



Texas Agricultural Extension Service

People Helping People

Restructuring The Farm Business

Danny Klinefelter*

Many farmers are concerned with restructuring their debts to meet cash flow commitments. Successful debt restructuring often requires the restructuring of assets and/or the business itself. Before a farmer investigates restructuring options, he should consider at least four important areas.

Projected Cash Flow

The first involves projected cash flows. A farmer should have at least a 3-year realistic projection in order to evaluate alternative restructuring plans. From that basis, different potential outcomes can be analyzed in terms of prices, yields and major input costs. The Jackson Farm Credit District studied a group of Production Credit Association borrowers over several years, and found that, on average, they overestimated cash receipts by 15 percent and underestimated cash expenditures 17 percent. The uncertainty in agriculture does cause some error. However, if errors are purely a function of market and production variability, both revenues and expenditures should be underestimated as often as they are overestimated, unless there is a bias in the estimates. Often the farmer uses too much wishful thinking and too little accurate information when making estimates.

Profitability

A second consideration is the profitability of the business. Barring sufficient inheritances, non-farm income and asset appreciation to offset losses, a business has to be profitable to survive any length of time. For management purposes, it is important that income be evaluated on an accrual basis. While most farmers will, and probably should, stay on a cash basis for income tax purposes, cash basis income accounting is often a very inaccurate measure of business performance. In a cyclical industry such as agriculture, we can expect periodic downturns when the operation may not be profitable for a period of time. Extended periods of losses, however, mean something needs to be changed.

*Extension economist-farm management, The Texas A&M University System.

Interest Expense

In deciding whether or not asset or business restructuring needs to be considered in addition to debt restructuring, farmers also should look at two key financial ratios. The first is interest expense as percent of adjusted gross revenue (cash revenue adjusted for changes in inventory.) If interest expense exceeds 15 percent of adjusted gross revenue, a farmer should look seriously at how efficiently the business is organized and operated, and how profitably debt is being employed. In most cases where interest expense is greater than 20 percent of adjusted gross revenue, and in almost all cases where it is greater than 25 percent, simply restructuring debts is not going to solve the problem. The farmer will have to find a way to increase income, reduce debts and/or significantly reduce interest costs.

Farm's Financial Leverage

The second financial indicator is the farm's financial leverage. Using the debt-to-asset ratio as an indicator of leverage, once a firm exceeds 50 cents in debt for every dollar in assets there is a strong likelihood that some business restructuring needs to take place. However, a final decision on whether leverage is too high should include an analysis of the business's profitability and cash flow. Some very profitable, very well managed businesses are highly leveraged by design.

If, after considering all these factors, the farmer decides that something needs to be done, he should carefully explore all available restructuring alternatives to determine which one best suits his particular situation. Too often farmers limit their thinking to a few standard options, when they may need to be innovative. Unfortunately, there is no single prescription that will work for every operation. Just like a medical problem, any solution will depend on a specific diagnosis based on the business and the individuals involved.

Following is a brief look at some of the alternatives farmers should consider. Some might not fit a particular situation, or might not even be available. However, they may trigger other ideas to be explored.

FmHA Financing

The Farmer's Home Administration (FmHA) is an alternative source of credit that allows farmers to restructure debt with more favorable repayment terms and possibly lower interest rates. Aside from its emergency loan programs, FmHA is involved in two types of agricultural loans—direct or insured loans which are made from FmHA to the farmer, and guaranteed loans which are made by a commercial lender with FmHA guaranteeing a certain percentage of the debt. The latter provides an incentive for commercial lenders to finance operations that may involve more risks than they would normally be willing to assume. Under both of these programs there are operating loans and farm ownership loans. Currently, direct operating loans can be extended for up to \$200,000 at 8.625 percent interest with repayment terms of up to 7 years. There are special provisions which allow these loans to be reamortized for up to 15 years if circumstances warrant. Guaranteed operating loans can be extended for up to \$400,000, but the rates are established by the lenders and repayment terms normally are not as long as for direct loans.

