis of production efficiency shows little difference between percent calf crops weaned per cow exposed. This implies that both farm groups were equal in their ability to manage the cow herd. However, calf weaning weights per cow exposed average 70 lb. greater for high income farms.

This data points out one of the major problems of many producers. Percent calf crop, which is the most popular measure of production efficiency, showed no significant difference. However, higher weaning weights of cattle on more profitable farms was obviously due to better milking cows and/or selection of better quality bulls, which may indicate superior management after calves hit the ground! For example, this would result in an additional $2,800 per year in calf sales for an 80-head herd (70 lb. × 80 cows × 50¢/lb. = $2,800). If half was attributed to better bull selection ($1,400), most producers could justify paying for a high-quality, production-tested bull.

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In conclusion, farm record analysis finds cost control conservative. Investment strategies with emphasis on excellent livestock selection, along with strong farm management practices throughout the year pay dividends for livestock producers and can provide extra income in uncertain times.

The following is a summary of what our most efficient and better-managed livestock farmers are doing.

Strategies for efficiency and cash flow

1. Keep accurate records of your farm business. Then use them to analyze your financial and production situation.
2. Concentrate on cost control with an eye on production management throughout the year.
3. Be careful in investing in capital items which do not generate income.
4. Consider renting and leasing of land as a better alternative than buying.
5. As cow-calf producers, give equal weight to weaning weight and calving percentage. It takes almost the same cost to produce a 400-lb. calf as it does a 500-lb. calf.

Financial management strategies

One of the biggest challenges facing agriculture for the remaining part of the century is the farmer's ability to develop strategies which can circumvent financial crises. Smaller income margins, price and cost squeeze, volatility, and the greater use of borrowed capital make financial management extremely important in tackling the cash crisis facing the farmer. Whether a producer is just beginning, highly leveraged or has the farm nearly paid for, there are basic financial strategies that will put him in a much better position to prosper.

Debt serving ratio

The debt serving ratio is one of the basic guidelines used by agricultural finance professionals to see how annual cash flow projections and debt payments mesh. It is calculated by dividing debt payments by total cash receipts and non-farm income. Generally, for a farm producing $80,000 gross

farm income and $20,000 non-farm income ($100,000 total annual income), the total debt payments (principal + interest) should not exceed $25,000 annually. For livestock and crop producers that are affected by cycles, weather and other inherent risk, this ratio should not exceed 20 percent. Ideally it should be under 15 percent to avoid cash crunches if debts are being paid off over an extended period of years. If a farm should exceed these guidelines, it is essential that the producer monitor operating, family living and production costs. Only an extremely efficient operator can survive these debt load guidelines without financial difficulty.

Cash flow cushion

Now is an opportune time to analyze your cash position for next year. The cash flow cushion is a frequently used measure in determining a farm's ability to handle risk and uncertainty in the future. It is calculated by taking gross farm income and non-farm income and deducting farm and family living expense as well as debt payment. The residual should be at least 20 percent of debt payment. This allows a buffer for unexpected expenses, increased interest rates or reduced incomes, so the cash crisis can be avoided.

For example, a farm with $100,000 in farm and non-farm income; $50,000 in cash farm operating expenses, excluding interest; $15,000 in family living deductions; and $25,000 in annual debt payments would have a residual of $10,000. In the example, the cash flow cushion would be 40 percent ($10,000/$25,000), which would be considered good.

If a producer analyzes the business for a given year and finds there is little residual, concentration on production management, cost control and restructuring debt may be alternatives to generate the necessary residual to handle the uncertain agricultural economy.

Designing credit packages

A basic problem of farmers in cash crises is the inability to pay back borrowed capital properly. Many producers have plans that call for paying back too fast or have repayment schedules that are not compatible with income streams. Generally speaking, a 15- to 25-year payback is the best alternative for land and building improvements. Too often, farmers are lured by low interest rates with accelerated paybacks in situations where large capital expenditures have been in land or improvements. This financial strategy frequently puts an extreme burden on the farm and family to generate income to meet paybacks. More often than not an attractive interest rate leads to financial tragedy. In general, five- to seven-year financing on machinery and equipment is recommended strategy for farmers in periods of stressed cash flow, such as those we will be facing in the future.

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Producers must be extremely careful to match payments with income flows. Farm families frequently find themselves in desperate situations when payments are due, however livestock and crops are not ready to market or would receive higher prices at some other point in time. A projected cash flow on at least a quarterly basis is a basic tool that frequently assists the farmer and agrilender in making marketing and financial decisions. An agrilender with some flexibility in repayment plans can be extremely useful, too.

Farmers also must be more cautious in managing excess cash flows in a given cash flow planning period. This is particularly true with crop and livestock producers who receive incomes once or twice a year. Too often, excess cash in the checkbook is the stimulus for poor capital investment decisions where purchases are made on an impulsive or emotional basis. Advice here is to keep excess cash in an interest-bearing account (such as money market certificates, etc.) where excess cash can earn interest and reduce the possibility of poor investment decisions.

A final suggestion is to consolidate your credit among a few agrilenders. This assists in coordinating payments and security agreements, and reduces communication problems and general hassle in case of a financial crisis. It is much easier to adopt a plan and coordinate your financing (or refinancing) with a few lenders than with numerous creditors. Careful examination of payments and implementation of reasonable payback strategies are essential for success.

Summary

When ancient Greeks first introduced money in a barter economy, it played havoc. Use of money created two-word maxims by philosophers of the period that are applicable today. The first was "know thyself" and the second was "be moderate." They may not be bad watch words for today.

Knowing thyself in a financial sense means keeping good records and getting back to basics, strategies and common sense while making tough decisions.

Being moderate may be analogous to the farmer who has the discipline to follow those strategies and rules, yet has the ability to change management philosophy to cope with changes in the economy.

Producers are going to have to abandon the idea that inflation and booming markets are going to bail them out. They are going to have to concentrate on situation analysis and appropriate responses. Translated into financial terms, Aristotle might have said, "if you can't cash flow it, forget it." AJ