



DAVE'S GPS

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Liquidity, Liquidity, Liquidity

By Dr. David M. Kohl

How have credit and financial analysis in agriculture changed in recent years? This question was asked by a participant in a recent seminar. Historically, considerable emphasis was placed on the debt to asset ratio and collateral position in response to competitive market pressures, low quality financial information, and the lack of standardized financial and benchmark ratios. In recent years, volatility in prices, costs, and overall markets has increased dramatically. Economic cycles appear to be more abrupt and farm debt concentration has intensified. Agricultural operations are also much more interconnected. Rather than owning assets, more producers are controlling assets through renting and leasing, placing a premium on operating lines of credit that are critical to carrying out annual operations. In light of these trends, scenario planning and sensitivity analysis on cash flow and profits have become much more important in financial and credit analysis. While the other factors are still important in a balanced approach to analysis, the ability to operate at the peaks and troughs of economic cycles places a special emphasis on financial liquidity.

Financial liquidity is the ability of a business to turn current assets into cash without disrupting normal operations. Selling half of the livestock herd, land, or machinery line would provide revenue, but not reoccurring revenue, and it could disrupt the sustainability of the business.

Historically, many lenders have utilized the current ratio to measure liquidity. The old standard benchmark was a two to one ratio, that is, two dollars of current assets to every one dollar of current liabilities (due within a year). While the current ratio is still viable, it frequently does not measure liquidity in the context of business size as well as other metrics. In work with farmers, I have found they often have trouble understanding the current ratio and it is often in “lender speak” rather than “producer speak.”

A liquidity ratio that is being used more often is the working capital to revenue ratio (current assets minus current liabilities, divided by total revenue). Some lenders utilize working capital to expenses, a similar ratio. Producers can quickly see the application of this ratio. A 25 percent working capital to revenue or expenses can be verbalized to producers that, if needed, the business could cover one quarter of the annual business expenses or revenue.

The great commodity super cycle is in the rearview mirror and grain and row crop prices are moderating, but expenses are remaining high. These conditions have caused the classic “tail effect” to emerge. In other words, many farms and ranches are facing negative margins or margin compression until expenses adjust down, which usually requires nine to 24 months. During this “tail effect” period, the importance of working capital and burn rate on working capital will become more important in credit analysis.

How does one calculate the working capital burn rate? For example, a young grain producer in Nebraska projected his farm was going to bring in \$2 million in revenue, but lose \$200,000 overall in 2015. Red flags rise because of the loss and most likely a coverage ratio less than 100 percent, or the inability to meet debt service requirements. Examining this producer’s balance sheet finds \$1 million in current assets and \$500,000 in current liabilities. The current ratio would be a two to one ratio, a sound financial metric; however, the working capital to revenue ratio would be 25 percent, in the yellow light warning area. Generally speaking, above 33 percent working capital to revenue is green or strong, while less than 15 percent is a dangerous red light.

To determine the resiliency of the business, one would then calculate the burn rate on working capital. Simply put, divide working capital of \$500,000 by projected losses of \$200,000 for a ratio of 2.5. This means that if the losses continue at this level, working capital would be depleted within two and a half years. What is a recommended minimum working capital burn rate? At least one year is needed for flexibility and agility. Ideally, one would like to see the ratio above three years. In doing this simple calculation, one can ascertain the timeline the producer has to make the necessary adjustments in business practices to right the listing ship. Having adequate working capital and a solid burn rate are components of a self-insurance policy that will be very valuable in a volatile economic environment.

How is burn rate calculated when a business does not project a loss? A secondary burn rate on working capital can be calculated. For example, assume in the previous illustration the grain producer also has a livestock enterprise, which turns the tables with a \$200,000 profit. Assume the debt service commitments, including principal and interest, are \$100,000 annually. Divide working capital of \$500,000 in the previous example by the debt service commitments of \$100,000, which results in a five year burn rate. In other words, there would be sufficient working capital to cover five years of debt service payments. What is a good metric? Less than 2.5 years would be a sign of caution, while above five years would be a solid green light. Of course, a yellow light would be in between 2.5 and five years.