In FmHA's farm ownership loan program, direct loans can be made for up to \$200,000 at an interest rate of 9.25 percent. Guaranteed loans can be made for up to \$300,000, but are at a market rate of interest. The maximum term on these loans is 40 years. A commercial lender usually will stick with his normal repayment period.

FmHA also has a limited resource loan program, which offers operating and farm ownership loans at even lower interest rates. The base interest rate currently is 5.625 percent the first year on operating loans and 5 percent on farm ownership loans. Repayment ability is reviewed each year, and rates can escalate annually until they reach the normal direct rate.

Note: The interest rates quoted on FmHA loans are as of June 1986. Since the rates on FmHA loans are based on the government's cost of capital, they change over time. For current rates, check with your county FmHA office.

Another possible alternative for farmers with FmHA guaranteed loans is the interest rate buy-down provision included in the 1985 Farm Bill. The provision permits FmHA to buy down up to 2 percent of the interest rate on guaranteed loans if the rate reduction is matched by the lender, and if such action is necessary for the operation to cash flow.

Leasing vs. Purchasing

Another financing option to consider is the possibility of leasing versus purchasing assets. The terms of a lease often are better matched to the useful life of an asset than are debt terms. For example, a loan on a combine may be arranged for a 3-year payout,

whereas a lease would typically be for a 5-year period. Also, leases usually involve fixed interest rates as opposed to the variable or floating rates of most term debts. That is an important consideration when interest rates could rise significantly over the next few years.

Leases also can be advantageous because they transfer unneeded tax benefits from the lessee to the lessor. When many farmers are experiencing losses or very low income levels, there may be few tax benefits from the investment tax credit and depreciation that go along with an asset purchase. On the other hand, some leasing companies or lenders involved in leasing may be in a higher tax bracket, and if they retained those tax benefits, could offer the borrower a lower lease payment. It might also be advantageous for a landlord or an individual investor to buy capital assets such as storage facilities, irrigation equipment or harvesting equipment and then lease them to the tenant. If the landlord is in a higher tax bracket than the tenant, both could benefit. Many investors and landlords are looking for places to invest funds, particularly now that money market rates are down. Because of the potential tax effects, this arrangement might best be initiated when assets are added or replaced, rather than selling and leasing back existing assets.

However, the sale and lease-back of existing assets may be a viable alternative. In some cases, lenders have taken title to assets in partial or full satisfaction of a debt and then leased the property back until it can be sold. This happens most often when there is a large amount of acquired property and thin markets for land, machinery and equipment. If the farmer has no equity in the asset, the lender may be looking for ways to minimize his loss. A farmer's cash flow requirement for debt servicing and taxes often is from 15 to 18 percent of the land value (where the debt is nearly the same as the asset value). This can be reduced to about 6 to 7 percent of the asset value for cash rent. This option also is applicable where seller financing is involved, particularly on a contract for purchase. It may be to the advantage of the person buying the land to forfeit the contract and lease the property back. In other cases involving land contracts, sellers have been willing to renegotiate the contract downward if land values have fallen substantially and if default is otherwise imminent.

The sale and lease-back concept is not restricted to dealing with lenders. Several corporate and individual investors looking for long-term appreciation and/or tax shelters, and not wanting to be involved directly in the daily management and operation of the business, have entered into similar arrangements.

Lease Renegotiation

Another debt restructuring alternative involves the renegotiation of leases. Rental rates are likely to be

reduced first on the marginal land in areas where there is not much demand for farm real estate. The deciding factor is not the debt load of the farmer, but whether or not the landlord has options in terms of other possible tenants. What needs to be evaluated is the contribution of each party to the lease arrangement. It may be that the land input is simply not worth the same as it was two or three years earlier.

Another option in renegotiating a lease is to change from cash payments to a share rent in order to shift part of the risk. Or, disaster clauses can be built into leasing arrangements so that cash rents are based on yield levels or a combination of yield and price levels. A fourth option might be to combine cash and share leases. In this case a minimum cash lease is established and payments above that level are on a share basis. There are also a number of options available for flexible cash lease arrangements, and the Extension Service can offer information to help you explore these.

