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Working Capital is Disappearing

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Cornhusker Economics

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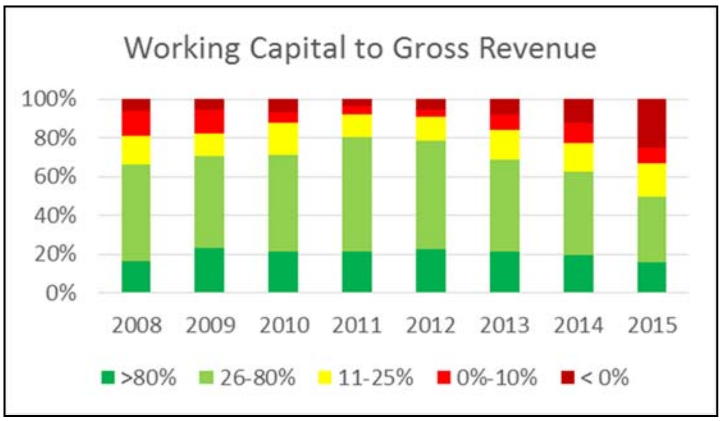
Market Report	Year Ago	4 Wks Ago	7-8-16
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	151.00	130.00	120.57
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb.	280.09	176.50	172.89
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	233.11	*	148.60
Choice Boxed Beef, 600-750 lb. Carcass.	242.21	222.40	209.33
Western Corn Belt Base Hog Price Carcass, Negotiated	78.04	76.84	76.77
Pork Carcass Cutout, 185 lb. Carcass 51-52% Lean.	80.69	85.16	89.01
Slaughter Lambs, wooled and shorn, 135-165 lb. National.	159.41	139.90	158.51
National Carcass Lamb Cutout FOB.	361.12	*	347.17
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu.	5.15	3.82	3.19
Corn, No. 2, Yellow Nebraska City, bu.	4.11	3.86	3.23
Soybeans, No. 1, Yellow Nebraska City, bu.	10.08	10.66	10.13
Grain Sorghum, No.2, Yellow Dorchester, cwt.	8.14	6.17	5.09
Oats, No. 2, Heavy Minneapolis, Mn, bu.	2.91	*	2.58
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton.	180.00	138.75	165.00
Alfalfa, Large Rounds, Good Platte Valley, ton.	85.00	90.00	75.00
Grass Hay, Large Rounds, Good Nebraska, ton.	95.00	85.00	80.00
Dried Distillers Grains, 10% Moisture Nebraska Average.	127.75	149.00	137.50
Wet Distillers Grains, 65-70% Moisture Nebraska Average.	42.50	47.50	38.50

* No Market

Why is everyone talking about working Capital?
It seems just about every farm management topic/article/presentation is talking about working capital these days. We've heard experts talk about "Cash is King" for years but why is it really important?

Working capital by definition, shows us how much of a "cushion" there is between the assets you plan to sell in the next 12 months and the debts you will owe in that same time. That includes your operating note, but it should also include the payments you will make on your term debt (equipment and land). So it's easy to think that the more working capital you have, the better. So how much working capital do you need? It depends on your operation. $100,000 of working capital seems like a lot and it may be for an operation that grosses $200,000. But for an operation that grosses $10 million, $100,000 is not much working capital. To better define how much working capital is appropriate, we look to a ratio called Working Capital to Gross Revenue. This allows us to look at working capital more appropriately for each operation. So the first operation we used in the example with $200,000 of gross income would have a ratio of 50% ($100,000 of working capital/$200,000 of gross revenue). The second operation would have a ratio of 1% ($100,000 of working capital/ $10,000,000 of gross revenue). A 1% cushion is not much. The industry standard set by the Farm Financial Council is 30% but opinions vary.

One of the things we are seeing in the farm financial data we collect is a steady decline in working capital in individual operations. The average working capital to gross revenue fell to 28.1% at the end of 2015, which was the first time it registered below 30% since 2006. What is more alarming to me is to see the number of individual operations whose working capital has eroded to a dangerous level. The chart shows the Working Capital to Gross Revenue of operations included in the Nebraska Farm Business, Inc. averages. When we discuss financial ratios, we often use a "Red/Yellow/Green" light analogy to show the health of the ratio. Those in the green are "good to go", the yellow is a caution area and the red indicates a problem that needs to be addressed. In the chart, I have included two shades of "red". Those that are in the dark red have negative working capitals. The lighter red shows



those with less than 10% of gross revenue. In total, 32% of operations included in the averages have a working capital to gross revenue ratio that would be considered in the "red light" area. You can see the rapidly increasing trend of the number of farms included in the "red" area on the chart and the corresponding decline of those in the "green". This chart shows just why so many people are getting concerned about working capital for many operations.

