



Economic Toolbox

Operating Line of Credit

OR

Cash Flow Budget

With milk prices swinging two to three dollars between highs and lows during the year, developing and using better cash management systems is important for several reasons. The business must be able to meet its cash obligations for operating expenses, debt service and family living. Not having sufficient cash will get you into trouble with your vendors, your lender and your spouse and family. With insufficient cash, you impair your ability to reduce operating costs with "prepaid discounts" or buying when the price is right. Your lender relationship can sour when you fail to meet debt service obligations. This can lead to higher interest rates, more bank fees, and difficulty when applying for new credit. Finally, not meeting the needs and expectations of your family can hurt the most.

Operating Line of Credit

When your farm needs more cash than it can generate internally, you need to borrow funds. When these funds help the business complete its normal *operating cycle* (production and sale of goods), an operating line of credit is required. An operating line of credit is normally borrowed and repaid on an annual basis for most farms.

Compare this to funds needed for the *capital investment cycle*, which is the purchase and use of fixed assets including real estate, equipment and breeding livestock. Mortgages and term notes are the facilities that fund the capital investment cycle. These types of loans are paid back over a period that reflects the life of the asset, usually several years or more.

If you are experiencing cash flow problems, you must first find the cause.

Automatically assuming that insufficient cash is due to the nature of your operating cycle could delay progress in addressing important problems. These problems could include poor profitability, paying off debt too fast, or taking too much cash from the business for family living. If cash shortages are due to normal operating conditions, then getting an adequate *operating line of credit* is the first step in meeting the cash needs of your business. The operating line bridges the gap between income and expense caused by milk price variability, seasonal operating needs, or normal fluctuations in milk production.

Cash Flow Budget

The cash flow budget is the economic tool to decide how large the operating line of credit needs to be, when to borrow, and when to repay. The cash flow budget is a month-by-month projection of the sources and uses of cash. With milk prices being more volatile, the budgeting process is more difficult *and* more important.

A cash flow budget has several components, each relating to the source and use of cash on the farm. Figure 1. shows how a cash flow budget can be used to determine the size of an operating line of credit, and when the loan can be repaid. In the figure, operating income (1) is the only source of cash. Uses of cash include operating expenses (2), debt service (3) and family living (4). On some farms, non-farm income may contribute to family living, reducing this use of cash. Sales and purchases of capital assets have been excluded for clarity.

The example in Figure 1. shows that uses of cash in May, exceed sources by \$5,400. The primary reason is that operating expenses are higher due to the need to pay for seed, fertilizer and chemicals. This would be considered a normal part of the farm's operating cycle, and should be covered by the operating line of credit. The loan is repaid in November and December as income increases due to higher seasonal prices and milk production.

For dairy farms, many lenders amortize the operating loan on a 10 or 12 month period. When operating loans cannot be paid back in one year due to disaster losses, or expansions, there are several options. One option is to take part or all of the operating note and amortize it out over a three to five year period. This allows the borrower to start with a reduced operating line balance.

Mark Honey, Assistant Vice-President and Agricultural Loan Officer with Key Bank in Jamestown notes that sometimes, especially on larger farms, operating lines of credit are converted into permanent working capital. Under this arrangement, the principal balance is never really paid off. Rather, cash is borrowed and repaid monthly up to a set limit.

Reality Check

Few farm businesses take the effort to put together a monthly cash flow budget. Historically, when done by hand, the process is laborious, tedious, and lacks the powerful "what-if" capability. Computerized spreadsheets are really essential to make the cash flow budget a useful tool. With a computer model set up, one can instantly see the effect of reducing the price of milk, changing milk production estimates, or decreasing the cost of labor and feed. With a personal computer, good accounting software an electronic spreadsheet, cash flow budgeting can vastly improve your ability to understand and improve your farm's cash flow.