



02/28/13

Working Capital: The Key in Volatile Times

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My memories take me back to Super Bowl Sunday in 1989 in St. Louis next to the old Busch Stadium for the first meeting of the Farm Financial Standards Task Force. I was facilitator of a diverse group of experts from the ag lending and agriculture industry, fresh from the Farm Financial Crisis. Our initial objective was to identify key ratios, criteria, and benchmarks that could be used nationwide across the agriculture industry. Interestingly enough, at the time, farm prices were relatively stable for many commodities and land values were just beginning a two-decade ascent.

Much of the Task Force's debate centered on whether liquidity and the criteria to measure liquidity, namely the current ratio, was relevant in credit and financial analysis. For example, at that time dairy prices never varied much, and corn, wheat and soybean prices had been level for many years with an occasional "blip" because of weather. Task Force professionals from the West Coast contended that liquidity was very important in their commodities, thus the criteria and metric remained in the recommendations.

Fast-forward two decades and the liquidity measure and working capital have never been more important due to the wild world of global economics with a surprise around every corner, creating mayhem on cash flow and balance sheets. Whether I am at banking and lending schools or producer seminars, emphasis is being placed on liquidity and working capital criteria. Let's conduct an in-depth examination of working capital and what it means in your credit analysis and your customers' decision-making process. However, I want to emphasize that working capital examination is only one part of a balanced approach to credit analysis.

First of all, liquidity is the ability of the business to generate cash without disrupting normal operations. This is why it is important to develop a cash flow statement in conjunction with a liquidity analysis to ascertain cash conversion needs and opportunities. Historically, the current ratio (current assets divided by current liabilities) has been used as a measure of determining liquidity. While the current ratio is still viable, working capital to revenue is becoming a more popular metric as farm and ranch businesses become larger and more complex. For instance, a business with \$200,000 in current assets and \$100,000 in current liabilities would have a solid current ratio of two to one. However, if this business is generating \$1 million in revenue, the working capital (current assets minus current liabilities) divided by total revenue would be a

marginal metric at 10 percent. The working capital to revenue ratio is more appropriate than the current ratio for explaining the liquidity position of larger businesses.

Study of the FINBIN database by the Center for Farm Financial Management at the University of Minnesota finds that the top 20 percent of producers have a 47 percent working capital to revenue ratio, while at the other end of the spectrum, the bottom 20 percent of producers had 13 percent working capital to revenue. The bottom group represents much more risk if a downturn were to occur, suppressing profits and cash flow.

Working Capital Myths

There are various myths surrounding working capital. Many think that working capital is only cash on the balance sheet. Others feel that the higher the current ratio or working capital to revenue ratio, the lower the risk. This is not always the case. For example, one must look at the quality of the current assets. Some fail to analyze the concentration factor. For example, are all the current assets in one category, i.e. inventory, receivables, or prepaid expenses, or are they diversified in several groups?

Components of Working Capital

Now let's conduct due diligence on the working capital component. First, is the inventory, i.e. grain, livestock, or plants for sale, price-protected if possible? Seven dollar per bushel corn in the bin can suddenly change to three dollar inventory which can devastate working capital. Quality and salability of assets need to be examined. Analysis of the sale of these assets in inventory in alignment with operating expenses or cash conversion must be determined. Discounted prices often occur when assets are sold in distress or quality has deteriorated.

Moving to receivables, what is the quality and age of the receivables? Many grain producers are using deferred contracts to move income forward for tax reasons. Will these contracts be honored, and again, what is the length of the cash conversion cycle?

Many producers use prepaid expenses, such as feed, fertilizer, and seed, as a means of tax management. First, can the business make a 12- to 18-month commitment with this money? The timeline starts when the check is written and ends when the crop or the asset is harvested, stored, and then eventually sold. Many producers and some lenders fail to realize that prepaid expenses are like an unsecured line of credit to the agribusiness firm for a considerable period of time.

Cash is a critical element of working capital that few producers maintain on their balance sheet. Some of the more progressive producers are keeping one to two months of average expenses in cash in the bank. This is not only a buffer in a downturn, but also a strategy to quickly capitalize on discounted purchases and assets. The cash component of working capital is not about the return on assets in the bank, but the return of the assets in a timely manner.

No working capital analysis is complete without examining current liabilities, including accounts payable and accrued expenses. Accounts payable buildup is one of the first signs of cash flow difficulties. When accounts payable are less than 5 percent of revenue, it is considered low risk, but when accounts payable rise above 25 percent of revenue, it is a sign of deeper financial issues and difficulties.

Lines of credit must be closely monitored. Are the lines being utilized for the purchase of long-term capital assets, i.e. machinery, land etc., or used for business operating needs, as they should be? Are lines of credit suddenly maxed out, which is often a sign that the business is in rapid growth, having financial difficulties, or both?