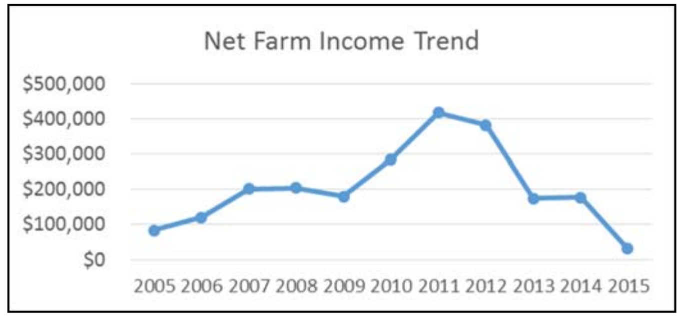
How do we fix Working Capital shortages?

There are really just a few things we can do.

1. Increase net income.
2. Refinance debt to move current debt to an intermediate or long term position.
3. Sell assets to generate more cash.

Increasing Net Income

The decline in net farm income has created this working capital problem but that's not to say we can't fix a decline in working capital with increasing net income. The chart shows how dramatically net farm income has dropped in the past 5 years.



It's important to remember that increasing net income does not have to be about finding income that isn't there on commodity crops. It could also be increasing non-farm income or adding a new enterprise to the operation. Adding sources of income that were not a traditional part of the operation is a great way to cover some of the expenses that are not being met by current commodity prices.

Another way to increase net income is to reduce expenses. It's not easy to think of one place a farm could cut $100,000 of expenses. Instead of thinking in whole dollars, try thinking about cutting 10 cents out of each dollar you spend. Saving 10 cents seems easy. If you're spending $1 million dollars, that 10% savings will get you the $100,000 at the end of the year. Cutting non-farm costs will also help increase working capital since less income will be taken from farm profits for living.

Refinancing Debt

Refinancing Debt can be a great tool you can look at with your lender. While we are seeing average debt-to-asset ratios climb, they are still relatively low for most operations. This means that while the operations are experiencing a cash flow crunch (decreased working capital) we are not seeing an equity crisis. If an operation has a low debt-to-asset ratio and low working capital, refinancing may be a good option.

Refinancing simply means that we are going to take out a term note that may be secured by land or equipment. The proceeds of that new note go to pay down the operating note which reduced the debt that must be paid in the coming 12 months and increases working capital. The new note is spread out over a term of years that makes the payments manageable for the operation. It doesn't change the operation's debt-to-asset ratio or net worth but it is just a restructuring of the debt so that the debt lines up with the assets that have equity.

Selling Assets

Over the winter, we started hearing from producers that lenders were suggesting the sale of assets to help with the deteriorating working capital. The sale of assets may be a double edge sword and it should be cautiously evaluated. Selling assets can generate immediate cash that can be used to reduce the current debt load but there are a couple big drawbacks.

The first is the income tax implication with selling assets. Most assets on farm depreciation schedules have no basis remaining. (Land would be the exception since we are not allowed to depreciate the purchase cost of land.) They have either been on the farm for more than 7 years or they were bought with the intent of using the Section 179 expense election which allowed us to write off the full purchase price in the year of sale, which leave us zero basis. While each taxpayer's situation is unique, the tax bill could easily be as high as 32% (25% Federal with another 7% State tax) of the selling price. It may also not have much effect on the tax bill if the farm is also seeing an operating loss (negative Schedule F) but we have few operations in this situation.

The second drawback is the reality that selling an income producing asset means we can't generate as much income as we were prior to the sale. Selling a tractor may result in a better cash flow position if the payment on the loan is more than it would cost to rent a similar tractor. Another option is to trade into a cheaper model that may not have as many bells and whistles, but will still get the job done. We want to be aware that if we sell the asset that makes us money without a more reasonable option to replace it, we have tied the hands of the operation in the future.

Conclusion

It is important to know what caused the working capital shortage. Refinancing or selling assets will not solve a problem of overspending on family living or poor farm management. They will only be a short-term "band-aid" fix and we'll be right back in the same position in a year or two. If instead the problem was caused by buying a lot of assets with cash or having used the operating note in the past few years, refinancing may be a perfect fix. Refinancing will allow the debt to be in the correct position and will give the producer time to get the cash generated to pay for the assets. Each operation is unique and the benefits and drawbacks of each option will need to be evaluated individually.

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