

## Financial Management Alternatives

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While we do not know what the exact income figures will be, we do know that the major impact of the current low prices will be low income. The first step for farmers--and everyone involved in agriculture--is to fight the urge to deny this problem. The second step is to respond in ways they deem appropriate to their situation.

Farmers, their families, and their business colleagues need to be aggressive in their search and implementation of alternatives; they can't afford to be passive. One of the first items that should be on the list of things to do is "talk." Farmers need to talk with their spouse and family, their friends, their bankers, and everyone else involved with their business. Communication is very important — communication about the situation and about alternatives. Listen to more people than yourself and the people in the coffeeshop. Discuss the situation and alternatives with your management team: your spouse, family, partners, lenders, and other people critical to the success of your business.

To assess where a farm is or where it is headed, a cash flow should be done for both the remainder of 1998 and all of 1999. Doing them together is necessary because some alternatives may be beneficial for one year and detrimental in the other year. For example, asking for the full 1999 transition payments in 1998 may help the cash flow and income situation in 1998 but it will decrease the cash receipts in 1999. Doing the cash flows for both years will allow better informed decisions to be made. Also, the tax implications of alternatives may affect both years.

The following financial management alternatives are listed roughly from the easiest change or adjustment to the most severe. How far down the list a farmer needs to go depends on how bad the initial cash flow problem is estimated to be. The basic idea of each alternative is described as well as some potential concerns that need to be evaluated before the alternative is chosen.

Improving marketing skills. One of the first financial skills needed for the remainder of 1998 and in the future is better marketing skills. Farmers can protect themselves and their financial condition by protecting against extreme adverse price movements. Learning the skills needed to make wise use of hedges, options, contracts, insurance, financial reserves, and other risk management tools will help many farmers deal with risk in the future.

Cutting expenses. Most expenses are already spent or committed for 1998, but there is some

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room to reduce expenditures. Nonessential repairs can be cut. Go easy on capital expenditures for machinery, equipment and buildings. If new machinery is truly needed, consider leasing, sharing, or custom hiring versus owning; the initial expenditure may be lower. Prepaying less expense for the 1999 year may be a very obvious way to cut expenditures. However, if input suppliers offer better discounts this fall compared to other years, the decision may be harder to evaluate. On the personal side, family living expenses can be curtailed to some degree. All of these potential cuts need to be discussed with the management team to decide whether the expenditure is indeed something that can be cut or delayed to another year.

**Increasing income.** Are there ways to increase income that have not been used before? If you have an empty feedlot, is it worthwhile to buy some feeders yourself or is someone else interested in renting the facility from you. The exposure to risk by renting to someone else needs to be evaluated: the cost of insurance, the risk of nonpayment of rent, any additional costs or work due having someone else's livestock on your farm. The potential of increasing nonfarm income to replace declining farm income may be an alternative for some farm families.

**Government payments.** Weigh the interest savings from taking out CCC loans vs. the income potential from the loan deficiency payment (LDP). The LDP may be more beneficial if you do not need the cash flow generated by the CCC loan. Also, the recent change allowing farmers to receive all of their 1999 government transition payments in 1998 may help with cash flow problems. However, marketing and tax considerations will affect these decisions as will the concern for 1999 income. These considerations will cause different farmers to make different decisions based on their unique situation.

**Tax management.** Consider all possible (legal) ways to minimize taxes. Remember income averaging is now available starting in 1998. Also, remember that net operating losses can now be carried back up to 5 years. If taxable income is extremely low, be sure to obtain the maximum earned income credits available. Take advantage of all the state education credits. In some situations, a family's taxable income may be below the minimum taxable level, that is, no tax is due. In these cases, the farmer may find it beneficial to sell some products to raise income up to the point of entering the minimum taxable brackets. For instance, if corn can be sold in 1998 without raising taxes, a price of \$1.60 may be equivalent to receiving \$2.00 and losing \$.40 to the federal and state governments if the farm was in a combined 20% tax bracket. While the price of \$1.60 is still low, this option still needs to be considered.

