



## Economic Toolbox

### **More Working Capital**

In the last column, we defined working capital as resources available for your farm to meet operating needs during its business cycle. These “resources” can include stored feed, crop inventories held for sale, supply inventories such as seed or medicines, and of course, cash. At some point during your farm’s operating cycle, these current assets are converted into cash which is used to pay for operating expenses, family living, principal repayment, and capital purchases. If any is left over it can be squirreled away for retirement or rainy days.

Having too much working capital (and too much cash) is not a problem that many farms have. In fact, just the opposite is more likely. When working capital is insufficient to meet the operating needs of the business, bad things happen. On many farms the first symptom shows up as increasing accounts payable. The feed bill doesn’t get paid-off all the way, or the vet bill gets passed over this month, or the fertilizer bill gets put back into the “to be paid” pile. In more serious working capital shortages, all three happen at the same time - for a few months in a row. If this has happened to you, you have experienced a shortage in working capital.

#### **Business lifeblood**

Cash is the lifeblood of a business. When there’s not enough of it to go around, action needs to be taken. First, you must determine the cause of low working capital. There are four basic causes for cash shortages and each cause will require a different solution. Sometimes, problems exist in several areas at the same time, making solutions even more difficult to attain.

**Problem area #1 - Poor Profitability.** If long running profitability problems are causing shortages of cash, then you must take a long hard look at your future in your industry.

Profitability is essential to maintaining and improving working capital. The price received for milk, meat and crops is only one factor in the profitability equation. Farm magazines are filled with the “secrets” of successful farm businesses - cost control, high quality products, marketing skill, above average yields and production. These fundamentals must in place, and must be continually improved upon. Generally speaking, financing your way to improved long-run profitability is a difficult chore.

Short term profitability problems are a different situation altogether. A drought, flood, disease epidemic or other catastrophic event can and does reduce working capital. Farms that show long-run profitability can overcome these set-backs by refinancing operating notes and accounts payable with longer term notes and mortgages through their regular lender or the USDA Farm Service Agency. For example, a farm owes \$50,000 on a fertilizer bill that cannot be paid because a flood ruined a crop. By borrowing \$50,000 on a 12 year note and paying the fertilizer bill, current liabilities are reduced from \$50,000 to about \$2,500 which is the amount of principal due on the note in the next 12 months. By shifting debt from the current to the non-current category, the farm has improved its working capital position.

Problem area #2 - High principal repayment. Many farmers want to pay down debt as quickly as possible, and in some cases, their lenders want them to as well. While this is a noble goal, it can be carried to the extreme with negative consequences on working capital. Paying off debt too fast drains the cash resources of a business and sometimes prevents it from putting the cash to better use. For example, cash you are paying on a 10 percent interest note could be better used to pay off a feed bill which carries an 18 percent annual interest charge. Perhaps that same cash could be used to invest in additional cows that can return 15 percent. Locking yourself into a short term amortization schedule increases your current liabilities and reduces your ability to put cash to its highest and best use in your business. A safer, more flexible strategy is to get the longest terms possible on notes and mortgages, keeping your committed cash outlays as low as possible. Then, when you have excess cash and it makes

sense in your income tax strategy, make extra principal payments on your loans.

Problem Area #3 - Paying for capital purchases with cash. This problem is akin to the previous problem, only it is more extreme. If you have ever heard anyone complaining that she owes a lot of income taxes but doesn't have any cash to pay them, it's a good bet that problems 2 or 3 are the cause. Draining your checking or savings account to buy a new piece of equipment has the effect of moving assets from the current portion of your balance sheet to the non-current portion. Yes, you now own that piece of equipment or those new heifers outright, but the next time milk prices take a dive, you have no cash in reserve to keep current on the feed bill. Protect your working capital by keeping some in reserve and using debt wisely.

Problem Area #4 - Family draw too high. A profitable farm business of any size is only able to provide a certain amount of excess cash that can be used by the family for living purposes. By taking more cash than the farm can provide, you will be eating into the business' working capital. If the family needs exceed what the business can provide, then there are three options. Grow the business, improve the profitability of the business, or bring in additional money from off-farm employment.

### **Short-term solutions**

Sometimes a business needs working capital now, *right now*. Restructuring debt, expanding your business, or getting off-farm employment are not options that can get you by in the next three months. In the heat of the battle there's little time for the luxury of long-term solutions. Here are some tricks that may apply to your situation to free up cash and improve working capital: 1) Ask your lender for interest-only payments or no payments for a period of time. 2) Sell assets that are not contributing to cash flow or the business overall. This could include real estate, equipment, or livestock. Warning: don't sell secured assets without permission from your lender. 3) Take advance payments on accounts receivable or other future income such as government payments, or milk receipts. 4) Barter. 5) Work out credit or repayment strategies with

suppliers at reduced interest rates. 6) Sell assets and lease them back. 8) Get an operating loan from your lender with equity you may have in inventories, growing crops, or accounts receivable. 7) Use credit cards only as a last resort.

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