David M. Kohl

Professor, Virginia Tech
Agricultural Finance and Small Business Management
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Working Capital: The King of Financials

By: Dr. David M. Kohl

Working capital, the king of financials, is very appropriate in today’s agriculture business environment. Increased volatility on income statements and cash flows with large numbers in an uncertain economic environment places a premium on the top half of the balance sheet. Current assets and current liabilities are used to determine financial liquidity and working capital. While many producers have a strong equity position as a result of appreciated land values, paper wealth does not pay the bills. Many businesses are equity-rich and liquidity or cash flow poor.

Let’s examine everything you wanted to know about working capital, but were afraid to ask. The definition of liquidity in the business is the ability to sell assets to generate income without disrupting normal operations. Selling off half of the land or machinery line, or in some cases livestock, could generate cash, but it would often be destructive to the long run operation of the business.

Working capital is current assets minus current liabilities. Current assets generally can be turned to cash within one year, while current liabilities are to be paid off within the next 12 months. Current assets consist of inventory, receivables, crops growing in the field, prepaid expenses, and good old-fashioned cash. Current liabilities include accounts payable, use of the operating line of credit, principal due on term debt within one year, and any accrued expenses.

Many lenders will calculate the current ratio (current assets divided by current liabilities) as a measure of liquidity. A solid level used to be a two to one current ratio. However, as farms have become larger, a new standard emerged, which is working capital divided by gross revenue, or in some cases expenses.

How Do You Stack Up?

Analysis of farm record data across the U.S. on commercial farms finds that the top 20 percent of managers generally maintain approximately 50 percent working capital to revenue while the bottom 20 percent maintain 10 percent to 15 percent of working capital to revenue. A goal should be to have at least 33 percent to 50 percent of revenue in working capital as a financial shock absorber. This is also very appropriate if one is thinking about expansion, a major acquisition, or a change in business strategy which increases the likelihood of financial adversity.

Burn Rate

This winter when you are meeting with your lender or your farm management instructor, a term called burn rate on working capital may be a topic of conversation particularly if you are in a sector of the industry experiencing negative margins or cash flow, such as the grain sector.

For example, a young farm couple in Omaha, NE approached me and indicated that they could possibly lose $200,000 in 2015 given the price and cost dynamics of the business. The big question was whether they should risk asking their landlord for a reduction in land rent, when there is a possibility they could lose the land and never have the opportunity to rent it again. A quick analysis discovered that they had $1 million of current assets and $500,000 in current liabilities, or a working capital position of $500,000. With revenue of $2 million, the working capital to revenue ratio would be approximately 25 percent.

Applying the burn rate principle, I divided working capital of $500,000 by the projected negative margin of $200,000, and the burn rate was approximately 2.5 years. That is, with the price, cost, and margin dynamics in place, the business would burn thru their working capital cushion in 2.5 years, leaving them with no financial shock absorber

What About Positive Margins?

Can you still conduct a burn rate analysis if you project a positive margin? Absolutely! In this case, divide working capital by total principal and interest payments on an annual basis. For example, if one had $500,000 worth of working capital and $100,000 of annual debt service payments, the ratio would be 5 to 1, or a five year reserve of working capital to meet annual debt service obligations. What are some good metrics for the burn rate on debt service payments? A strong green light ratio would be 5 years or more; a marginal yellow light ratio would be 3 to 5 years; and less than 3 years would be a cautionary red light. In this case, it is green light territory, indicative of strong financial liquidity, allowing for resiliency and agility.

True Working Capital

A new term called true working capital is emerging in agricultural finance. It refers to which assets could be turned to cash and the timeline of liquidating assets without taking a steep discount or experiencing adverse sale conditions. The most liquid working capital of course is cash. A general recommendation is to have a cash balance of two months of average business expenses or enough cash to meet one year's principal and interest payments.

Second, examine inventory, i.e. corn, beans, cattle, hogs, etc., to be sold. What is the timeline of turning this inventory to cash? What is the marketing plan of each commodity, and how does it align with cash flow needs? As a rule of thumb, it is important to have sufficient inventory to cover operating lines of credit balances as a minimum.

Third, if you have crops growing in the field, what stages of production are these in, and are they covered by insurance? What level of coverage applies? The same assessment can be given to livestock, given the stage of production and marketing plan.

Fourth, many producers use prepayment of expenses as a tax management tool. Remember prepaid expenses often encumber operating money and cash for up to 12 to 18 months. Thus, this item's true liquidity is often in the distant future.

Next, are accounts receivable collectible? What is the time frame for collection? From personal experience, when an industry is in the economic down cycle, receivables become less collectible on a timely basis, impacting true liquidity.

One final consideration many do not consider in true liquidity analysis is the consequence of deferred taxes. Current assets often have been expensed when creating their value on the balance sheet. Thus, the sale of these current assets without offsetting expenses, i.e. payables or accrued expenses, being paid can result in a hefty tax bill. In some cases this can amount up to 40 percent of the sale price of the asset when the current assets are taxed at the ordinary federal, state and local tax rates.

While this discussion is not all-inclusive, it does present some factors to consider concerning working capital, the king of financials. Working capital to revenue, trends, benchmarks, burn rate analysis, and examination of true working capital will be high priority items in a volatile economic environment. Cash flow and being financially liquid will be critical in developing a successful, sustainable business model.