David M. Kohl

Professor, Virginia Tech
Agricultural Finance and Small Business Management

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Critical Data Points and Questions

By: Dr. David M. Kohl

With cold days outside and the holiday recovery complete, now is the time to update financial statements and examine last year's performance. Whether it is one's farm management instructor, lender, or advisor, remember that another set of eyes is always valuable in the optimism of looking forward as well as the wisdom of examining the past. During this process, there are some critical data points and questions that need to be addressed; so let's take a look at a few.

One of the first areas to analyze is the income statement, preferably on an accrual basis. Of course, when examining any data, the trend analysis is very imperative. One of my favorite ratios is the operating expense to revenue ratio, which divides operating expenses (excluding interest and depreciation) by revenue. After calculating the ratio and determining the three to five year trend, this analysis provides a good sense of the business' direction. During the great commodity supercycle (2006 to 2012) this ratio was often under 65 percent for the most efficient businesses. Now with the softening of commodity prices, this ratio has crept up to 75 percent for the same businesses. When the operating expense to revenue ratio exceeds 90 percent, it is a sign of danger. Many lenders find that this level of financial efficiency forces refinancing and restructuring requests because current margins do not allow for debt servicing.

Next, if the operating expense to revenue ratio indicates caution, one must determine why. Was it the result of poor production, inefficient cost management, undisciplined marketing, or a combination of all three? Of course, sometimes it is the stage of the economic cycle and lower prices that squeezed margins. Whatever the reasons, corrective action is needed and an advisory team is extremely useful in mapping out and monitoring a written plan of improvement. If in an adverse financial situation, one must be prepared to address the source of the shortfalls and commit to correction.

Another useful ratio and data point is the term debt to EBITDA. To calculate, add intermediate and long-term debt; and then, divide that sum by EBITDA (net income plus depreciation and interest paid before taxes). This ratio measures the business' ability to service debt over the average life of the loan, which must weather economic cycles, as well as business and personal challenges. Again, examine the three to five year trend. Remember that the ratio can vary as a result of increased term debt or variation in net income.

After calculating term debt to EBITDA, the next step with this critical data point is to determine what the ratio indicates for the business. A ratio of 3:1 or less shows the business to be resilient, agile, and in the position to flexibly take advantage of opportunities. A ratio between 3:1 and 6:1 is in the caution zone. And any number above a 6:1 ratio indicates vulnerability and a compromised ability to weather economic adversity. As an aside, if one is dependent on off-farm income or operates an outside business, those earnings can be included in the EBITDA figure in determining the term debt to EBITDA ratio.

Increasingly, lenders are discovering that many of today's refinancing and restructuring requests are going to support lifestyle or family living habits instead of the business. Specifically, how much EBITDA is being used to support family living expenses? This determination is critical as excessive family living expense is becoming a point of stress not only for family businesses but also for agricultural lenders. In order to determine your percentage, divide total family living expenses by EBITDA. A metric under 15 percent is within an acceptable and sustainable range for business withdrawals. A metric from 15 to 25 percent indicates moderate pressure to accommodate the current living standard. However, a metric above 25 percent places the business in a vulnerable position. In recent months, I have seen this metric as high as 40 to 60 percent. In one of these cases, the lender's solution was to determine a defined withdrawal amount from the business for the family, to which they committed.

Working capital to expenses is another crucial data point to assess. Lenders also use the current ratio to measure liquidity, but for producers, working capital to expenses is the more useful measure. Working capital levels above 33 percent (of past and projected expenses) represent agility and resiliency. Yet, anything under 10 percent indicates a vulnerable position, which could present major issues if cash flow and profit margins are challenged.

Taking a closer look at working capital, one needs to determine how much is cash and what percentage of current assets can quickly be turned into cash. Additionally, how do working capital levels match with pending and future obligations? Items like unpriced inventory in the grain bin, receivables on custom work that are not collectible, or prepaid expenses used to minimize taxes can each distort the true level of working capital. And of course, working capital is needed to meet expenses and service debt. In other words, the old saying still holds true that "Your hay in another person's barn isn't worth much."

Next, the debt coverage ratio (debt service obligations divided by debt service capacity) is a great profit and cash flow standby. Ratio levels under 110 percent have become almost commonplace for some businesses. And these businesses often require the refinancing of short-term operating debt into long-term debt. Today, an additional metric is the number of times a business has sought refinancing, and what corrective plan is in place to correct this pattern. More times than not, the plan for improvement entails strategies for the following: cutting expenses while maintaining or increasing production, seeking off farm income, paring down living costs, improving marketing, and reorganizing the business systems. Debt coverage rates consistently above 150 percent position a business for agility as well as resiliency.

Finally, the debt to asset ratio is also a good metric by which to measure debt levels. To calculate this ratio, divide total liabilities by total assets. When this ratio exceeds 50 percent the level of management acumen, the moderation of family living, and the focus of executing a good business plan become top priorities. Often, young producers, or those growing or transitioning their business are challenged to maintain an optimal debt to asset ratio, particularly in the downside of the economic cycle.

When assessing your financials by critical data points and past performance, remember that a weakness in one area can be offset by strengths in others. The real opportunity is to develop a plan that plays to the strengths, and minimizes and improves the vulnerabilities.