CORNHUSKER ECONOMICS

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Risk Management Challenges and Opportunities in 2010

Market Report	Yr Ago	4 Wks Ago	1/15/10
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight	$82.88	$79.38	$84.33
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.	113.79	105.93	114.30
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	97.33	96.96	98.21
Choice Boxed Beef, 600-750 lb. Carcass	149.78	138.63	144.91
Western Corn Belt Base Hog Price Carcass, Negotiated	58.07	62.19	67.01
Feeder Pigs, National Direct 50 lbs, FOB	60.00	*	*
Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean	56.80	70.73	73.61
Slaughter Lambs, Ch. & Pr., Heavy, Wooled, South Dakota, Direct	95.37	94.87	*
National Carcass Lamb Cutout, FOB	256.29	249.27	240.93
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu.	5.29	4.09	3.97
Corn, No. 2, Yellow Omaha, bu.	3.76	3.66	3.47
Soybeans, No. 1, Yellow Omaha, bu.	9.91	9.94	9.51
Grain Sorghum, No. 2, Yellow Dorchester, cwt.	5.29	6.04	5.57
Oats, No. 2, Heavy Minneapolis, MN , bu.	2.48	2.55	2.26
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.	*	135.00	135.00
Alfalfa, Large Rounds, Good Platte Valley, ton.	77.50	87.50	87.50
Grass Hay, Large Rounds, Premium Nebraska, ton.	85.00	*	82.50
Dried Distillers Grains, 10% Moisture, Nebraska Average.	145.00	116.50	108.50
Wet Distillers Grains, 65-70% Moisture, Nebraska Average.	44.87	43.62	40.50

*No Market

In 2009, agriculture was impacted by significant volatility in commodity and input prices and major world economic events. The world economy continued to flounder, resulting in reduced demand for agricultural commodities, particularly livestock products. The H1N1 outbreak further exacerbated the situation as consumers around the world reduced their consumption of pork. In the last quarter of 2009, unemployment in the United States reached ten percent and continues to rise each month, albeit at a slower rate. In recent reports economic analysts contend the reported figures underestimate the actual unemployment, and that we will continue to face ten percent or more unemployment through 2010.

With the economic environment in flux, more risk is being passed on to the producer. Manufacturers are passing risk on to the input suppliers, and the input suppliers are passing the risk on to the farmer. As an example, there have been situations this winter where farmers were not able to apply as much anhydrous as planned last fall due to the weather conditions, and the supplier is not willing to supply the unused anhydrous in the spring at the agreed upon fall price. On the commodity sales side, not only are prices more volatile, but methods of reducing that risk, in some situations, are shrinking. Some risk management tools are no longer effective and there is a need for the development of new tools. In the meantime, how do agricultural managers position themselves for 2010? Three strategies will be discussed: (1) financial analysis with a focus on working capital; (2) building relationships with business contacts, and; (3) a specific tax planning opportunity in 2010.

Financial Analysis

In a recent interview on ***Market Journal***, Mike Boehlje, Professor of Agricultural Economics at Purdue University, suggested the place to start is with the financial analysis tools (See: http://marketjournal.unl.edu/010810).

There are five basic components of financial analysis – liquidity, solvency, profitability, repayment capacity and efficiency. Liquidity is the ability of the business to meet its financial obligations as they come due. This includes taxes and family living, in addition to debt payments. Solvency, on the other hand, is the ability to pay all debts if all assets were

liquidated. Solvency measures the wealth of the business, and theoretically, whether or not the operation can stay in business in the long-run. The problem is that many operations go out of business due to a lack of liquidity. They may still be solvent, but a lack of cash may offer no alternative but to sell assets and cease operation. "Cash is king" has become the slogan in this risk-heightened environment. This article will focus on the working capital or cash position.

