

Abstract

Farm managers are currently in an agricultural environment of high risk and major changes in the farm business model (e.g., increases in leasing arrangements and outsourcing services). Cash is certainly important during these times, but it is even more important to make long-run decisions that generate earnings or profits. These profits should buffer the farm from the large amount of present and future risk and enable it to operate well into the future. Given today's agricultural environment it may not be an overstatement that "cash is king, but profitability is the kingdom!"

Cash is King — But Profitability is the Kingdom!

By Brian C. Briggeman and Michael D. Boehlje

Cash is king. What a simple and profound statement that captures the importance of cash flow to a business. Successful farm managers must have a firm grasp of their cash flows because cash is the lifeblood of any farm business. However, a myopic view of cash flow sustaining and maintaining a farm business is a short-term focus. While cash flow is important, all farm managers *should* be focused on decisions that sustain and maintain the farm business in the long-term. Making long-term decisions that will ensure the financial viability of the farm business is a difficult proposition. These decisions are even more complicated today because a farm manager might become complacent when agricultural commodity prices are high but when prices fall, the farm manager may be too anxious to manage the increased risk in agriculture and ends up hurting the long-term financial viability of the farm business. So, how should a farm manager begin to think about these long-term decisions in an agricultural environment that has high risk and major changes in the farm business model? Certainly cash is king but the important issue is – king of what?



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A Resurgence of Risk in Agriculture

The farming sector is in the midst of major financial and structural changes, and these changes have significant and important implications for farm managers. Some of these changes have been brought about by rising net farm income. Covey et al. (2007) shows that 2007 average net farm income is above its 10-year average, but these higher net farm incomes have come at a cost. Output prices are extremely volatile and input costs and fixed costs have significantly increased. Even the popular press has taken note of this increased volatility. An April 22, 2008 *New York Times* article reported that the March 2008 wheat and soybean prices were expected to vary by three times their historical monthly averages, and corn price was expected to vary twice as much as its monthly average.

Adding to this resurgence of output price risk, variable and fixed production costs are soaring. Table 1 shows the breakeven price for corn, soybeans and wheat for an average Indiana farm in 2008. Since 2007, variable production costs and land values have increased by approximately 50 and 20 percent, respectively. This increase in costs coupled with output price volatility has led to a significant compression in profit margins as well as margin risk for many farm businesses. And, working capital requirements just to plant the same acreage have sky-rocketed with the rising input costs; in fact some input suppliers are asking farmers to pay cash for fertilizer for the upcoming 2009 crop, further compounding working capital pressures.

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Many individuals have long held the belief that “cash is king” and many finance textbooks tout that cash flow management is critical to business success. Certainly analyzing historical cash flow statements can provide indications of financial troubles. In particular, it gives the business manager a clear indication of where and how cash is being generated to meet demands. In some cases, positive cash flows may not be a result of positive income, but from using depreciation allowances to cover operating losses or from liquidation of inventory or even fixed assets. Thus, the firm may “cash flow” in the short-term, but suffer operating losses and actually liquidate the asset base of the business (by not replacing the depreciable assets), either of which are clearly not acceptable in the long-run.

Cash is important but in an agricultural environment that is rife with volatility, making long-run decisions that generate earnings or profits buffers the farm from those risks and enables it to operate well into the future. Just as a “good” king makes decisions to grow and maintain

his kingdom, cash should be used wisely to grow and maintain the kingdom of business profitability. And although cash is essential to service current financial obligations, the longer term ability of the firm to safely borrow and repay the debt obligations used to purchase capital items is driven fundamentally by income generating capacity rather than cash flow. In other words, “cash is king, but profitability is the kingdom.”

Profitability and The New Business Model

Managing and measuring profitability in terms of return on investment or assets has always been a challenge for the farming sector. Documentation of profits primarily based on tax documents (Schedule F) and cash accounting, both not particularly accurate measures of profitability, has historically created this challenge. Today, structural changes in agriculture add to this challenge. Much like the agribusiness sector, the farming sector is investing in “soft” rather than hard assets. Soft assets are intangible investments like outsourcing activities and services or an organizational structure that can respond quickly to changing consumer demands and environmental conditions. In farming, more hard assets are being obtained through leasing agreements, joint ventures and strategic alliances where the farm acquires the services without the costs (or benefits) of ownership. These trends are evident in the pork sector in the form of contract production among producers, packers and retailers, and crop farms are using lease agreements to acquire machinery, equipment and land.

It is common for a farm to lease equipment, but based on our observations many farms are investing in other “soft” assets. For example, an increasing number of farms are contracting with others for such basic functions as chemical application, marketing and agronomic decisions. Human resources (such as accounting and legal) are increasingly acquired from service industries, and on a consulting basis rather than through permanent employees. Increasingly, specialized input purchasing, marketing services and strategic planning are being performed by “external” consultants. In essence, the farm of the future will include more soft assets and fewer hard assets for two fundamental reasons: (1) the earnings return on investment in soft assets will increase and be greater than returns on hard assets; and (2) the services of hard assets can be obtained in ways other than ownership. This future farm may financially outperform, particularly in return on investment or assets, a traditional farm that owns all the land and other physical assets.

The implications of this trend to more soft assets and outsourcing are profound for farm managers as well as lenders. The financial performance of farms will become increasingly dependent upon management and returns to management rather than ownership of assets and the capital earnings of these assets. Management will entail not only operations and marketing skills internal to the farm, but also successful negotiation of linkages with suppliers and distributors and having the proper external partners.

A further complication, for farm managers as well as those who finance farming operations, of this shift to soft assets and outsourcing is that more of the income and cash flow of the business will be

needed to invest in and support these activities. Traditionally, money spent on human resources (research and development, training, education and skill building) was considered an expense; in the farm of the future, it may need to be recognized as an investment.

A Final Comment

Cash may be king in the short-term, but profitability is essential for long-term survival and growth. Continuing to operate and thrive in agriculture requires an in-depth profitability analysis of the current and future changes to the farm business. Profitability and income analysis should take center stage for farm managers because they are the true keys to managing, sustaining and growing the kingdom.

References

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- Henriques, D. B. (2008, April 22). Price Volatility Adds to Worry on U.S. Farms. *New York Times*.
- Miller, A. W., Dobbins, C. L., Nielson, B., Vyn, T. J., Johnson, B., & Conley, S. P. (2008, February). *Purdue Crop Cost & Return Guide*. Purdue Extension ID-166-W. Revised.

Table 1. 2008 production and total production costs for an average Indiana farm

Commodity	Expected Bushels/Acre	Production Cost		Total Cost	
		Per Acre	Per Bushel	Per Acre	Per Bushel
Corn	157	\$367	\$2.34	\$641	\$4.08
Beans	49	\$168	\$3.43	\$442	\$9.02
Wheat	70	\$174	\$2.49	\$448	\$6.40

Note: Numbers are developed from Purdue University's 2008 crop cost & return guide.