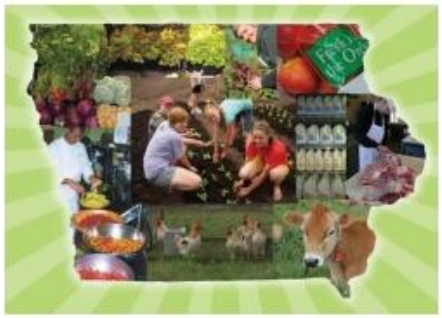
IOWA FOOD SYSTEM
working group

LOCALLY GROWN

Managing Farm Finances



"The next best thing to finding out you're right is to find out you're wrong as quickly as possible."

-John Manley, Chief Equity Strategist for Wells Fargo Advantage Fund, quoted in the Business section of the Wisconsin State Journal, Feb. 18, 2012.

Key Concepts

- Cash flow is critical…especially in the short run
- Profitability…also important
- Need both to be a sustainable business
- Three tools are particularly useful for planning
- Need three financial statements to measure progress

Profitability and Cash Flow

- Related but very different
  - Can be profitable with negative cash flow
  - Can have strong cash flow and be unprofitable

- Cash flow is absolutely critical
- Cash flow and profitability are both important in long run

"The most basic possible definition of a good business is this: It generates more cash than it consumes. Good managers keep finding ways of putting that cash to productive use. In the long run, companies that meet this definition are almost certain to grow in value…"

Source: Benjamin Graham, The Intelligent Investor, Revised Edition, 2003, commentary by Jason Zweig on p.308.

Pieces of a financial plan for your farm

- Enterprise budgets
- Cash flow projection
- Record-keeping system for tax purposes

Everybody should at least do these!

- Annual balance sheet on Jan. 1
- Income statement
- Statement of cash flows

These are musts if you want to calculate profitability and other financial performance.

Information From Balance Sheet

- Liquidity – Ability of the business to meet its current (short term) liabilities with current assets

- Solvency - Ability of the business to pay off all of its debts if it were to be sold tomorrow

Balance Sheet Ratios

- Liquidity ratio
  - ***Current ratio*** – Current assets *divided by* current liabilities.

  GOAL: The current ratio needs to be at least 1.1, preferably 1.7 or more

- Solvency ratio
  - ***Debt to asset ratio*** – Total liabilities divided by total assets

  GOAL: The debt to asset ratio needs to be less than 60%, preferably less than 30%

Common Liquidity Problems

Current assets consist mainly of inventories and receivables, not much cash

Operating losses carried forward year-to-year

Poorly structured debt

Forced sales of inventory at unprofitable prices

Large, unplanned expenses

Information From Income Statement

- **Net farm income** – Return for your unpaid labor, management, and financial investment in the farm

When combined with the balance sheet, allows us to calculate profitability ratios.

Profitability ratios

- **Rate of return on farm assets** – The "interest rate" being earned on all of the investments in the farm. *GOAL: Higher than interest on borrowed money*

  = Net farm income + interest expense – value of operator labor and management / average farm assets

Profitability ratios

- **Operating profit margin** – Illustrates the operating efficiency of the farm. *GOAL: minimum of 15%; preferably over 25%*

- *= Net farm income + interest expense – value of operator labor and management / Gross cash farm income +/- accrual inventory adjustments – feeder livestock purchased – feed purchased*

Common profitability problems

- Capital investment too high relative to income
- Depreciation or interest too high
- Operating expenses too high, particularly feed and labor
- High market values for assets. Makes it difficult to achieve adequate rates of return on assets & equity
- Sales prices are too low

Efficiency Ratios

- Asset turnover ratio measures efficiency in using capital (your assets). Generating a high level of production (gross income) with a low level of assets will give a high asset-turnover rate. GOAL minimum 30%, preferred 45% *

= *Gross cash farm income +/- accrual inventory adjustments – feeder livestock purchased – feed purchased / Average farm assets*

Efficiency Ratios

- Operating expense ratio = Operating expenses / gross farm income
- Depreciation expense ratio = % of gross income
- Interest expense ratio = % of gross income
- Net income ratio = % of gross income

These four ratios combined equal 100%. The lower the Net income ratio is, the more sales that are needed to reach your profitability goal.

Cash Flow Statement

All cash flowing into the operation (including loan proceeds) and all cash flowing out (including family living expenses, taxes, principal and interest payments) on an ***annual*** basis.

Where is the farm's cash coming from? Is there enough cash to cover operating expenses, family living costs, income taxes, and loan payments, and still have money left to replace stuff that's rusting, rotting, or wearing out?

Cash flow ratio

- Term Debt Coverage Ratio – Net cash flow divided by scheduled P & I payments on term debt. (USDA-FSA uses this ratio)

  GOAL: Minimum of 1.2; preferably 1.5 or higher

Common Cash Flow Problems

Volatile prices for farm production and inputs
Combined with Lots of depreciating assets and relatively high debt load

Sometimes a debt structure problem; more likely it's the debt level rather than structure.

Rarely a problem of family living expenses being too high.

Analysis Process

- Construct your balance sheet, income statement, and cash flow statement
- Identify and calculate 6-7 ratios that you want to work with; make sure you cover liquidity, solvency, profitability, financial efficiency, and repayment capacity
- Analyze the ratios; determine which is vulnerable
- Choose additional ratios that will help determine why the ratio is vulnerable

Questions…..

Any questions or comments?

Thank You for This Opportunity!

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GHF Analysis

- Balance Sheet - Liquidity

	Current Ratio	Working Capital	WC%Rev
2012	7.31	$26,373	8.6%
2013	3.60	$17,310	5.4%
2014	4.67	$40,390	9.4%
Goal	>2.0		>20.0%

General Questions:

Are accrual adjustments made at the end of the year?

What's included in current assets & current liabilities?

GHF Analysis

- Balance Sheet - Solvency

	Debt-Asset Ratio	Comments
2012	63.7%	
2013	55.5%	Stable asset values
2014	48.0%	
Goal	<40.0%	Trend is positive

General Questions:

Were there large capital outlays prior to 2012?

Trends in operating loans and debt structure?

GHF Analysis

- Income Statement/Balance Sheet - Profitability

	Net Income	Return on Assets
2012	$43,288	NA - Avg. assets
2013	$37,549	10.3%
2014	$51,056	12.2%
Goal	self determined	>8%

General Questions:

Were there large capital outlays prior to 2012?

Trends in operating loans and debt structure?

GHF Analysis

- Income Statement/Balance Sheet - Efficiency

	Oper. Exp. Ratio	Net Income Ratio	Asset Turnover
2012	84.8%	14.2%	NA - Avg. assets
2013	85.0%	11.6%	68.5%
2014	86.3%	11.8%	89.0%
Goal	<60.0%	>20.0%	>45%

General Questions:

Can Key Expenses be managed more effectively?

Do the expenses match the scale of the operation?

Can prices be increased?

Is depreciation expense and/or labor included?