Understanding Your Farm's Financial Health

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Production Measures

- Conception %, Heat Detection Rate
- Lbs milk/cow
- Tons/acre, bu/acre, etc.
- Compare to "averages" & look for trends
  - Identifies production issues (good & bad)
- Same goes for financial ratios

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Financial Analysis

- What you need:
  - Income Statement
    - Aka Schedule F or P&L
  - Balance Sheets
  - List of Financial Benchmarks
  - Calculator or spreadsheet
  - Common Sense

Ideally 3-5 years of these statements

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Areas of Importance

- Liquidity
  - How quickly can you put your hands on cash?
- Solvency
  - How much of your farm do you own vs your creditors?
- Repayment Ability ("capacity")
  - How able are you to make your loan payments?

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Areas of Importance

- Profitability
  - How much is your firm earning, after all expenses?
  - The “bottom line” (before taxes)
- Financial Efficiency
  - How well are you controlling your costs?
  - How well are you using your assets?

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Financial Ratios

- Compare a ratio to its industry benchmark
- Look for trends over time
  - Identify ongoing problems
- Look for ways to improve a bad ratio
  - Identify the problem and possible corrective actions

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Liquidity
enterprise's ability to pay short-term obligations

- **Current Ratio = Current Assets / Current Liabilities**
  - These come from your balance sheet
  - Benchmark: (**Green > 1.5** **Red < 0.8**)
    - ❖Higher is better, to a point
    - ❖“You have \$1.50 in current assets for every \$1.00 of current liabilities”
  - How liquid are your current assets?
    - ❖Cash, savings, feed inventories, prepaid expenses, etc.

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Liquidity

- **Working Capital / Expenses** = (CA – CL) / Total Expenses
  - Total Expenses comes from your Income Statement (Schedule F)
  - Benchmark: **Green > 25%** **Red < 15% (for enterprise that is stable)**
    - ❖Higher is better, safer
    - ❖“You have enough liquidity to cover ¼ (3 months) of your annual expenses”
  - More lenders are looking at this ratio today
    - ❖It relates your liquidity to the size of your operation

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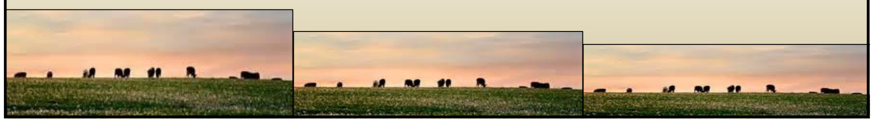
Liquidity

(Current Ratio = Current Assets / Current Liabilities)

- What if it's low?
  - Potential cash flow problems
  - More susceptible to financial "potholes"
  - You have less management flexibility
    - ❖No cash to take advantage of opportunities
  - Need strong cash flow & profitability



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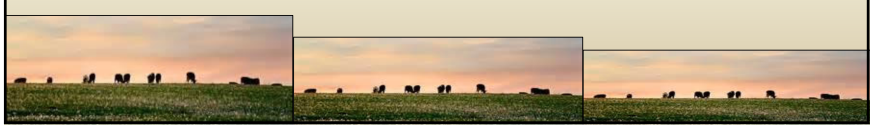
Liquidity

(Current Ratio = Current Assets / Current Liabilities)

- How to improve:
  - Build up your savings account
  - Build feed or supplies reserves as appropriate
  - Sell unneeded assets & pay down debts
    - ❖Start by paying down your operating loans
  - Improve the efficiency of your operation

Liquidity is like a shock absorber - It smooths out the "minor" potholes



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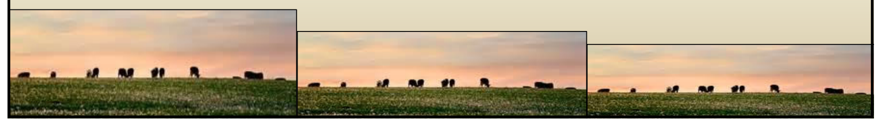
Liquidity

(Current Ratio = Current Assets / Current Liabilities)

- How to improve (continued)?
  - No new borrowing
  - Stretch your loans over a longer term to lower your payments
    - ❖Refinance??