Finally in the working capital analysis, deferred tax liability needs to be examined. This is a financial tidal wave or tsunami waiting to happen, which will be discussed in my subsequent articles. The “tax man” can take a big bite out of liquidity if revenue and expense patterns are not closely adhered to and strategies altered.

Liquidity, and particularly working capital, has come to the forefront in these years of agricultural volatility. It requires in-depth analysis with considerable due diligence in both credit analysis by the lender and financial analysis by producers.

Lender Tip: Working Capital to Revenue and Debt to Asset Ratio Matrix

The appropriate amount of working capital compared to revenue depends on the debt to asset ratio of the business. Operations with lower debt obligations may not need as much working capital as those with higher debt obligations. Refer to the table below for working capital to revenue guidelines.

Capital: Debt to Asset Ratio	Liquidity: Working Capital to Revenue Ratio		
	Green (low risk)	Yellow (moderate risk)	Red (high risk)
<20%	>20%	10-20%	<10%
20-50%	25-33%	15-25%	<15%
51-75%	33-50%	20-33%	<20%
>75%	>50%	33-50%	<33%

Global Economics

Since the last article, stimulus engines have been in full gear, particularly in the Asian region. Japan, the third largest economy in the world, has been full-bore in providing stimulus, which has raised its stock market index, the Nikkei, by nearly 15 percent in the past 60 to 90 days. The Japanese are attempting to re-inflate their economy and are encouraging their consumers to spend more. China, the second largest economy, has been providing stimulus to avert a potential crash that has been predicted by many leading economists over the past year. The stimulus has caused China's purchasing manager index (PMI) to rise above 50 for the past several months, which indicates a growing economy. Consumer spending in China is on the rise, particularly in the more urban coastal areas, as China is making a transition from a rural agrarian society to an urban society. The European economy continues to move along with modest growth at best, as Germany bounces between recession and positive economic growth.

Domestic Economics

Domestically, the U.S. economy is making a steady comeback despite inept government action in the debt and budget issues. A bright spot in the U.S. economy has been housing starts bouncing back to just under 1 million annually. Second, both the LEI and PMI have been positive, with the LEI increasing over the past several months and the PMI registered above 50, which is a sign of a growing economy.

Inflation appears to be under control, with both core and headline inflation under the 2 percent metric. Unemployment is stubbornly high at 7.9 percent or 14.4 percent when U-3 thru U-6 workers are included. This illustrates imbalances in the workforce related to employer needs versus employee skill base. This imbalance will continue to be an issue in manufacturing and particularly agriculture more use of technology and sophisticated systems to gain productivity.

Oil prices are on their usual spring increase, which has been seen over the past five years, generally impacting consumer spending. Consumer retail sales at some of the largest firms like Wal-Mart are down 7 percent. It will be interesting to watch these variables as the economy moves along toward the spring season.

Lender and Business Dashboard Economic Indicators (for the month of January)

<u>Indicator</u>	<u>Current</u>	<u>Green</u>	<u>Yellow</u>	<u>Red</u>
Leading Economic Index - LEI	94.1	✓		
LEI Diffusion Index	60%		✓	
Purchasing Manager Index - PMI	53.1	✓		
Housing Starts (millions)	0.890			✓
Factory Capacity Utilization	79.1%		✓	
Unemployment Rate	7.9%		✓	
Core Inflation	1.9%	✓		
Headline Inflation	1.6%	✓		
Oil Price (\$/barrel)	\$112.30			✓
Yield Curve	1.90		✓	

Lender and Business Dashboard Economic Indicator Benchmarks

<u>Indicator</u>	<u>Green</u>	<u>Yellow</u>	<u>Red</u>
The Conference Board Leading Economic Index® - LEI	Increasing	Flat to Decline	Decline 0.3% for 3 consecutive months AND >1% over the period
LEI Diffusion ¹	>60%	40%-60%	<40%
Purchasing Manager Index - PMI	>50	41.7-50	<41.7
Housing Starts (millions)	>1.5	1.0-1.5	<1.0
Factory Capacity Utilization	>80%	70%-80%	<70%
Unemployment Rate	5%-6%	6%-8%	>8% or <5%
Core Inflation	0%-2%	2%-4%	>4% or <0%
Headline Inflation ²	0%-4%	4%-5%	>5% or <0%
Oil Price ³ (\$/barrel)	<\$50	\$50-\$100	>\$100
Yield Curve ⁴	Steep	Flattening	Inverted

¹Ten indicators make up the LEI - measures % that are increasing; ²Includes food & energy;

³Consumer's perspective; ⁴3-Month Treasury Bill rate to 10-Year Bond rate