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CORNHUSKER ECONOMICS

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Department of Agricultural Economics
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Managing Financial Risk through Boom and Bust

Market Report	Yr Ago	4 Wks Ago	2/1/08
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	$86.34	$89.07	$88.36
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb..	110.47	116.22	121.27
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	*	*	*
Choice Boxed Beef, 600-750 lb. Carcass.	143.06	149.24	143.44
Western Corn Belt Base Hog Price Carcass, Negotiated.	63.24	47.09	54.29
Feeder Pigs, National Direct 50 lbs, FOB..	*	47.23	53.15
Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean..	64.75	56.19	59.32
Slaughter Lambs, Ch. & Pr., Heavy, Wooled, South Dakota, Direct..	*	86.63	87.87
National Carcass Lamb Cutout, FOB.	233.64	262.65	258.14
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu..	4.38	8.54	9.20
Corn, No. 2, Yellow Omaha, bu.	3.77	4.69	4.78
Soybeans, No. 1, Yellow Omaha, bu.	6.86	11.94	11.92
Grain Sorghum, No. 2, Yellow Dorchester, cwt..	6.16	8.43	8.50
Oats, No. 2, Heavy Minneapolis, MN , bu.	2.72	3.35	3.22
Hay			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.	135.00	135.00	135.00
Alfalfa, Large Rounds, Good Platte Valley, ton..	92.50	85.00	85.00
Grass Hay, Large Rounds, Good Northeast Nebraska, ton.	90.00	*	*

* No market.

We are again experiencing economic times in which one sector of the agricultural economy is experiencing prosperity while other sectors struggle. Ethanol has created an increase in demand for corn, while it has also increased the cost of feed for livestock producers. Agricultural profits have historically been cyclical. Some years produce high profits (boom), some years produce low profits and some years no profits (bust). Managing the risks associated with today's farm and ranch operations is crucial. Market volatility, increased input costs and large capital requirements are among the factors contributing to the risk of potentially negative financial impacts associated with production agriculture. An effective financial risk management strategy is a key factor for farm and ranch business success.

Lessons learned from the 1980's remind us of the importance of two financial risk management concepts, liquidity and a positive cash flow. Liquidity refers to the availability of cash or the availability of assets that can easily and quickly be turned into cash. The higher the liquidity of a business, the easier it will be to meet cash flow needs and to take advantage of buying opportunities that might come up unexpectedly. Liquidity helps to provide a cushion for the cash flow.

One strategy to consider that will take advantage of the high real estate values without selling or renting out one's land, is to restructure the farm's credit needs from short-term debt to long-term debt. How individual farm debt is structured can greatly impact the ability of that farm to weather those low profit or no profit years. This strategy will both increase liquidity and reduce cash flow debt payment obligations. Most areas of Nebraska are experiencing record or near record high real estate values, thus creating an increase in the collateral for a long-term loan. At the same time we have been experiencing a

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decreasing trend in interest rates. It appears 2008 should provide an opportunity to "lock in" an increased amount of the farm's total credit needs into long-term loans for many operations. Be sure to seek out a lending source that allows early pre-payment of the long-term loan without penalty, in case interest rates drop even lower or in case good times create extra cash and you decide to reduce your borrowing needs by paying extra principal.

Let's consider the example in Table 1 below. We have a producer who has obviously had some success over the years. Net worth of the business is $900,000. Total liabilities are $700,000 which include; $150,000 of carryover operating loans, $250,000 intermediate loans and $300,000 of long-term loans. Liquidity as measured by working capital (Current Assets – Current Liabilities) for the business is $50,000. Another measure of liquidity, current ratio (Current Asset/Current Liabilities), is 1.33. Let's assume the current debt has an interest rate of 8 percent, therefore annual interest expense would be $12,000. Let's also assume the intermediate debt has an interest rate of 6.5 percent with a repayment period of 3 years, creating an annual payment of $94,394. Assuming the long-term debt has an interest rate of 6.5 percent with a repayment period of 20 years, the annual payment would be $27,227. The total annual cash flow obligation for debt service, including principle and interest equals $133,621.

Table 1.

	Assets	Liabilities
Current	$200,000	$150,000
Intermediate	$400,000	$250,000
Long-Term	$1,000,000	$300,000
Total	$1,600,000	$700,000
	Networth	**$900,000**

Because of the increase in the value of the real estate, it is now possible to lock in longer repayment periods on a higher percentage of the total credit needs of the farm business. If long-term loans are to be used, the right to prepay those loans is essential to allow for flexibility should opportunities change. No prepayment penalty helps to reduce the risk of interest rates continuing to decline.

To restructure the debt for this operation, let's start with the long-term debt. Most long-term lenders have a loan to value percentage that they use as a guideline. Table 2 demonstrates restructuring the debt to increase liquidity and reduce cash flow debt payment obligations. First, looking at the loan/value ratio, let's assume the long-term lender will be comfortable with a 60 percent loan to value, which would allow us to borrow $600,000 using the $1,000,000 of land as collateral for the loan. If we see the current trend of declining interest rates continue, we may well have the opportunity in the next year or so to secure a loan at or below the 6.5 percent level we used in Table 1. Using the same 6.5 percent interest rate, however, $600,000 for 20 years @ 6.5 percent would create an annual payment of $54,454. We would still have $100,000 of credit needs remaining. If we were to structure that $100,000 as an intermediate loan at 6.5 percent for 3 years, the payment would be $37,758. The total annual cash flow obligation for debt service, including principal and interest equals $92,212. The net worth of the business has not changed; it is still $900,000. Total liabilities have not changed; they are still $700,000, but we have $0 in current liabilities creating liquidity as measured by working capital (Current Assets – Current Liabilities) for the business of $200,000, and a current ratio that is off the chart. Cash flow obligations for principal and interest payments have been reduced from $133,621 to $92,212, creating a reduction in debt service obligations of $41,409. If no pre-payment penalty exists one can still make payments of $133,621 or even more if they so choose, but the obligation is only $92,212.

Table 2.

	Assets	Liabilities
Current	$200,000	$0
Intermediate	$400,000	$100,000
Long-Term	$1,000,000	$600,000
Total	$1,600,000	$700,00
	Networth	**$900,000**

Although this strategy helps to reduce some financial risks by increasing liquidity and improving cash flow obligations, it also exposes another risk, the personal spending discipline needed to use the extra available cash for a sound business reason. Going out and buying some new paint that you really don't need or getting sloppy with management now that the pressure is off may be a greater risk than a tight cash flow or a high interest rate. Good overall management is still a critical key to success.

Remember, it's much easier to restructure debt during boom times than after the boom times are over. The opportunity is available now to financially structure some flexibility into management decisions, improve the cash flow position and enable one to take advantage of business opportunities yet to come. Restructuring debt during boom times may enable a farm to more easily adapt and stay profitable through these new and exciting uncharted good times and yes, through the bad times that most certainly will appear again some day!

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