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How Much Working Capital is Enough?

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The other day I was visiting with a large dairyman who indicated he only had three months of working capital remaining before he would be required to dip into equity. That raised an interesting question concerning how much working capital is enough. Also, what financial metric is needed to properly assess this component of your finances?

First, working capital is a measure of financial liquidity, which is the ability to sell assets without disrupting normal operations. For example, if one had to sell off half of the milking herd or machinery line to garner cash flow, this would not be considered working capital. At the other extreme, working capital is not just cash in the bank or money market account, which is another common thought amongst producers.

To calculate working capital, add up all of your current assets, including cash, inventories of crop and livestock for sale in the next year, collectable receivables, and prepaid expenses and supplies. For example, say they are \$500,000. Then add all current liabilities, including accounts payable, interest that has accrued, operating loan principal, accrued expenses, i.e. wages and taxes, and principal on term debt due in a year. For example, say it was \$250,000. Working capital is calculated as current assets minus current liabilities. In this case net working capital is \$250,000. This figure by itself is not beneficial.

Financial metrics

The most useful working capital metric is net working capital divided by farm revenue, or value of farm production. In this case, if the producer generated \$1 million in revenue, the metric would be 25 percent ($\$250,000/\$1,000,000$). As farms become larger and more diversified, this measure is becoming much more accepted by lenders.

Another metric that evaluates liquidity is the current ratio, which is current assets divided by current liabilities. In the case situation outlined above, the ratio would be two to one ($\$500,000/\$250,000$).

If one wanted to go deeper, particularly if the business is under financial stress, then the quick or acid test ratio would be an appropriate metric. Utilizing this ratio, one would include cash, receivables, inventory, and supplies that could be sold within 30 to 60 days and offset it against financial obligations on the balance sheet that are due within 30 to 60 days. In this case, say the quick cash items were \$100,000 and the obligations within the sixty-day period were \$50,000. The cash or liquid position in the short term would be covered.



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Let's examine some of the appropriate levels of working capital or financial liquidity. Concerning working capital to revenue or value of farm production, a ratio below 10 percent would be considered a business on thin financial ice. A position between 10 and 30 percent would be cautious but acceptable, depending upon debt levels and management. A metric above 30 percent would suggest a strong situation and would provide the business with the ability to handle short run adversity or take advantage of business opportunities with internal financing.

Please be cautious, however, when benchmarking working capital levels. One needs to test the sensitivity of working capital positions to changes in prices. For example, recently corn in storage at seven dollars per bushel declined to three dollars per bushel. This would cause a farm's working capital position to diminish quite quickly. When input costs double, resulting in operating lines being doubled, working capital can be impacted from the liability side as well.

A strong working capital position is needed for young and beginning producers who usually carry more debt because of age and stage of business. A healthy level of working capital can be built over several years of favorable economic cycles, like the grain industry has just experienced.

Strong working capital positions are a requirement for businesses that are heavily leveraged and focus on "earnings and turns." Examples could be large hog, dairy, and feedlot businesses that work off incremental margins, i.e. earnings, and position the business for quick asset turnover, i.e. turns, or revenue divided by assets. Any disruption in the business cycle similar to the current hog, dairy, poultry, and beef industries concerning prices and cost, requires deep pockets and high liquidity.

A strong working capital position is needed for producers with weak risk management programs who are exposed to price, cost, and interest rate volatility. If you have no strategy or lack the ability to execute, your lender will usually require a higher working capital reserve to buffer the cash flows.

Next, the current ratio metric is becoming less valid as businesses become larger and more complex. For example, a 2 to 1 current ratio is very favorable. However, if the business is generating \$1 million dollars of revenue, with \$200,000 in current assets and \$100,000 in current liabilities, the current ratio looks favorable at 2 to 1, but the business has insufficient working capital to revenue, in today's volatile economic climate.

Finally, the quick ratio or acid test ratio is now becoming very relevant, although it is not one of the Farm Financial Standards Council's recommended ratios. In businesses with financial adversity, being able to identify and isolate assets for sale to pay off demanding liabilities to maintain the business can be the difference between bankruptcy and workout with creditors. If one is in this situation, like the dairy discussed earlier, do not forget the deferred tax obligations. Many current assets have been expensed, leaving a business vulnerable to ordinary income taxes, which is sometimes as much as 40 to 50 percent of the proceeds of the sale of assets.

Working capital will continue to become a more important financial metric to understand in managing your business financials because of volatility and uncertainty in economics. Your challenge is to schedule an appointment with your lender and financial professional to ascertain your status and strategies to be proactive in managing your financials.



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