

Surviving a Farm Financial Crisis

October 1998

By:

**Steve Isaacs, Richard Trimble,
Carl Dillon, and Gregg Ibendahl**

University of Kentucky
Department of Agricultural Economics
400 Charles E. Barnhart Bldg.
Lexington, KY 40546-0276

Phone: 859-257-5762

Fax: 859-323-1913

<http://www.uky.edu/Ag/AgEcon/>

AGRICULTURE & NATURAL RESOURCES • FAMILY & CONSUMER SCIENCES
4-H/YOUTH DEVELOPMENT • RURAL & ECONOMIC DEVELOPMENT

Surviving a Farm Financial Crisis

Steve Isaacs, Richard Trimble, Carl Dillon, Greg Ibendahl
Farm Management Specialists, Dept. of Agr. Economics, University of Kentucky
October , 1998

Introduction

The term “Farm Crisis” is once again appearing in both the ag and popular media. Many commodity prices are down dramatically. Adverse weather has lowered yields in many regions. Discussion has begun about replacing government safety nets that were removed with “Freedom to Farm.”

A “Farm Crisis” in the 1980s sense of the term is a general depression of prices and yields that have widespread impacts on farm profitability. Some farms have experienced financial distress even in good times. Conversely, some farms will prosper even in times of widespread crisis.

The current, or impending, farm crisis has some similarities to the crisis of the 80s, but it also has some major differences. Inflation and interest rates are not as high or volatile as they were in the 80's. Land prices have increased gradually since their lows of the early 80s, but are probably not as overvalued as they were then. The health of global economies and the influence of relative currency values are just as, or more, important as in the last crisis.

Our intent in this article is to discuss some planning tools to help avoid financial problems, to present a couple of financial measures to help identify farm debt problems, and to evaluate some options for farmers that find themselves in a crisis situation. This is by no means a complete list of planning tools, financial analysis measures, or options available to farmers facing or already in crisis situations. In the coming months farmers should explore the full range of financial management options at their disposal.

Planning

Farm financial survival relies upon good management skills, including a successful production and financial plan. A special effort in developing a careful prepared, thoughtful plan can be well rewarded. In times when net returns decline, the need for careful planning becomes especially critical because the room to overcome problems and still make money becomes slim. Two fundamental tools which can help organize the decision making process and provide a written recording of the planning process are enterprise budgets and the cash flow budget.

Enterprise budgets

Developing enterprise budgets is a critically important part of a successful production plan. While a lot of data is required for an enterprise budget, reviewing past farm records can be helpful in highlighting areas for improvement. The budgets published by the Kentucky Cooperative Extension Service provide cost and return estimates that serve as an excellent base for developing your own enterprise budgets as well as providing data for making comparisons between enterprises on your farm. Although enterprise budgets have limitations creating a need to consider such additional factors as risk management and whole farm implications of the enterprise mix, enterprise budgets are helpful in 1) focusing attention to details, 2) evaluating production alternatives, 3) analyzing different production practices, and 4) providing data for other planning tool such as the cash flow budget.

Cash Flow Budgets

The cash flow budget is another excellent planning tool useful in farm financial survival. It is helpful in establishing a debt repayment plan and determining borrowing needs. Examining the cash flow budget may highlight ways to restructure debt or rearrange purchases to improve cash flow and reduce interest expense. Financial problems might be detected early enough to reduce their impact. The cash flow budget is also a tool that can help you determine the financial feasibility of making a major investment by examining the additional cash inflows and outflows created by the investment itself. While the cash flow budget doesn't

project profits, but rather net cash flow, it can assist in providing data for other important areas such as tax planning.

Analysis

Agriculture is usually considered a high-risk industry. A financial way to characterize these sources of risk is to view the firm in terms of its balance sheet. Traditional business risks are found mostly on the asset side of the balance sheet. Many of these risks can be traced to weather related factors and thus are beyond the control of the farmer. Farmers can develop strategies to minimize the effects of these business risks but the risks are still present.

Financial risks, by contrast, are directly controllable by the farmer. These risks are found on the liability side of the balance sheet and are determined by the degree of farmer borrowing. Most farmers use some amount of debt capital to provide operating funds and to finance new investments. However, farmers need to be careful that they do not take on too much debt.

