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Financial management during hard times

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> "Doing a good job of farming doesn't ensure financial success—it's important, but not a guarantee."
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> "When interest rates exceed asset earnings there is a limit to the amount you can borrow without going broke."

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Today, many farmers have severe financial problems. Some wonder whether they can survive. At the same time, there are other farmers who're not making great profits, but they appear to be getting by. A major factor is the amount of debt involved.

Managing debt and determining how much debt to carry is an important aspect of financial management. How much debt to carry varies greatly from farm to farm and from individual to individual. This Guide is designed to help you manage the debt on your farm and determine how much to carry.

During the 1970s, leverage was the key to financial success in farming. Farmers were able to borrow money at relatively low interest rates, and farm earnings and land inflation exceeded the rate of interest. Financial leverage, that is borrowing money to make more money, works well when the earnings of the assets purchased are higher than the interest rate on the borrowed money.

As we look at farm earnings over a long period of time, seldom have farm asset earnings exceeded that of the going interest rate. Table 1 shows the return to capital and management on Missouri farms for the last 10 years. Note first that returns vary greatly from year to year. Second, over the past 10 years even with some very excellent earnings, average returns have been less than 9 percent.

Figures 1 and 2 show the interest rates paid by farmers during the 1970s. By comparing these figures to Table 1, it is easy to see that during this period, farm interest rates have exceeded return to capital.

Whenever interest rates exceed the return to capital, there is a limit to the amount of money that you can borrow. Obviously, the farmer who has a higher return to capital can borrow more money. Return to capital is determined partly by your management ability and partly by yields and prices. The

Table 1. Percent return to capital and management by farm type, 1971-80.

Year	State	Crop	Dual crop-hog	Hog	Major-crop, minor-beef	Dairy
1972	13.0	12.8	16.5	16.9	12.1	10.7
1973	17.5	18.0	21.3	22.2	16.4	11.1
1974	5.6	11.2	5.3	.8	4.5	1.0
1975	5.8	5.1	8.7	16.7	2.3	2.5
1976	5.2	7.3	4.9	3.3	3.6	5.5
1977	6.8	7.2	7.2	10.4	5.2	6.3
1978	10.9	10.2	11.7	17.0	9.9	10.0
1979	9.3	10.5	6.5	3.6	10.3	9.1
1980	4.9	6.0	2.9	2.2	2.7	5.7
1981	2.5	3.0	.8	.6	-4.4	5.9
10-year average	8.2	9.1	8.6	9.4	6.3	6.8

*Source: University of Missouri Mail-in Record Program.

Figure 1. Interest rates on farm real estate loans

Quarterly data life insurance companies (new commitments) and Federal Land Banks (new loans). Semiannual data for seller financed, annual beginning in 1980. Federal Land Bank rates do not include charge for the stock borrowers are required to buy.

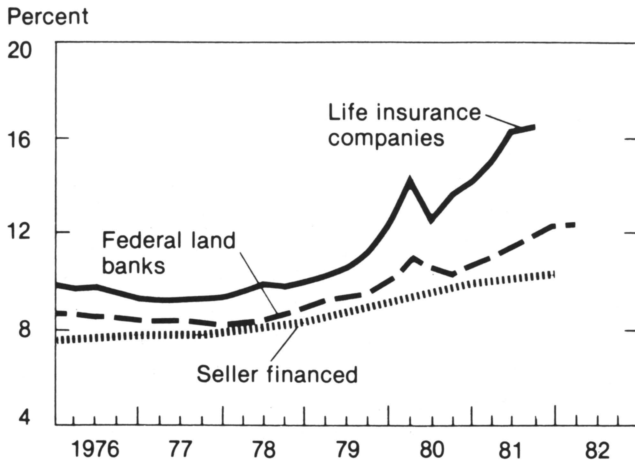
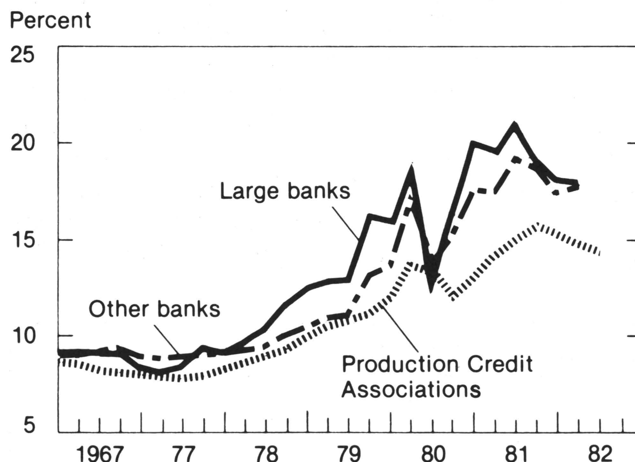