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Solvency

enterprise's capacity to meet its long-term financial commitments

- Debt/Asset Ratio = Total liabilities/Total assess Goal < 30%
- Equity / Asset Ratio = Net Worth / Total Assets
  - Equity = difference between what you owe and current value of your assets
  - These come from your balance sheet
  - Benchmark: (**Green > 70%** **Red < 30%**)
    - ❖Higher is safer
    - ❖"You have paid outright for 70% of your assets"
  - For Young/Beginning Farmers -- > 30%; During/After Transition involving new debt -- > 30%

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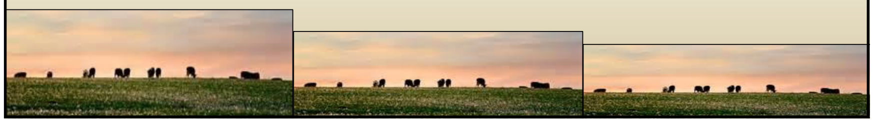
Solvency

Total liabilities/Total assess

- What if your solvency is low?
  - More of your cash flow is earmarked for debt payments
  - Less management flexibility
- How to improve:
  - Sell unneeded/under-used assets & pay down debt
  - Lease vs own; borrow; co-own; go without
  - Improve profitability & pay down debt, add to savings



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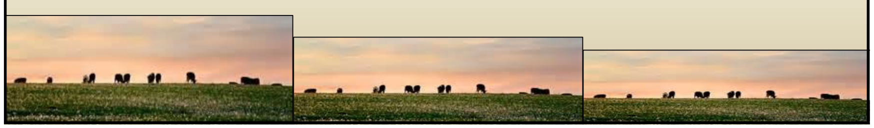
Repayment Capacity

- **Debt Coverage Ratio**

  Debt Repayment Capacity / Total P&I Payments

  Net Farm Income
  + Depreciation & Interest Expense
  + Non-farm Income
  - Family Living & Income Taxes (or Owner Withdrawal*)
  = Debt Repayment Capacity

Net Farm Income, Depreciation, & Interest Expense come from your Income Statement



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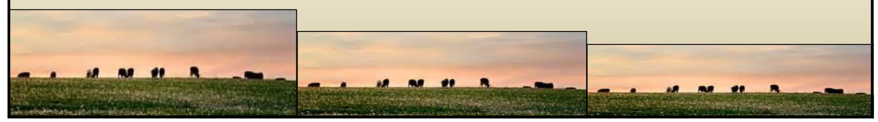
Repayment Capacity

- Benchmark:
  - Higher is better (**Green > 150%** **Red < 110%**)
- Tells you how much cash you have available to make your P&I payments
  - "$1.50 of cash for every $1 of loan payments due this year"



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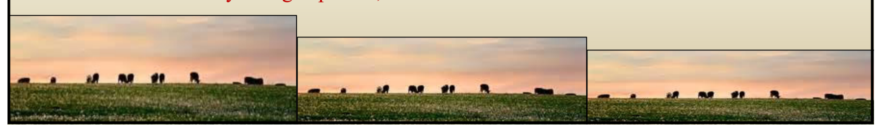
Repayment Capacity

- How to improve:
  - Increase revenues
    - ❖Quantity sold, selling prices, improved quality or consistency, new products
  - Decrease expenses (top 5)
    - ❖Feed/feeding system, vet, labor, interest, etc.
  - Refinance your debts
    - ❖Lower APR, longer repayment terms
  - Reduce family living expenses, increase non-farm income



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Profitability

- **ROA: Rate of Return on Assets**

$$\frac{\text{(Net Farm Income + Interest – Mgt Fee)}}{\text{Total Farm Assets}}$$

  - Benchmark: (**Green > 8%** **Red < 3%**)
    - ❖Greater than your cost of money (APR)
    - ❖Greater than the rate of inflation (3%)
    - ❖Higher is better, to a point