Debt/Asset Ratio

There are several financial ratios that can give an indication of when a farmer may be too heavily leveraged. A balance sheet measure is the debt to asset ratio. This ratio compares the total debt obligations owed against the value of the total farm assets. In effect, this single time point ratio measures the percentage of the business assets claimed by someone else. Because the agricultural sector has a heavy reliance on nondepreciable assets (i.e., land), debt to asset ratios appear low relative to other economic sectors. Typically, the debt to asset ratio for agriculture is 15 to 18 percent. In 1998, the ratio was 15 percent but had been above 20 percent in the mid 1980s when farm real estate values fell. Debt to asset ratios may vary based on the firm's size, tenure position, age of operator, and enterprise mix. Debt/asset ratios below 50 percent are preferred. Debt to asset ratios above 50 percent indicate that more of the farms assets are owned by the lender than by the farmer. Ratios above 100 percent indicate that the business is insolvent.

Interest Expense Ratio

Another important measure for determining if the farm leverage is too high is the interest expense ratio. This ratio, taken from the income statement, is the total annual farm interest expense divided by annual gross revenues. The interest expense ratio provides a guide that relates a firm's financial expenses to its ability to serve them. This ratio measures the financial leverage effects over a period of time and is a counterpart to the single time point ratio of debt to assets. Interest expense ratios below 10 percent are preferred. Typically, farmers may have trouble generating sufficient earnings to meet cash flow needs if the interest expense to gross revenue exceeds 15 to 20 percent.

Options

Farms in severe financial crisis often have limited options to resolve a bad situation. It is important to **plan** to avoid financial problems and to use **analysis** to indicate the progress and severity of financial problems. However, knowing what **options** are available can help chart a course of action to head off or resolve financial distress.

Cost Cutting

Cost cutting is often suggested as a possible solution to the income and cash flow problems facing a farm business during periods of low commodity prices. It is possible that some producers may have become somewhat lax in their cost control efforts during the past few good years in agriculture. If you are included in this group, then increasing your efforts to control production costs may prove worthwhile. In general, lower commodity prices do indicate a need to reduce the general level of inputs. But, you should not push this idea too far. The general rule that should be applied here is simply: *“As long as the value of the output is greater than the cost of the input, continue to add input.”*

The easiest way to apply this general rule as you go about making decisions about your farm

business is to simply ask the question: “Will it pay?” You must guard against cutting cost without thought as to how the cost cutting will impact the productivity, efficiency, and effectiveness of your farm business. One major input that you should not reduce during these tough times is the management of your farm business. Now is the time to increase the diligence of your decision making to insure that you are making the choices that prove most beneficial to the ongoing success of your farm business.

Asset Liquidation

Asset liquidation is another option that might be considered to help improve cash flow. This option is much like the cost cutting option previously mentioned. The good times that agriculture has experienced may have allowed your business to accumulate some unproductive assets. If this is your situation, now might be the time to liquidate them. This liquidation could add to current cash flows and help to meet current cash obligations.

There are a couple of potential drawbacks with this option. While this could be a good time for your farm business to liquidate some unproductive assets, many other farmers may have the same idea. This could result in depressed prices for used machinery, equipment, and breeding livestock. As a result, you may not be able to realize as much for these assets as you had expected. More importantly, as you sell these assets you may actually be liquidating your productive business. Just as with the cost cutting option, you must realize what you are doing as you liquidate assets to insure that you are not slowly going out of business.

Refinancing

Refinancing or changing the debt structure of your farm business is another option that might be considered to solve current cash flow problems. Interest rates are at record lows for recent times. Therefore, this may be the right time to consider refinancing your real estate debt. This refinancing option could lower interest rates and lengthen the repayment period, both of which should reduce the current cash flow requirements to service real estate debt requirements. Also, you might be able to obtain a fixed rate mortgage to protect your business against future increasing interest rates.

You may also want to consider the refinancing option as an opportunity to roll operating debt into real estate debt. This option would change your debt structure by simply placing some existing operating debt against real estate equity. This should offer your farm business the opportunity to reduce the current cash flow obligations to meet operating debt payments. This refinancing will increase your real estate debt, but this debt should be at a lower interest rate and repayment should be spread over a longer repayment period. Both of these changes should reduce current cash flow obligations to meet debt repayments and leave more cash to meet other business or family obligations.