Figure 2. Interest rates on farm nonreal estate loans.

Rates on PCA loans include service fees. Bank data starting in 1977 are from surveys made by the Federal Reserve System; data for prior years relate to different groupings of banks, collected by the Federal Reserve System and the Federal Reserve Bank of Minneapolis.



year-to-year variation in return to capital is often beyond your control. In determining how much debt to carry, you need to know what return to capital you are earning.

Leverage example. Leverage can be a springboard to financial wealth. But leverage can also drag a business to financial ruin. The key to financial management is to walk the tightrope without falling.

Let's take the case of two imaginary farmers—Leverage Larry and Conservative Carl. Let's start them out with the same size farm and give them the same amount of assets. (See Table 2.) Larry is a younger man who has had to borrow 75 percent of his assets. That gives him a net worth of only $100,000. On the other hand, Conservative Carl is older and more fortunate. He has a debt of only $100,000 which gives him a net worth of $300,000. Rather than expand, he has maintained a high equity position in his operation.

Let's look at these two farmers under two different conditions for earnings and interest. In a good year, earnings on assets are 10 percent and in a poor year 5 percent. Let's also look at interest rates at two different levels, a low rate of 8 percent and a high rate of 15 percent.

Good year—low interest. When asset earnings were high and interest rates low, both Larry and Carl seemed to be doing well. Carl made more money than Larry, but Larry seemed to be making good financial progress.

Good year—high interest. Then, when economic conditions changed, interest rates jumped to 15 percent. This had a serious impact on Larry. He was about $5,000 short, and his lender became concerned with his cash flow. Conservative Carl had to make greater interest payments and had less left over but still seemed to be smiling.

Poor year—low interest. Both farmers faced a poor year of low asset earnings, in this case 5 percent. Larry has a problem. He's $4,000 short. Conservative Carl seems to be having some problems, but still has a good cash balance.

Poor year—high interest. When the worst happens—low asset earnings and high interest rates—how do these farmers fare? Larry has extremely severe financial problems. He lost $25,000, and he may not be able to survive, especially another year like this. Conservative Carl has got a tough time too, and his lender may be concerned, but he has staying power.

This example shows the problems and the risks of carrying extremely high levels of debt. It shows that the person with less debt is able to weather problems much easier.

Reducing assets

Will the selling of assets to reduce debt help Larry's problem or improve Carl's situation? This answer isn't always definitive. Let's see what happens when both farmers sell $100,000 worth of assets and use the proceeds to pay debt.

Let's make a very critical assumption that may not be true in many such cases. As we reduce the size of the operation, the **rate** of earnings on the assets will be the same. This is shown in the two columns on the right hand side of Table 2. After selling assets, Larry's equity has gone up from 25 to 33 percent, and Carl now has 100 percent equity in his operation.

In a good year with low interest rates, both Larry and Carl made $2,000 less in income than before the

Table 2. Leverage example.