Mgt Fee = Owner Withdrawal or Family Living Expense

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Profitability

- If it's too low:
  - Living off depreciation or paper gains
    - ❖Will have trouble replacing assets when they wear out….
  - Must make profits to stay in business long term – will the transition help?
- To improve:
  - Increase revenues
  - Decrease top 5 expenses
  - Get rid of unneeded or under-used assets

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Rate of Return on Assets

- Net income + interest / total assets > 8% is good
- **ROA** gives a manager, investor, or analyst an idea as to how efficient a company's management is at using its assets to generate earnings.

  OR

  how much profit a business is generating from its capital.

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Financial Efficiency

- **Operating Expense/Receipt Ratio**

  (Total Expenses – Depreciation – Interest) / Gross Revenues

  - Benchmark: (**Green < 70%** **Red > 85%**)
    - ❖Lower is better, to a point
  - Measure of cost control
    - ❖"It costs $0.75 in operating costs to generate $1 of sales."
    - ❖Leaves $0.25 for taxes, family living, interest, depreciation, etc.

These come from your income statement.

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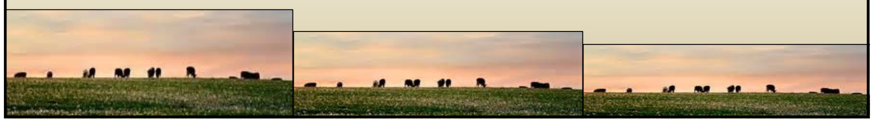
Financial Efficiency

- What if your Op Exp/Rec ratio is too high?
  - Lower profitability; cash flow problems
  - Higher operating needs; loan repayment problems
- How to improve:
  - Decrease top 5 expenses without hurting production
  - Increase revenues (pricing, quantity sold, etc.)



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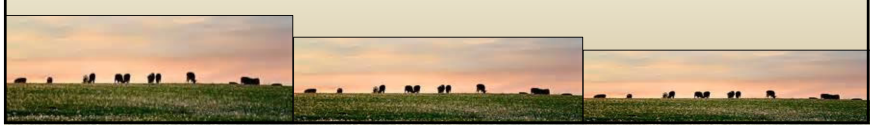
Financial Efficiency

- **Capital (Asset) Turnover Ratio = Gross Sales / Total Assets**
  - Gross Sales comes from the Income Statement
  - Total Assets comes from the Balance Sheet
  - Benchmark: (**Green > 40%** **Red < 15%**)
    - ❖Higher is better
  - Measure of how much revenue you are generating from your assets
    - ❖"Idle assets are killers!"

Doc White's Bird Poop Principle!!



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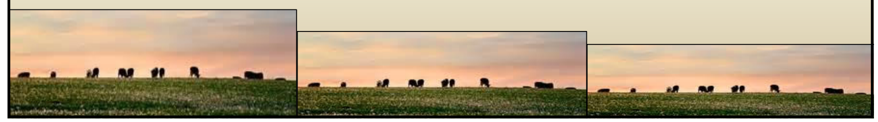
Financial Efficiency

- If it's too low
  - Too many "idle" or unproductive assets
  - Lower for land-intensive enterprises
- How to improve:
  - Get rid of unneeded or under-used assets
  - Generate more sales with existing assets
  - Find new uses for your assets - Custom work?



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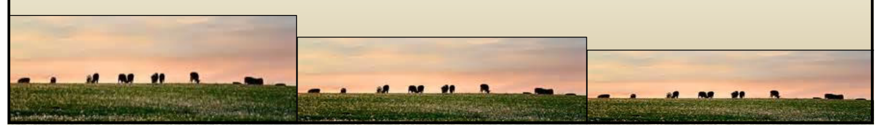
Use The Ratios to Improve

- Powerful information
  - You already have the info – use it
  - Compare to benchmark, look for trends
- Capitalize on your strengths
- Identify potential problems BEFORE the transition
- Improve your relationship with your lender!



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