**Zero based budgeting.** With the prospect of low prices continuing into 1999, farmers may need to reevaluate how they grow their crops and livestock. Every expense should be evaluated for its benefit compared to its cost. Some expenses are obviously worthwhile: seed, some fertilizer, feed, etc. However, what is the best seeding rate when crop prices are low? Is that tillage needed or is it "recreational"? Is it worthwhile to pay technology fees when other pest control methods are available? What is the optimal protein percentage when

hog prices are so low? The decision may be to continue growing as we currently are but it may not be either. For example, if soil tests indicate sufficient levels of P and K, this may be the year to farm what is in the soil and not build up levels.

Land rent negotiation. Low prices are a very good reason to talk with landowners about renegotiating cash rents. Consider changing to a share rent or a flexible cash rent for the future of increased risk. A good starting point for rent negotiation is estimating the revenues and costs for both the tenant and the landowner. By splitting the total revenue and costs, both the tenant's maximum bid and the landowner's minimum bid can be estimated. This is done as an example using information from the Southwestern Farm Business Management Association for 1997 (Table 1). Note that the estimates in Table 1 are different from the usual enterprise budget. Since rent is the cost to be determined, it is left out of the costs. Two items used in rent negotiation but not usually in an enterprise budget are the returns to the farmer's labor and management for production (\$25 per acre in this example) and the landowner's money tied up in the estimated value of the land (\$88 per acre which is a 5% return on land worth \$1750 per acre). Based on these estimated yields, prices, and costs, the tenant's maximum cash rent is the difference between revenue and costs or \$62 per acre in this example. In order to pay the estimated costs and receive the desired returns to land investment, the landowner's minimum cash rent is the total of these costs or \$121 per acre in this example. In most years, the landowner's minimum and the tenant's maximum would define a negotiating range between these figures. In this example, there is not enough income to satisfy both parties so negotiations involve one or both parties accepting a lower than desired return. For example, the landowner may have to accept less than \$88 return on the money invested in land or the tenant would have to expect less than \$25 per acre for labor and management. If this is not acceptable, other costs must be decreased or revenues increased so the two parties can reach agreement.

Liquidate unprofitable enterprises. Now may be the time to consider liquidating that unprofitable cow-calf enterprise or that farrowing unit that needs updated facilities to be profitable. Weigh the pros and cons of these decisions. If short term debt can be substantially reduced by selling assets being employed by these enterprises, cash flow may improve dramatically. On the other hand, it is not usually desirable to liquidate enterprises when asset values are low. But sometimes it is necessary to stop the bleeding. Most enterprises are probably covering their cash costs. To make liquidation pay, you need to find a more profitable way to employ the resources they were using. This is often operator labor. You may need to consider increased off-farm employment, for example, to use the freed-up time profitably.

Refinance. Take advantage of the very low interest rates now available and refinance your debt at lower levels. Spending money to refinance may be very wise even in a tight cash flow situation. Even a 1% drop in the interest rate can be worthwhile for reducing cash flow requirements as well as the cost of borrowing for loans to be held longer than the next 3-4 years.

Restructure. Moving short-term debt to long-term debt by refinancing can be a very good strategy if two conditions are present. First, will the business be able to handle the debt load in the future? Second, is the management able to assure that a short-term debt problem will not recur in another year or two?

A new mortgage. Another option to consider (and to be wary of) is obtaining an operating loan by putting a mortgage on currently unmortgaged land. This may seem like the only way to obtain an “operating” loan, but what impact does it have on future plans? What impact on the solvency of the business?

Rent out land. If your personal situation for 1999 looks very bad but you have some solid evidence that the situation may improve for future years, consider renting out all or part of your land and subleasing your rental land for 1999. This option may sound very drastic, but it may make good financial sense. If you can't obtain sufficient operating funds from your lender or from your own reserves, renting your own land to someone else and continuing to farm the land you rent may help preserve your farm operation through a tough period for better years in the future. Talking with your lenders and landowners is certainly necessary so they all know your plans and reasons.

