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Responding to Financial Stress

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Cornhusker Economics

Cooperative Extension

Institute of Agriculture & Natural Resources
Department of Agricultural Economics
University of Nebraska – Lincoln

Responding to Financial Stress

Market Report	Yr Ago	4 Wks Ago	5/31/00
<u>Livestock and Products,</u>			
<u>Average Prices for Week Ending</u>			
Slaughter Steers, Ch. 204, 1100-1300 lb Omaha, cwt.	\$65.12	\$69.76	\$69.38
Feeder Steers, Med. Frame, 600-650 lb Dodge City, KS, cwt.	78.00	*	93.38
Feeder Steers, Med. Frame 600-650 lb, Nebraska Auction Wght. Avg.	94.25	94.92	96.00
Carcass Price, Ch. 1-3, 550-700 lb Cent. US, Equiv. Index Value, cwt.	105.52	112.96	112.27
Hogs, US 1-2, 220-230 lb Sioux Falls, SD, cwt.	29.75	45.50	53.50
Feeder Pigs, US 1-2, 40-45 lb Sioux Falls, SD, hd.	*	*	42.59
Vacuum Packed Pork Loins, Wholesale, 13-19 lb, 1/4" Trim, Cent. US, cwt.	97.35	108.45	134.40
Slaughter Lambs, Ch. & Pr., 115-125 lb Sioux Falls, SD, cwt.	80.00	97.37	89.62
Carcass Lambs, Ch. & Pr., 1-4, 55-65 lb FOB Midwest, cwt.	174.00	210.00	202.50
<u>Crops,</u>			
<u>Cash Truck Prices for Date Shown</u>			
Wheat, No. 1, H.W. Omaha, bu.	2.92	3.02	3.04
Corn, No. 2, Yellow Omaha, bu.	1.90	2.07	1.78
Soybeans, No. 1, Yellow Omaha, bu.	4.24	5.04	4.77
Grain Sorghum, No. 2, Yellow Kansas City, cwt.	3.19	3.92	3.03
Oats, No. 2, Heavy Sioux City, IA, bu.	1.24	1.26	1.21
<u>Hay,</u>			
<u>First Day of Week Pile Prices</u>			
Alfalfa, Sm. Square, RFV 150 or better Platte Valley, ton.	*	115.00	105.00
Alfalfa, Lg. Round, Good Northeast Nebraska, ton.	*	47.50	45.00
Prairie, Sm. Square, Good Northeast Nebraska, ton.	*	67.50	70.00
* No market.			

Drought, low grain prices and high fuel prices are on the minds of many Nebraska farm families this summer. The impact of these events will of course be different by area of the state, by enterprise mix on each farm and the financial position of the business coming into this year. Unless managed properly, these events are likely to lead to financial difficulty this fall or next spring.

A recent article by Purdue University agricultural economists suggests that managers can employ a number of specific strategies if their business is under financial stress. The strategies can be categorized into three types of managerial responses: 1) managing cash flow, 2) managing liabilities, and 3) managing assets.

The selection of a strategy depends on the source of the stress. First, consider stress that is caused by an external event and is of short duration. This situation might be a business that has a record of being profitable, but is impacted by a drought in which yields for the farm are depressed for this year, but recover under normal weather the following year. The manager's response may include actions such as reducing planned capital purchases, reducing fertilizer rates or negotiating with lenders for interest-only payments on term loans. These actions buy time until rainfall normalizes, prices improve or the economic environment becomes more favorable.

The second situation is one in which the cause of financial stress is internal to the business and is long-run in nature. This problem is fairly common among farm businesses, given the general decline in profit margins over the last decade. In this situation, the financial stress comes on gradually, but may be accentuated by an external event, such as drought. In the new lower price environment, the farm business may no longer be generating a sufficient amount of revenue to recover from an event such as drought. While cost cutting or debt restructuring can buy time, financial stress will likely reappear. Alternatives



to increase the value of production from fixed resources and lower per unit fixed costs should be considered.

Strategies to manage income and cash flow through increasing revenue, reducing cost or increasing output will not only reduce current financial stress, but will have long-run benefits in terms of increasing profitability or net margins in the farm business. But in many cases, these strategies are either not available or do not provide sufficient benefits to relieve financial stress. In this case, more drastic action may be required, such as selling assets to pay off debt. Examples of actions managers might consider are listed below.

Consider the following actions to increase net income and manage cash flow. While a manager's reaction to these suggestions may be "Been there, done that," reconsidering these actions in light of the present business environment could be worthwhile.

1. **Control cost.** While producers may feel they have cut costs to the bone, farm record summaries typically show a wide variation in unit production costs. This suggests that many of those with average or above average costs could benefit from added cost control efforts.
2. **Renegotiate cash rents.** Rents are one of the largest cost items in crop farming. While the rental market is very competitive, if all producers in an area are impacted by drought, higher fuel prices and low crop prices, this may be a possibility.
3. **Reduce capital spending.** This is possible if capital purchases were budgeted in the cash flow plan and they can be postponed.
4. **Reduce family withdrawals.** This is a sensitive topic, and it is best to involve the whole family in generating ideas to reduce family spending. Cuts should not be made in areas that might create problems in the long run, such as health and medical insurance.
5. **Increase revenues.** Evaluate the productivity of fixed assets. Sometimes grain storage or hog facilities can be rented out, or underutilized machinery can be used to do custom work. Some families have begun game hunting as an enterprise, and charge hunters a daily or annual fee.
6. **Increase non-farm income.** Many families have taken this action already. The length of this commitment may depend on whether the financial stress is viewed as a temporary or a long-run problem.

Consider the following actions to manage debt.

1. **Extend loan terms.** Longer terms to repay term debt will often reduce cash flow pressures, but the debt still must be repaid. This strategy does

nothing to reduce cost or increase income, but it does buy time.

2. **Interest only payments.** This may be a solution if the loan is well secured and the cash flow shortage is assumed to be temporary.
3. **Increase collateral.** This action does little to relieve the root causes of financial stress. It does give the lender a stronger financial position in case of default in the future. Be careful to assign no more collateral than is absolutely necessary.
4. **Reduce debt.** The funds might come from non-farm earnings, gifts or loans from family members or the sale of farm business assets. This action buys time, assuming that the financial stress is temporary. If the root problem is an internal one, the financial stress will reappear.

Consider the following actions to manage assets.

1. **Liquidate investments and reduce debt.** If the business is fortunate enough to have accumulated cash and financial reserves, these can be used to reduce debt. Unfortunately, businesses facing financial stress usually do not have significant reserves.
2. **Sell inventories and pay down debt.** This action may be necessary if the stress is severe. Actions should be taken to minimize the income tax effects of selling inventories. This may also reduce next year's income and impair the income producing capacity of the business.
3. **Sell capital assets and reduce debt.** The sale of land and machinery also has tax implications and may reduce the income producing capacity of the business. Sell capital items that are not cost effective to the business first.

A trend sheet which shows the performance of a business over a period of years can be helpful to the manager in selecting strategies to deal with financial stress. In addition to monitoring the current ratio, debt to asset ratio and return on equity, trends in the operational ratios reveal a great deal about the performance of a business. The operational ratios are the percent of gross revenue that is required for operating expenses, interest, depreciation and the residual for net farm income. Records of business performance are a valuable management tool in good times as well as in bad times.

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Reference: Boehlje, Michael, Craig Dobbins, Ken Foster and Alan Miller. "Responding to Financial Stress, What are the Options?" *Purdue Agricultural Economics Report*. December 1999.

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