Part 1 of 2:

Financial Focus

Current economic cycle requires “stepping up” intensity on financial management says economist.

*by **Kindra Gordon,** field editor*

Downturn. Reset. Slump. These are all words being used to describe the current ag economy — particularly in comparison to the record-breaking commodity prices from a few years ago.

Where exactly are we in this economic slowdown? Ag industry economist David Kohl shares this perspective: “I call the years from 2008 to 2013 the ‘great commodity super cycle’ in agriculture. … It was the Mount Everest of profits.”

Now, he points to the dramatic dip in commodity price charts and says, “We are on the other side of Mount Everest.”

Thus, Kohl, who is a professor emeritus of agricultural and applied economics from Virginia Tech and crisscrosses the country speaking to ag industry groups, says the No. 1 question he’s being asked is, “When is this market going to turn around?”

To answer, he offers a baseball analogy: “I think we’re in the fourth or fifth inning of this economic reset.” He explains that the U.S. economy is currently only growing at about 1%, and says, “After a recession the growth rate is typically 3%-4%.”

Of this, he offers stern advice to ag producers, “We are at a time in the economic cycle where intensity on financials is going to have to step up.”

Farm income forecast

Regarding farm income projections, Kohl shares a stark reality, saying, “We are moving back to pre-2008 as far as farm incomes.” He notes that during the “Mount Everest of profits” phase, the top 20% of producers were easily making money. Even the bottom 20%-30% of producers were making money.

In today’s market, he anticipates, “The top 40% of producers will still make money, but the bottom 20% may not. … That’s the true reality.” He notes the saying, “low prices cure low prices,” and believes some producers could go out of business.

How can producers ensure they are not among the casualties in the bottom 20%? Kohl says, “The difference is volatility of prices — that will be the new normal, and it will require astute marketing.”

Kohl also references the five Cs of credit — a system used by lenders to gauge the creditworthiness and stability of borrowers — noting that Cash flow, Capital, Character, Conditions and Collateral are also good indicators of financial viability.

“There is a sixth C that will be a difference maker for the next several years — the Cranium,” he adds. “Can you plan, strategize, execute and monitor? That is often missing. Many producers don’t plan and can’t pull the trigger when it’s time to execute their plan.”

He continues, “Often the business grows faster than the management ability, which leads to this situation where managers can’t execute and make decisions.”

Kohl also underscores that in the current economic climate producers “can’t just produce their way to profit,” as increased production can’t compensate for unsustainable expenses. He shares that farm business management data has revealed that producers in the top 20% of profit compared to those in the lower 20% of profit often have similar production yields — the difference is that more profitable producers keep costs in check.

Thus, he emphasizes that knowing cost of production — by enterprise — and having a written marketing plan that addresses production, marketing, finances and risk management are essential management tactics.

“It’s simple, but important,” he says, referring to the written marketing plan. “Then, when you have market volatility you can make decisions for profit.” (See “Management musts to weather current economic downturn,” page 107, for a list of additional essential financial management strategies.)

Kohl also advises scenario planning, which entails asking a variety of “what if” questions and how those scenarios may impact cash flow.

“With computer spreadsheets today, it’s pretty easy to do. If you’re too old to work a spreadsheet, it’s time to bring in the younger generation,” he says. “Involving the younger generation is critical to agriculture’s future.”

Five adjustments

Kohl believes that for producers to keep their ag entities viable for the future, five proactive adjustments need to be considered. They include:

1. Making adjustments on cash rent and other lease arrangements. He reports that those producers in the top 20% of profitability typically have cash rents that are $50-$60 per acre lower than less-profitable producers. He notes that tax increases are making it more difficult to get landowners to come down on cash rents, but he encourages producers to approach their landlords and negotiate.

2. Adjusting input expenses where possible. Similarly, Kohl reports that farm data shows that the upper tier of profitable farm businesses spend less (per acre) on input costs than the lower tier. He suggests producers run the numbers to determine where they can curb expenses — from transportation and fuel to feed, fertilizer and the like.

3. Trimming family living expenses. Kohl reports that from 2007 to 2013 family living expenses in ag families doubled.

“During good economic times, people make more and spend more,” he notes, but Kohl underscores that those times have changed. Thus, spending habits also need to be reined in.

"It requires tough communication for family," he emphasizes. "It's a family affair."

Kohl says data indicate farm family living expenses often average from $65,000 to $90,000, but they can balloon to as high as $125,000 to $150,000 — a $60,000 difference.

"This is a difference maker," says Kohl. "Never put a family living budget on an annual basis; put it on a monthly basis."

4. Utilizing risk-management tools. Kohl reiterates his advice for producers to "use their cranium and have a marketing plan that they are willing to execute." He notes that producers must be prepared to seize a profit window when it appears. He again shares data showing those producers in the top 20% of profitability are better at marketing and risk management; specifically, they wait for profitable margins, but may not risk waiting for the largest profit margin possible.

5. Lowering capital investments. With lower commodity prices reducing farm income, Kohl says capital investments also need to be rethought — particularly on machinery. Kohl says opportunities to diversify operations and possibly generate alternative income streams should also be considered.

Management musts to weather current economic downturn

The ability to plan, strategize, execute and monitor for your farm business is essential to achieving viable profits, believes economist David Kohl. He offers the following list of what he calls "difference maker" management tactics — and says these will be paramount for ag businesses as the ag industry experiences an "economic reset" through 2020.

Kohl suggests individuals who take action in seven or more of these categories are most likely to sustain their business, while those who are only doing three or four of these activities are at a higher risk.

- Analyze enterprises by cost of production;
- Develop a written marketing plan;
- Utilize a written business plan;
- Set goals and execute goals;
- Develop management succession plan;
- Establish and utilize advisor team;
- Develop risk-management plan;
- Offer training programs for management and employees;
- Develop environment/conservation management plan; and
- Secure long-term written lease arrangements or ownership of 75% of land/assets.

Success equation

All total, Kohl says the business equation for success is this: O + C + L + M2 = P. That is

O = overhead cost control;
C = knowing costs;
L = having liquidity and recognizing cash is king
M2 = marketing and management for margins
P = people, profits and plans

Kohl summarizes saying to producers, "Sweat the small stuff — plan, strategize, execute and monitor. To be in the top 20% of profitable producers, surround yourself with good people, make every attempt to keep overhead costs low, know thy costs, maintain liquidity and working capital, invest in productive assets, and invest in yourself through continual learning." AJ

Editor's Note: *Kindra Gordon is a freelance writer and cattlewoman from Whitewood, S.D. Kohl shared his remarks Sept. 28, 2016, in Deadwood, S.D., during a program hosted by Farm Credit Service of America.*