	Initial Position		Sell $100,000 assets	
	Leverage Larry	Conservative Carl	Leverage Larry	Conservative Carl
Assets	$400,000	$400,000	$300,000	$300,000
Liabilities	300,000	100,000	200,000	0
Net Worth	$100,000	$300,000	$100,000	$300,000
Percent equity	25%	75%	33%	100%
Good year-low interest				
Asset earnings 10%	$ 40,000	$ 40,000	$ 30,000	$ 30,000
Interest on debt 8%	24,000	8,000	16,000	0
	$ 16,000	$ 32,000	$ 14,000	$ 30,000
Good year-high interest				
Asset earnings 10%	$ 40,000	$ 40,000	$ 30,000	$ 30,000
Interest on debt 15%	45,000	15,000	30,000	0
	-$ 5,000	$ 25,000	$ 0	$ 30,000
Poor year-low interest				
Asset earnings 5%	$ 20,000	$ 20,000	$ 15,000	$ 15,000
Interest on debt 8%	24,000	8,000	16,000	0
	-$ 4,000	$ 12,000	-$ 1,000	$ 15,000
Poor year-high interest				
Asset earnings 5%	$ 20,000	$ 20,000	$ 15,000	$ 15,000
Interest on debt 15%	45,000	15,000	30,000	0
	-$ 25,000	$ 5,000	-$ 15,000	$ 15,000

sale. It is clear in the other three conditions that Larry is in a much more favorable position. However, even in a poor year with high interest rates, a 33 percent equity level is insufficient to break even.

Carl's position is less clear. In some years, he made more money by holding fewer assets, but the trend is less clear. What this shows, is that for large, very heavily leveraged operations, it may be possible to reduce both assets and debt to return to a more profitable level. For those operations with a high percentage of equity, such as Carl's, selling assets has only minimal impact on profitability and financial risk.

Certainly, each situation must be examined carefully. But simply doing a good job of farming may not ensure financial success. You must do a good job of planning and balancing debt with owned assets.

Know your financial condition

To evaluate your financial condition properly, you need to have good farm records that will provide you with the needed information. There are three basic farm financial statements that you should prepare for your farm operation.

1. Balance sheet
The balance sheet gives a picture of the financial condition of your farm operation at any one point in time.

2. Cash flow
A cash flow record shows where money came from and where it went. A cash flow projection shows how much money you expect to take in and how much you plan to spend, including interest and debt payment.

3. Profitability
This shows the amount of profit that your farm operation made. It adjusts net cash income with depreciation and changes in inventory.

Just having this information is not enough. You need to study it and learn how to interpret it. This takes time and experience. Often, it is useful to seek professional help. Over time, comparing statements will show you the strengths of your operation and also provide warning flags for impending financial problems.

Early warning signs

There are signs that provide early warnings for pending financial difficulties. A person who has good records and studies them will be able to see problems very early; others will learn of them at a much later stage, often when it's too late for easy solutions.

Accounts payable increasing. One of the very early signs of coming financial problems is the inability to pay bills. Do your accounts payable—fertilizer bills, fuel bills, etc.—seem to be piling up because you do not have the cash available to pay them? Do you seem to be struggling to meet scheduled debt payments? Both are signs of potentially severe financial problems not far off.

Working Capital. Working capital is the difference between current assets and current liabilities on your farm balance sheet. If you do a good job separating assets on your farm balance sheet, the status of your working capital can be a key indicator of trouble. Those farms with a good working capital—that is, current assets exceeding liabilities by a comfortable margin—will find that they can avoid serious financial problems and meet severe fluctuations in prices and weather. An early sign of developing financial problems is a small, or decreasing working capital. If you have negative working capital, you can be sure that you will have difficulty obtaining short-term loans. Your short-term lender will be reluctant to refinance without a good plan or additional security.

A way to obtain more working capital is to refinance the farm operation by borrowing more long-term money on land and paying off the short-term debt. Even in good times during the 1970s, many farmers ran short of working capital. Refinancing worked because land was inflating and interest rates were reasonably low.

Now in the early 1980s, refinancing has been much less feasible. Long-term interest rates increased, which in many cases meant that refinancing of land would increase interest costs. Also, long-term lenders became more reluctant to refinance highly leveraged operations. They began to look more closely at the cash flow and repayment ability than in the past. Finally, the rate of land inflation slowed and in some cases decreased slightly.

