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Screening Guide for Negative Margins

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It is amazing how much a few years can change economic fortunes. Today, many agricultural producers face the economic realities of low commodity prices coupled with persistent high costs. In many cases, margins will be negative in both past and future operating lines of credit, which will be a priority topic for 2016. Times have changed for lenders due to regulatory scrutiny, which also affects the way producers must now request credit. At this point, producers need to go to their lender with a business and financial plan. The following is a 10 point screening guide to ascertain your possibility of renewing credit and whether your business is sustainable for the long-term.

First, one must demonstrate that your business was profitable with sufficient liquidity in the past. For grain producers, the years from 2007 to 2012, the height of the super cycle, must be emphasized. When demonstrating profitability use accrual adjusted income statements rather than Schedule F tax forms. Often profits are minimized for these forms and are not a true reflection of the profits. Quick accrual adjustments to inventories, receivables, payables, and other current assets are necessary. Farm management instructors, lenders, and accountants can be helpful resources in completing this analysis.

While analyzing your profitability, determine if your rate of return is above interest rates paid and the long-term rate of inflation, which is generally 4%. Remember when your rate of return exceeds inflation, the buying power of your business is growing.

After determining your rate of return, the second step in analyzing your business is to examine your net worth, both gains and losses. If your net worth increased, were the gains simply a result of adjusting asset values or appreciated assets? Lenders prefer to see increases in earned net worth achieved through retained earnings, reduction of principal on term debt, or profits. It is imperative for producers to build a case showing earned net worth gains, specifically, in the peak part of the cycle.

Thirdly, determine whether your business built working capital during the stellar years. Is the working capital on your balance sheet protected by a risk management plan? Specifically, does your risk management plan include options, hedging, crop insurance, and valid contracts? Successful managers historically maintain a working capital to revenue or expense ratio above 33 percent. Some managers that did not maintain an adequate working capital to revenue ratio now exhibit low or negative working capital margins.

The next step is important, particularly for those in a tough financial situation. Can you tighten your family living budget? In working with your lender, the ability to cut family living withdrawals is one of the best opportunities to demonstrate your commitment to corrective action and business sustainability. Develop an itemized, personal family living budget. More importantly, commit to that budget and make every attempt to live within its perimeters. Often, this requires the whole family's participation in the budgeting process.

The fifth step in this process is a thorough assessment of all assets. Most importantly, eliminate unproductive assets. Recently in a consult session, it was clear that an employee position must be eliminated from the business payroll. Interestingly, this position was held by the uncle. Between salary and "perks," this uncle cost the business $168,000 annually or $0.31 per bushel of corn. This may have been manageable during the commodity super cycle, but today's commodity prices cannot sustain such a high cost structure.

Next, can you follow and execute a marketing and risk management program and have you in the past? Additionally, did you execute your plan during the peak part of the last cycle? Some producers lost a percentage of their profit margin by following their plan during the great commodity super cycle. However, these producers still achieved good profits and minimized losses. Over the next few years, a well-developed and executed marketing and risk management plan will not be an option, but a requirement.

Seventh, develop a plan to reduce operating costs. Ideally, today's producer should cut 10 to 30 percent of overall costs. One strategy is to focus on the larger four to five expense categories and attempt to reduce each of them by a small percentage. Watch out for the infamous "miscellaneous" category. Both for business and personal budgets, if the miscellaneous category exceeds 10 percent of total expenses, itemizing is prudent.

Efficiency must be a top priority. Are you willing to shed unprofitable land, machinery, or livestock? After analysis, some producers found they would be more efficient and more profitable if they gave up certain pieces of rented ground. This practice often occurred during the 1980s farm crisis years.

The next to last step in your business analysis is to calculate your burn rate. If you have a negative margin, divide that number into the working capital. For example if the working capital is $500,000 and the negative margin is $200,000, your burn rate is about 2 ½ years before working capital is depleted. If your rate is under one year drastic action is required. A rate of three years or more allows you time to implement corrective strategies.

Finally, what is your debt servicing ability over the amortized period of the term debt? To calculate this number, divide term debt by your EBITDA which is net income plus depreciation and interest paid before income taxes. If your ratio is below 3.5 to 1, your business position is strong. Inversely, if your ratio is above 6 to 1, your business is under tremendous pressure from cyclical vulnerability in agriculture.

The bottom line

After objectively completing the screening guide, if your tally is eight or more in the "yes" column, you have a strong a case for sustainability and credit, despite negative margins. If you have less than five, you may have an issue and immediate corrective action is needed. For all tallies in between, develop a thorough, proactive plan for improvement throughout the reset years.

In conclusion, despite challenges presented by the economic reset, this screening guide can help you achieve both short-term and long-term business sustainability. Examine and analyze all components of your business including costs, assets, financials as well as strategic business plans. Please take time to complete the screen guide with your own personal self-assessment. Then, prioritize corrective action for improvement. Good luck!

Screening Guide for Negative Margins

Historically has the producer/entity:	Yes	No
Been profitable above interest rates and rate of inflation?		
Shown growth on balance sheet which is earned vs. appreciated net worth?		
Built and protected working capital in positive cycle?		
Been able to cut living expenses if needed?		
Been able to sell unproductive assets?		
Followed and executed a marketing risk management program?		
Have the ability to cut 10 to 30% of costs?		
Been able to shed unprofitable land, machinery, livestock, & human assets if necessary?		
Had a burn rate for working capital 2.5 years or more?		
Had a term debt/EBITDA ratio <5 to 1?		

Scoring Key:

>8 Yes boxes checked= strong case for sustainability
5-8 Yes boxes checked= modest case for sustainability
<5 Yes boxes checked= very questionable for sustainability

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