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The Importance of Working Capital

We often hear phrases such as "protect your working capital," "watch your liquidity," and "cash is king," when referring to short-term financial analyses of farm businesses.

All of these phrases generally refer to the working capital of a farm business. A significant decline in working capital in a farm operation can lead to a rapid deterioration in the overall financial outlook for an entire farm business.

The simple definition of working capital involves total assets subtracted by total liabilities. While that definition sounds quite simple, getting true and accurate working capital data can be much more complex in many situations. Current assets usually include available cash from bank accounts, accounts receivable, grain and livestock inventories, prepaid crop and livestock expenses, hedging account balances, and any other short-term assets. Accounts receivable could include crop insurance or government farm program payments, deferred sales payments on grain or livestock that has already been delivered, and money owed to a farm for custom or contract work.

Current liabilities include all accounts payable, unpaid taxes due, any crop input loans with cooperatives or seed companies, farm operating loan principal balances, and accrued interest on all loans. Current liabilities also include the amount of loan principal payments due in the next 12 months (not the entire principal balance) on all term loans and real estate loans. In the case of grain that has been placed under CCC Loan with the Farm Service Agency, either the entire value of the grain should be listed as an asset and the loan amount as a liability, or just the estimated net value of the grain should be listed as an asset.

A financial ratio often used to express the level of working capital is the current ratio, which is simply current assets divided by current liabilities. A current ratio of 1.7 or higher in a farm operation is usually considered quite solid, while a ratio below 1.2 is usually a warning sign of potential short-term financial challenges or cash-flow difficulties in a farm operation. If the current ratio drops below 1.0, it likely means that there could be difficulty in paying all

Kent Thiesse
Farm Analyst, Vice President
MinnStar Bank, NA
Lake Crystal, MN

kent.thiesse@minnstarbank.com
(507) 381-7960

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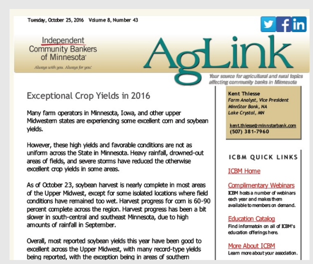

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Exceptional Crop Yields in 2016

Many farm operators in Minnesota, Iowa, and other upper Midwestern states are experiencing some excellent corn and soybean yields.

However, these high yields and favorable conditions are not as uniform across the State in Minnesota. Heavy rainfall, drowned-out areas of fields, and severe storms have reduced the otherwise excellent crop yields in some areas.

As of October 23, soybean harvest is nearly complete in most areas of the Upper Midwest, except for some isolated locations where field conditions have remained too wet. Harvest progress for corn is 60-90 percent complete across the region. Harvest progress has been a bit slower in south-central and southeast Minnesota, due to high amounts of rainfall in September.

Overall, most reported soybean yields this year have been good to excellent across the Upper Midwest, with many record-type yields being reported, with the exception being in areas of southern

Kent Thiesse
Farm Analyst, Vice President
MinnStar Bank, NA
Lake Crystal, MN
kent.thiesse@minnstarbank.com
(507) 381-7960

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accounts payable at the end of the year, as well as repaying the entire principal balance on a farm operating loan for the previous year. In more serious situations, there could also be difficulty in paying all required loan payments on term loans and real estate loans.

Another ratio that many farm financial advisors and ag lenders follow very closely is the level of working capital to gross revenue in a farm operation, which more accurately reflects the liquidity needs based on the size of a farm operation. That ratio divides the calculated working capital for the farm operation by the annual gross revenue of the farm business.

For example, a farm operation with a calculated working capital of $200,000 and an annual gross revenue of $400,000, would have a ratio of 50 percent, which would be quite strong. However, if a farm operation had a gross revenue of $2 million with $200,000 working capital, the ratio would be only 10 percent, which could be a financial concern if not addressed.

A working capital to gross revenue ratio of 30 percent or higher for crop farms and 20 percent or higher for livestock farms, would be considered as fairly strong. If the ratio drops below 10 percent, it is usually an indicator of some financial stress in a farm business, which may require some financial restructuring. If this situation occurs, it is best for farm operators to consult with their ag lender to find some workable solutions.

Based on the Farm Business Management records for over 1,200 southern Minnesota farms, the average working capital to gross revenue in 2015 was about 27 percent, with crop farms averaging over 38 percent, and livestock farms averaging 16-17 percent. The data also illustrated that farm operations in the bottom 20 percent of net income in 2015, had an average ratio of just under 12 percent, while farm operations in the top 20 percent of net farm income had an average ratio of nearly 40 percent.

As we end 2016 and enter 2017, the level of working capital will likely be a concern for an increasing number of farm operations. This is due to large variations in 2016 crop yields and year-end grain inventories, lower values for livestock on hand, as well as increasing levels of accounts payable and farm operating loans at the end of 2016. Farm operators in portions of south-central Minnesota and other areas of the Upper Midwest that incurred reduced crop yields last year are especially feeling some added financial stress from a decline in working capital, compared to a year earlier.

Once a farm operator has identified a need for improvement in working capital, they should consult with their ag lender and farm business management advisors to develop a workable plan.

Some possible ways to improve the working capital in a farm operation include:

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Bank Locator
Get a map and directions to any one of our member banks or branches.

ATM Locator
Find an ATM located on the In Balance® Network.

- Use any extra income generated by the farm business to pay accounts payable or to reduce the farm operating line of credit, rather than making extra principal payments on term loans.
- Avoid spending excess cash from the farm operation to purchase capital assets or land, or to add unnecessary term loans with annual principal payments.
- Consider refinancing term loans and real estate loans to longer-term financing to reduce annual principal payment requirements. Long-term interest rates are currently favorable for this option.
- If the farm operating loan is close the maximum principal level, or if the farm operation had carryover farm operating debt from the previous year, it may also be advisable to refinance some of the farm operating debt with longer term financing.
- Consider selling any unused or extra farm assets or land parcels to generate extra income that could be applied as loan payments. Remember to account for tax liability when considering the sale of land or other assets.

Most working capital shortfalls can be worked out if they are identified early, while there are still some manageable solutions available.

For more information, contact Kent Thiesse, Farm Management Analyst and Vice President, MinnStar Bank, Lake Crystal at: 507-381-7960 or kent.thiesse@minnstarbank.com.

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