



WORKING CAPITAL NEEDS VARY

Soon the harvest season will be over and we will be taking balance sheets and reviewing profit and loss statements for 2009. This year will be an opportunity for many farmers to bulletproof their balance sheets by improving working capital to half annual cash expenses, which should provide a comfortable financial shock absorber to get you through financial bumps in the road ahead.

Let's take a closer look at working capital and what other factors might impact the level, so you can feel comfortable with where you are.

Working capital is calculated by adding your current assets minus current liabilities. Take that figure and divide it by your annual cash expenses, including payments and living. If that figure is less than 20%, it's considered a red light area and needs to be watched. Below are the guidelines for red, yellow and green lights.

WORKING CAPITAL
(WORKING CAPITAL / ANNUAL EXPENSES)

- **GREEN LIGHT:** OVER 50%
- **YELLOW LIGHT:** 20-50%
- **RED LIGHT:** UNDER 20%

RED LIGHT DOES not necessarily mean bad. Knowing your working capital percentage, what affects it and how to manage it is more important than the particular figure.

Your working capital needs to be evaluated before key decisions are made. How to structure debt on machinery or real estate is a decision that depends on your working capital level. Alternatives can be how much to put down on a purchase, or whether to fix the interest rates.

Other factors to consider include

the percentage of income that is stable vs. the portion susceptible to volatility. For example, I was working with an Illinois client last month, and one-third of his income was from contract hog feeding income, which is fixed for a number of years and backed by strong financials of the pig owner. In his case, working capital can be lower as there is less potential income variance.

Secondly, look at the debt coverage ratio (profit plus depreciation, plus term debt interest, divided by term debt payments). In one case I observed, the ratio was 4.59:1. Limited demand on cash flow to meet

debt obligations reduces the requirement for high levels of working capital.

Next let's look at the expense/revenue

ratio. Many livestock-intensive operations have high (above 80%) expense/revenue ratios and this presents more risk, increasing the need for higher levels of working capital. With an 80% expense revenue ratio, a 10% drop in revenue (about a two-day move down in the corn market) and a 10% increase in expense means your margins are gone.

CAN ONE HAVE too much working capital? Having working capital in excess of 50% of cash expenses – although a quite comfortable position – is probably not making maximum use of your equity. As working capital increases, it generally results from reduced operating debt. If your operating debt is at 6% or 7% inter-

est rate, that is your opportunity cost of that capital.

As a result, I have clients in this case looking at alternative investments that are somewhat liquid, yet with returns above the rate they are paying on their operating loan. This adds to diversification, which we discussed in last month's issue, and if the investment is relatively liquid, it can be used to rebuild working capital if needed.

In summary, adequacy of working capital needs to be viewed and analyzed based on a number of factors – doing that is being Riskwise. **CSD**

NEW REALITY

In many of the risk-management plans we have done in 2008 we see profit per acre of \$150-250 is commonplace. That is up from the \$50/acre we have observed over the past decade. This emphasizes the window of opportunity we have to add to our financial reserves.

However, as I have written in prior issues, cycles occur, and as the agricultural economy cycles, those returns will drop. However, if they drop to \$50/acre, you will be far worse off on a return on cash investment basis as costs have nearly doubled. So from a risk-adjusted basis since costs have doubled, you are only as well off with \$100 return/acre now as you were with \$50/acre return previously. ◀◀

Moe Russell is president of Russell Consulting Group, Panora, IA. Russell provides risk management advice to clients in 34 states and Canada. For more risk management tips, check his Web site (www.russellconsulting-group.net) or call toll-free 877-333-6135.