Measure Working Capital

Historically, the current ratio or the value of current assets divided by the current liabilities was the primary liquidity measurement used. The metric prescribed by the Farm Financial Standards Council is a ratio of 1.7. This means to be in a strong current situation, a business will have at least $1.70 in current assets for every dollar of current liabilities. Any incurred liabilities that are due in the next 12 months must be met. Current assets such as unsold grain can decrease in value, and a ratio of 1.7 provides a cushion. However, with farm sizes increasing, higher input costs and more volatility in the prices of both inputs and commodity prices, we need to go a step further in assessing the liquidity position of the business. That step is analyzing the working capital situation. Working capital is the difference between current assets and current liabilities. Neither the current ratio nor the absolute dollar value of working capital takes the size of the operation into consideration. The level of working capital needs to be related to the cash needs of the business. For example, working capital of $100,000 is very adequate if the farm is grossing $400,000, but is not sufficient if the gross is double that. The Farm Financial Standards Council has developed the following criteria for the ratio of working capital to gross farm income:

Green or Strong:	Greater than 25%
Yellow or Caution, Monitor Closely:	Between 10% and 25%
Red or Immediate Action is Needed:	Less than 10%

Using the $100,000 of working capital example, if the farm grosses $400,000 the working capital to gross income ratio would be 25 percent, putting it on the border between "green" and "yellow." However, if the gross was $800,000, the ratio would be 12.5 percent, or getting close to the red zone.

Some analysts and consultants prefer to relate the working capital to the operating expenses, rather than the gross income. Management consultant Moe Russell recommends his clients maintain a working capital to operating expense ratio of 50 percent. (See: http://marketjournal.unl.edu/121109).

The level of working capital is like a two-edged sword. If you have too much, your cash may not be working hard enough. But with too little, you don't have an adequate buffer for a situation where costs increase and receipts decline. Reduced working capital can occur where profits are being invested back into a profitable growing business. But monitoring the working capital and maintaining a balance consistent with the needs of the business is a key risk management strategy.

Enhance Relationships with Business Contacts

There are two aspects to developing relationships with contacts. Enhancing relationships can mutually benefit both parties and reduces counter party risk. Counter party risk has become an issue in our volatile economy. This is the risk that input suppliers or commodity purchasers will not complete transactions that were negotiated. This may be a result of a variety of situations ranging from the other party going out of business to fluctuating prices, with the other party not willing or able to complete the transaction at the agreed upon price. The purchasing of fertilizer is a good example. There is a risk the supplier will not be able or willing to supply the quantity agreed upon at the negotiated price.

Moe Russell suggests developing business relationships to the extent of sharing confidential information with each other. This is where the mutual benefits may come into play. Try to make the relationship such that culmination of a transaction is a win-win for both parties and any cancellation will damage at least one of the parties. By sharing confidential information, such as financial situations, both parties are fully aware of what is at stake and are making a commitment to follow through so both will benefit.

Study and Monitor Regulatory and Legal Risks

There has been a lot of discussion about climate change and proposed legislation. But this is only one of a number of topics in the regulatory and liability area that could impact your business over the long-run. These include EPA regulations, farm liabilities, pesticide use and worker protection and relationships.

Estate and Retirement Planning

Many crop farm operations have had record net incomes over the past two years. Livestock operations have generally not fared as well recently. If profits are available it's a good time to be more active in investing those funds for retirement. There is a special situation available in 2010 regarding retirement funds. During 2010, traditional IRAs, which were invested with pre-tax dollars, can be converted to Roth IRAs. Roth IRAs are funded by after–tax dollars but have the advantage that the money is tax free when it is taken out. The proceeds of traditional IRAs become taxable when the money is taken out. Similarly, the funds from a traditional IRA are taxable if they are converted to a Roth IRA. Check with your accountant to determine the best strategy for your family. For some farm families, such as livestock producers who might be projecting a low net farm income and have traditional IRAs, it is an excellent opportunity to get a tax break.

Summary

We continue to be challenged by the downturn in our economy. Some risk management suggestions for farmers and ranchers for 2010 are:

1. Utilize the financial analysis tools. Look particularly at your working capital situation.
2. It may be helpful to coordinate purchases and sales, or at least pre-purchasing of inputs covered by forward pricing of grain.
3. Work on enhancing relationships with business contacts.
4. Take opportunities to plan ahead for retirement income.

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