Refinancing may still offer an opportunity for obtaining additional working capital. However, this avenue is less feasible for many operations than it has been in the past. A farm operator who uses this method several times needs to look very closely at management and determine the real cause of the problem. The problem could be rapid growth, improper financial structure, or key problems with production management.

Solving severe financial problems

There are no easy solutions. Many times, the solutions require drastic steps because the problems are severe. The solutions proposed here are clearly for farmers with very serious financial problems. A basic assumption is that the problem is financial rather than in production management.

• Increase income

Clearly, any way to increase income without incurring added expenses will help solve the problem. In days when farm debts were smaller and interest payments were lower, it was often possible to obtain a part-time job to solve temporary financial difficulties. The magnitude of many debts today does not make this a feasible solution. It is, however, one alternative that needs to be carefully examined.

• Maintain working capital

Once a person has a very serious financial problem, working capital has already disappeared. The goal of good financial management is to maintain a good working capital position. This can be accomplished, by properly structuring debt. When purchasing capital assets, it is important to finance them properly. Once working capital has disappeared, it is often difficult to make changes.

• Refinance

This has been discussed earlier. When a shortage of working capital or short-term debt repayment are major problems and equity exists in long-term assets such as land, refinancing land continues to be one solution. If the problem is in production management, then this is only a temporary solution.

• Obtain lower interest rates

This, of course, is easier said than done. However, in some cases it is possible to obtain Farmers Home Administration financing at lower rates. This possibility varies from year to year, depending on FmHA policy. Sometimes, it is possible to renegotiate terms of land contracts. In some cases, land sellers, particularly if they are relatives, may be willing to work out other arrangements on land contracts. Possibly, a land contract coming due can be refinanced with the seller at lower than market rates of interest. If major alterations of contracts are negotiated, it is advisable to seek legal counsel because there may be tax consequences.

• Sell unproductive assets

In some farm operations, assets exist that are currently unproductive in terms of generating cash income. Examples of this, may be wasteland or even timberland. It could also be a set of buildings. Or it may be some unused machinery. Often, farmers find selling some of these assets a difficult decision. Frequently, there are sentimental or other reasons for not disposing of the assets. Sometimes, the potential appreciation of these assets appear to be large. But whenever possible, selling unproductive assets to pay off debt is an excellent way to reduce debt without affecting income.

- **Sell assets and reduce size of business**

This alternative essentially means liquidating part of the business. This is a difficult approach and one that sometimes is not feasible on many farm operations without liquidating the entire business. It is one very frequently used by many large and small businesses alike. Sometimes, it is possible to sell a part of the business. For farms, this usually amounts to selling off some land. Sometimes, the land can be rented back, but often the purchaser will want to farm it. Cutting back on land may also mean reducing the size of equipment. This takes careful planning to make sure that expenses are cut back at least as much as income and that net income will be large enough to support the farm operator and his family.

- **Get a partner**

This is a relatively new idea and takes some sales ability on the part of the individual farmer. There may be a wealthy person in the community—doctor, lawyer, or even a well-to-do relative—who may be willing to go into partnership with an aggressive, productive farm operator. This partner may be willing to provide the financing and to forego short-run income for long-run returns and capital gains. In some cases, this may be a sales lease-back arrangement. Other forms of business arrangements such as incorporation, limited partnerships, or regular partnerships are also possibilities. It takes careful planning and a knowledge of the legal aspects to make this work. A key point is to convince the potential partner that he or she will benefit financially by foregoing income in the short run and during times of economic problems in the farm community to achieve long-run gains and profits.

Summary

There's more to farming than just doing a good job producing crops and livestock when the farm must be financed with debt capital. This requires a business-like approach and knowledge of finance. It sometimes requires bold moves. An acceptance of high leverage implies acceptance of risk. Rescuing operations from financial disaster may require exceptional skill and drastic moves. It takes great courage to take the proper steps.

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