Sell excess assets. How much machinery is needed to farm? Sell any extra tractors or equipment that you and your team decides you do not need or can obtain the services of through other means. If the combine is larger than needed for your size farm, could it be sold and harvesting done by a custom operator. (The other option of doing more custom work yourself is an obvious alternative is mentioned below also under increasing income.)

Sell productive assets. In extremely severe situations, selling income producing assets may be an alternative that has to be evaluated. Do a cash sale only; if you are in need of cash, don't consider a contract for deed. Selling productive assets needs to be evaluated for its impact on cash flow, the solvency of the business, and the impact on potential income production. Can the assets be sold for a reasonable value or will its forced sale drop its price? Will the cash received for the asset allow a sufficient amount of debt reduction? In some areas, selling a portion of land for nonfarm uses may be an alternative; for example, land along a river or with a view may be sought after by people wanting either a cabin site or a rural residence. These alternatives may raise a good cash flow and not affect the potential for future income potential. One caution in all of these asset sales is the impact on the retirement plans. If the land for cabins or rural residences is part of a farmer's retirement fund but is now used to pay operating debts, what happens to the retirement plans?

Liquidate? If you have to get out, do so before you have lost all your equity. We have heard farmers say they do not plan to repeat what some of their neighbors did in the 1980s: struggle to survive and lose everything anyway. Even though it is heart wrenching and dream shattering, many farmers who have quit realize that they can live happily in town and in other jobs. The skills and qualities possessed by farmers (management, personnel,

leadership, initiative, work ethic, honesty, etc.) are what other employers are looking for.

Most farms will be able to survive one down year with a combination of these suggested measures. For those who remain in farming, better risk management skills will be needed both for 1999 and for the long run. With the 1996 farm bill, the Federal government has been taken out of the business of actively protecting farmers from the downside risk of the market, that is, low prices. So farmers need to consider many new facets of risk management that weren't needed before. Hedging, forwarding contracting, and options have been available and need to be used when appropriate. Satisfactory, profitable prices need to be taken when available; let the speculators speculate. New forms of crop insurance (such as, crop revenue coverage, and "Dollar-for-dollar") are being offered and developed to provide protection for both price and yield risk. Using the futures market and buying insurance are not the only risk management tools available. Simple tools can be very powerful for reducing risk exposure. Controlling debt and not overextending the risk bearing capacity of the farm will be crucial. Farmers may also need to develop financial reserves or "rainy day funds" for future poor years.

As an ending note, let us return to the first step that is necessary to deal with the financial situation facing farmers and others involved in agriculture: fight the urge to deny this problem.

Table 1. Comparison of tenant's and landowner's costs based on information from the Southwestern Minnesota Farm Business Management Association.

	Tenant's Share:		Owner's <u>Share</u>
	Long Range Plan <u>Corn</u>	<u>Soybeans</u>	
<b>REVENUE</b>			
Yield	120	40	
Price	2.25	6.00	
Transition payment	39	1	
Other income	<u>1</u>	<u>2</u>	
Total	310	243	0
<b>DIRECT EXPENSES (except rent)</b>			
Seed	33	16	
Fertilizer	48	5	
Chemicals	29	30	
Crop Insurance	6	10	
Drying fuel	5	-	
Fuel & oil	10	8	
Repairs	21	17	
Misc.	7	4	
<u>Operating interest</u>	<u>10</u>	<u>8</u>	
Total	169	98	0
<b>OVERHEAD EXPENSES</b>			
Hired labor	7	5	-
R. E. Taxes	-	-	15
Farm insurance	3	3	3
Utilities	3	2	1
Interest (opp.)	7	5	88
Depreciation	35	28	5
<u>Miscellaneous</u>	<u>8</u>	<u>7</u>	<u>4</u>
Total overhead	63	50	116
Labor & Management	25	25	5
<u>Total Listed Expenses</u>	<u>257</u>	<u>173</u>	<u>121</u>
Net Return (w/o rent)	53	70	-121
Average Net Return	62		-121