Is working capital important for dairy, poultry, and other enterprises that have contracts or monthly cash flow? Historically, as facilitator of the Farm Financial Standards Task Force, heated debate often centered on this point. However, the recent avian flu outbreaks and extreme volatility in dairy prices along with other commodities has placed more attention on the importance of working capital and burn rates, even for agricultural operations that have contracts or receive monthly income.

Next time we will drill down and discuss true working capital and the questions every lender needs to ask about liquidity.

Lender Tip: Liquidity Benchmarking

It is important to benchmark producers from year-to-year on working capital to revenue ratio trends. Currently livestock ratios in general should be increasing, and, of course, grain enterprises are most likely decreasing because of the economic cycle. Recent data from the Center for Farm Financial Management's FINBIN database found that the top 20 percent of producers maintain a working capital to revenue ratio of approximately 40 percent. The low 20 percent of producers have 10 percent to 15 percent. Think about which producers have the most flexibility and resiliency in a downturn, or agility to capitalize on opportunities.

Position to Transition: Put your GPS on Kansas City, MO, this fall for the ABA National Agricultural Bankers Conference to be held on October 25 – 28, 2015. Join Farmer Mac and me for a stellar training event loaded with new information, actions, and networking with other lifelong learners.

Global Economics

It is amazing how a country such as Greece, which represents 2 percent of the total economy of the European region, can play havoc on world economic markets. The German and other European banks have considerable exposure in Greece, so this bears watching for the possible start of a house of cards of institutional failures.

The quantitative easing in European central banks is bolstering equity markets in the region and lowering the value of currency, which encourages cheaper exports from that region. The Asian region, including Japan and China, are using similar strategies with similar results. Equity markets are up considerably throughout most of Asia, except in China where equity markets declined dramatically, down nearly 25 percent recently. The Chinese economic leaders are still making an attempt to shift their citizenry to more consumption with less infrastructure investment. China has dropped its benchmark interest rate four times in recent months to ignite an economy in moderation.

As a side note, a number of Mexican bankers participated in the Graduate School of Banking at Louisiana State University this year. Their perceived biggest challenge for both the economy and banking in Mexico was government dysfunction, which sounds familiar! Brazil and Mexico, which are experiencing issues with a dysfunctional government, represent approximately one-half of the Latin American economy.

Domestic Economics

Let's examine the dashboard of economic indicators to determine where the U.S. economy stands midyear. The Leading Economic Index (LEI) is still positive. Its diffusion index in recent months has been above 60, indicative of a strong economy for the next three to six months. The purchasing manager index (PMI) is above 50, also signaling a growing economy. This metric has been above 50 for much of the last 18 months as the U.S. economy moves into its 75th month of business expansion since the great recession.

Oil prices have rebounded to \$60 from a low in the \$40 range, which has been good for consumers but challenging for businesses in oil and gas producing states.

Factory utilization is still in the high 70s, but discussion with people in the industry finds that some expect more layoffs later in the year as a result of the strong U.S. dollar inhibiting export potential. My trucker friends, who are my early warning intelligence, are now indicating inventories are stacking up in warehouses and trucking assignments are slowing in some regions of the country.

Housing starts have bounced back above 1 million in recent months, but are still below the ideal number of 1.5 million annually.

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Unemployment rate is registering in at 5.5 percent (U-3) and 10.8 percent (U-6). Strong job growth of 280,000 on the May report, was a positive sign as any number above 225,000 is considered strong.

First quarter gross domestic product (GDP) growth was -0.2 percent. Some say this was caused by weather, while others are questioning government statistics. This will be a closely watched metric by the Federal Reserve for possible interest rate increases later in the year.

Core inflation and headline inflation (including food and energy) are benign as a strong dollar and technology are suppressing inflation. Closely watch the two previous dashboard indicators, unemployment rate and GDP growth, for hints of higher interest rates.

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

<u>Indicator</u>	<u>Current</u>	<u>Green</u>	<u>Yellow</u>	<u>Red</u>
Leading Economic Index - LEI	123.1	✓		
LEI Diffusion Index	90%	✓		
Purchasing Manager Index - PMI	52.8	✓		
Housing Starts (millions)	1.036		✓	
Factory Capacity Utilization	78.1		✓	
Unemployment Rate	5.5%	✓		
Core Inflation	1.7	✓		
Headline Inflation	0.0	✓		
Oil Price (\$/barrel)	\$59.33		✓	
Yield Curve	2.12	✓		

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