Use the Good Times to Get Your Business in Shape

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Agriculture, particularly crop agriculture, has been on an extended positive run. Midwest land values are climbing like California real estate was during the early 2000s and interest rates are at historic lows. At the same time input and output price volatility has increased. My point isn’t to cry wolf, no one knows when we’ll have a downturn; but, there are a few things to pay particular attention to during good times. Jim Collins new book “Great by Choice” says the great companies in times of chaos self-impose two kinds of discomfort: the discomfort of unwavering commitment to high performance in difficult conditions, and the discomfort of holding back in good conditions. Some lenders have even developed underwriting standards that have higher requirements during the top of the cycle periods versus normal times in order to avoid contributing to the problems like in the late 70s and early 80s when they jumped on the competition driven irrational exuberance bandwagon which only exacerbated the 1982-1987 farm financial crisis.

The place I would start is to look at a combination of key financial metrics. The second would be to start tracking several key macro leading indicators, both ag and non-ag. I’ll touch on a few here and will talk about others later.

Number one is the need to evaluate profitability on an accrual adjusted basis. This doesn’t require a full blown accrual accounting system or switching away from cash accounting for tax purposes. It just requires having balance sheets as of the beginning and end of the period for which you’re measuring income. It also requires that the balance sheets are complete, i.e., they include the accrual assets and liabilities such as accounts receivable, inventories, prepaid expenses, investment in growing crops, accounts payable and accrued expenses. Then it’s a matter of a few adjustments to your cash income based on changes in the accrual accounts. Basically, the adjustment to cash income is by the same amount and direction (+ or -) of changes in accrual assets and the opposite of the amount of change in accrual liabilities. Most extension services have guidelines or you can go to the Farm Financial Standards Council (FFSC) website to get a copy of their recommendations. The FFSC, states with farm record keeping services and many ag lenders have found that cash basis income can lag accrual adjusted income by as much as 2-3 years in reflecting developing problems or on the other hand that the business has started to turn around. That’s often too late to take the action that’s needed. The fact is you can have a positive cash basis income and be keeping your
loans current, and be going broke.

A second is to evaluate if debt is being used profitably in the business by looking at whether your ROE (rate of return on equity) is greater than your ROA (rate of return on assets). It is possible for ROA to be greater than ROE and the business to still be profitable if the business isn’t too heavily leveraged, but it means that the owners are accepting a lower rate of return on their own funds in order to offset the fact that the return on borrowed funds is less than its cost. The reason is that debt doesn’t share in profits above its cost, i.e., interest. Therefore any return on invested borrowed capital above its cost becomes a residual return to the owners and pushes the rate of return on equity above the average return on all funds (debt and equity, i.e. ROA) employed in the business. If the rate of return on borrowed funds is less than its cost, the owners’ capital absorbs the shortfall and it drags the rate of return on all invested funds down. If the business is liquid enough, has sufficient cash flow to make it work, this isn’t always a bad thing. The reason is that frequently borrowed capital is used for land purchases and the appreciation in land values isn’t included in the ROA or ROE unless the land is sold. So land generating an annual income return of 5 percent, but using borrowed funds costing 8 percent may still be a good deal in the long run if land values are also appreciating at an annual rate of greater than 3 percent. Obviously, the effect will differ based on how highly the business is leveraged and what your debt coverage ratio is after the purchase.

The third is the ratio of net working capital (current assets less current liabilities) to gross revenues. This one is a little trickier, because the minimum standard depends of several factors. For example, how heavily leveraged is the business, how variable are cash flows from year to year, are rents share, flex or fixed cash? The general guidelines I follow are the following:

- Share rent (or owned land) and a debt to asset ratio of less than 25 percent, then a working capital to gross revenue of at least 25 percent
- Flex rent and a debt to asset ratio of less than 40 percent, then a working capital to gross revenue of at least 30 percent.
- Fixed cash rent and a debt to asset ratio of less than 50 percent, then a working capital to gross revenue of at least 40 percent.
- With fixed cash rents and a debt to asset ratio of over 50 percent then a working capital to gross revenue of at least 50 percent.

I will be discussing other measures you should be focusing on in future articles.