



Agribusiness Finance Report

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MANAGING FINANCIAL STRESS: SYMPTOMS AND STRATEGIES

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Volatile crop prices, increasing costs and tightening credit conditions can create short term financial stress for a farm/ranch business.

Several strategies are available for coping with financial stress, but because of the diversity in farming operations, not every strategy will be equally successful. The purpose of this document is to help managers assess their financial positions, describe actions that ease short term financial problems and provide insights into the strategy that will best fit their needs.

Stress Awareness

Diagnosing the source of financial strife requires recognition of the symptoms before problems become serious. Financial indicators of business stress include

- Consistently low cash balance and working capital (current assets minus current liabilities).
- Inability to pay off operating notes within the accounting cycle.
- Inability to meet scheduled term debt payments.
- Anticipated shortfall in paying debts as they come due or unanticipated use of business credit.

- Consistently declining gross margins (revenues minus variable costs).
- Selling assets to meet debt payments, especially noncurrent assets.
- Servicing fixed costs prevents the purchase of variable inputs (e.g., fertilizer) reducing farm productivity.

These symptoms may be a result of low prices, decreased yields and/or higher input costs. Short term financial stress can be alleviated with several management strategies.

However, an important question for the farm manager is whether this stress is truly short term (operational) or is the result of a weakening of the business's strategic position. Strategic stresses cannot be solved with short term strategies but instead require wholesale changes. Sources of strategic stress include being too small to gain access to markets or inputs, losing productive resources such as irrigation wells, or not being competitive for land and labor inputs. Addressing a strategic shortcoming with operational strategies may simply cause the business to lose its equity more slowly rather than solving the underlying problem. An exit strategy

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Managing Cash Flow The principle behind managing cash flow is that each input should pay its own way so that expenses are matched by revenues within the accounting cycle, with the exception of goods purchased for later resale (e.g., yearling cattle) whose ownership may extend across two accounting cycles.

Cash flow management strategies include:

- Controlling costs so that inputs generate necessary cash flow. As an example, perform soil tests to precisely match nutrient requirements for crops rather than applying rules of thumb from previous years.
- Renegotiate cash rents or alter terms of share rents. Cash rents are a large expense for the farm business and can often be negotiated on an annual basis.
- Increase utilization of assets to generate more revenue. While they may increase expenses and reduce the useful life of assets, custom harvesting and hauling can generate cash for the business. Likewise, leasing unused storage can provide cash income.
- Put off capital expenditures until the financial stress passes. Purchasing used or repairing equipment can stretch cash resources until operations return to normal.

Managing Debt is a second general strategy for dealing with short term financial stress. Open communication with a lender and a pro forma cash flow statement are useful when

- Negotiating loan repayment terms to reduce cash flow pressure. This strategy is a short term fix and will eventually cost the farm business in terms of increased interest expense over the life of the loan. This strategy “buys time” for the manager to make other changes.
- If the loan is well secured and cash flow challenges temporary, lenders may agree to interest only payments.
- Re-amortize carryover from an operating loan into an intermediate term loan. This may reduce the size of payments until financial stress is removed.

- Reduce debt with non-farm earnings, gifts from family members or by attracting outside investment.

Importantly, these strategies can reduce financial stress in the short term, but will cost the business in interest expense in the long term. It is unlikely these strategies will lead to an increased net worth.

Managing Assets represent a third category of reducing short term financial stress. Particular strategies include:

- Renting assets to other farmers, especially cash renting cropland or one year’s calf crop. This strategy can generate cash early in the accounting cycle and is often combined with custom farming or off farm employment.
- Selling inventories is not always attractive with existing market conditions, but it can allow the manager to pay down farm debt. This is especially true if there are substantial carrying charges associated with the inventory.
- Selling capital assets can help the farm meet debt obligations, but would be undesirable if the sale of such assets reduce the farm’s future earning potential. It can often be very difficult to grow the farm once its assets have been reduced.

Selecting Among Strategies

Many creative strategies exist for mitigating financial stress, but not all will be equally successful. How should the farm manager choose among them? A general philosophy is to take measures that disrupt business operations the least, but adopt more serious measures as the challenges become more serious. Knowing an enterprise’s (or farm’s) breakeven point helps gauge how serious the action must be.

Breakeven Point The breakeven point for any business is the level of production at which total revenues to the operation just equal total costs. In this case, total revenues are price times yield times total production area and total costs are the sum of both variable costs (seed, fertilizer, chemical, diesel) and fixed costs (taxes, insurance, depreciation, cash rent). At the beginning of the year, the manager chooses inputs to meet or exceed the breakeven yield for the farm, but low commodity prices, adverse weather or rising costs

may mean the business is generating less total revenues compared to costs.

Near the Breakeven point a more intensive management of costs may be enough to diminish financial stress. Reducing costs can also reduce revenues, so managers should use partial budget analysis to better understand both the cost and revenue impacts of an action.

Further from the Breakeven point fixed costs, which cannot be changed in the short term, become increasingly important so that reducing variable costs will not reduce financial stress. In this case, turning assets over faster (e.g., custom farming) enhances revenues and puts the farm operation closer to the breakeven point.

Drastic action is needed when fixed costs become so dominant that neither cost reduction nor revenue enhancement are effective. Asset reduction and liquidation strategies are necessary. Commonly, this point occurs when fixed costs are approximately 40% of total costs. Look to liquidate those fixed assets that create the high fixed costs.

Financial Tools that are the most helpful for diagnosing and correcting financial stress include an updated balance sheet, pro forma cash flow statement and enterprise budgets. A partial budget is useful when comparing alternatives and calculating the firm's working capital and repayment capacity for debt service.

Summary

Short term financial stress can cause significant hardship for the farm and/or ranch business. Combating financial stress requires a careful accounting and budgeting of farm costs, revenues, debts and assets. Simple measures, such as managing cash flows, can relieve financial pressure when the farm's output is near its break-even point. More drastic measures, such as increasing the use of assets or even liquidating assets are warranted as fixed costs become a large share of total costs. Resources that help managers adapt to financial stress can be found at the CSU Extension Agribusiness Management website <http://www.coopext.colostate.edu/ABM/>