The most appealing aspect of this refinancing option is that it should cost your farm business very little. If economic conditions in agriculture prove to be much better than expected, and your farm income proves to be much greater than you expected, you can simply pay off the operating debt which you refinanced as real estate debt. You have had the additional real estate debt at a lower interest rate which should have reduced your interest cost. In addition, you have been able to provide a measure of insurance against the expected tough economic times at little cost to your farm business.

Changing the Enterprise Mix

Few farms produce only one commodity or product. This diversification of enterprises is usually a result of the resource base available on the farm, profit potential of various enterprises, and the personal preferences of the farmer. The enterprise budgeting process referred to in the planning section of this article is the primary tool to use to evaluate different enterprises in the farm plan. This should be an ongoing process, but the stresses associated with financial crisis will cause many farmers to ask, “What can I do to make more money?”

Changes in the enterprise mix should be based on the relative profitability of different enterprises and the riskiness associated with different enterprises. Some commodities that look good on paper may have

wide variability in yields and/or prices. When putting pencil to paper to evaluate enterprises, you should at least run an average, best case, and worst case scenario. Computerized spreadsheet budgets available from county ag agents or from the ag economics Web page “<http://www.uky.edu/Agriculture/AgriculturalEconomics/>” can be useful in comparing alternative enterprise mixes.

Farm and Off-farm Alternatives

Some times the traditional farm enterprises aren't generating enough income to pay operating expenses, make debt payments, and provide for family living expenses. Many producers will search for “alternative” enterprises or “niche” marketing opportunities. A simple acronym to guide this process is PRIMER. The letters of PRIMER stand for Profitability, Resources, Information, Marketing, Enthusiasm, and Risk. Use enterprise budgets to assess profit potential, determine what resources are currently available or will need to be acquired. A crisis situation is usually not the time to attempt to borrow new funds. Information may be difficult to come by or may be expensive to acquire for more obscure alternatives. Marketing is often a key variable for alternative enterprises. If markets were well established, they would probably be traditional enterprises. Enthusiasm is important. Be sure you want to get into the enterprise, but also know why and when you should get out. Finally, most “alternative” enterprises will be risky. Carefully assess the production and financial risks. A crisis situation may not be the best time to try an enterprise whose success is questionable.

We often forget that three-fourths of Kentucky's farms have off-farm income. For many farms in crisis this may be the best alternative. Currently, unemployment rates are low in most areas (regions with manufacturing plant closures are notable exceptions), so some off-farm opportunities do exist even if they are not the first choice among the options to deal with a financial crisis.

Sell Out

This is generally considered the option of last resort. Often, when this option is considered, there are no other options available. Many times the sale of the business is a requirement of creditors or bankruptcy court. This is usually not a preferred option. However, in some situations this may be the best option. Financial, personal, and family stresses associated with the impending failure of a business are extreme. In the 80s many farm communities lost friends and neighbors to suicide. Stress counselors are available in most areas. Confer with local physicians or the health department to find what help is available and use it.

On the financial side, if sale of the business is being considered, make sure to explore the tax implications of a sale. One of the most commonly overlooked, and financially devastating taxes is the capital gains tax due on the sale of capital assets. Although Congress recently lowered the federal tax rate ceiling to 20 percent, the federal and state taxes on the sale of capital assets like land can be as much as 26 percent of the gain in value over the life of the asset. For example, land purchased 35 years ago at \$300/acre and sold today at \$1900/acre could have a “contingent tax liability” of over \$400/acre. This tax which is “contingent” upon the sale of the asset should not be overlooked.

Conclusions

Farm crisis days are back. There will be many similarities to the 80s when many farmers left the industry. There are some major differences such as lower interest, inflation, and unemployment rates.

Some final suggestions for dealing with financial crisis: Don't delay action. Take steps to avoid financial difficulty if possible. If and when hard times arrive, don't ignore them. They are not likely to go away on their own. Keep communication channels open. Our first reaction to adversity is often to hide it. Make sure family members, partners, and creditors are kept abreast of the situation. Family members, partners, and lenders are more likely to help than to condemn. This is a collective not an individual crisis situation. Don't feel you have to endure it alone.