Shared Appreciation Mortgage

Another financing alternative is the shared appreciation mortgage (SAM). There was a lot of interest in this concept when property values were escalating, but it may make even more sense in areas where land values have fallen to the point that long-term appreciation is likely. Standard commercial lenders probably will not be using this concept right now, but it may be a possibility if a farmer has seller or insurance company financing. Advantages of the shared appreciation mortgage are that the purchaser usually gets a fixed, lower interest rate in return for a share of any appreciation in property values. A SAM works on the principle that at the end of a specified period (usually 5 or 10 years) the property will be sold or reappraised, and a percent of any appreciation that has occurred will be paid to the lender or added to the principal of the loan. Although the buyer must give up some of the potential appreciation, it may make an otherwise impossible purchase feasible because of the reduced interest rate. From the seller's standpoint, the SAM may be a way to enhance the marketability of the property. Retiring farmers who sell their land and plan to live on the revenue of the sale may find the SAM to be a hedge against future inflation which could erode the purchasing power of a fixed income.

Down-sizing

Down-sizing is another way to reduce debts and interest costs. The first place to start is with non-productive assets such as vacation homes, hunting leases, boats, airplanes, three-wheelers, extra trucks or cars, etc. These things are not necessities if the survival of the business is in question. Once non-productive assets have been disposed of, the next step is to sell business assets that are draining cash flow, i.e., those that are not paying for themselves.

Because this may involve selling assets at a loss, the decision to do so requires enterprise level analysis. Most farmers are not on a good enterprise or profit center accounting system. However, an analysis can still be carried out through enterprise budgeting.

It is important for farmers not to get "married" to specific assets or enterprises. For example, farmers should analyze the carrying costs on land—the principal, interest and real estate taxes on a per acre basis versus the cash needed to rent comparable land. A specific example involves a farmer who purchased a section of land 6 years ago for \$900 per acre, of which he financed \$700. Last year, the debt was down to about \$600 per acre but so was the value of the land. An analysis revealed that the property was producing about 10 percent of the operation's total revenue, but was accounting for about 40 percent of the operation's total debt service. The farmer negotiated a settlement with the Land Bank whereby title was transferred to the lender in settlement of \$550 per acre of the debt. This left a \$50 per acre debt. But principal, interest and real estate taxes had amounted to approximately \$100 per acre, annually and the farmer was able to rent comparable land for \$35 to \$40 per acre. In the first year alone, the difference allowed him to repay the remaining debt and still be better off than before.

Any strategy which involves down-sizing or partial liquidation of assets should take into consideration the tax and tax recapture consequences that might be triggered. Also, the importance of enterprise analysis and knowing which part of the business is doing well cannot be over emphasized. Selling off the business's most productive assets may generate much needed cash flow, but it may also eliminate any possibility for future profitability. Obviously, a major difficulty in partial liquidation is that often no one wants to buy the part of the business a farmer wants to sell. But careful analysis may reveal opportunities for liquidation. For instance, a piece of land 20 miles away might be a productive farm, but the time and costs required to move equipment could make it unprofitable for one farmer but profitable for another.

Outside Investment

Farmers ought to consider family members and/or outside investors as sources of funds, but both can be difficult. Family members usually don't have sufficient money or don't see the farming operation as a viable investment opportunity. Often farmers don't seek outside investors until there are no other financing alternatives. That is usually too late, because putting together a deal and finding an outside investor group can take from 6 months to 2 years. There usually are substantial costs and legal complexities involved in putting together an investment package. However, local investors such as businessmen, doctors and lawyers may be interested.

There are several methods of bringing outside investor capital into the business. One is the sale and lease-back arrangement, where property is sold to the investors or family members and then leased back or farmed on a custom basis. Another is to set up a corporation with two classes of stock—common and participating preferred. This would help family members who have money in other fixed return investments—such as CD's and bonds—and would like to be assured of a minimum return on their money. With a participating preferred stock, they could receive first preference in terms of dividends each year and be assured priority ahead of common stockholders in the event of a liquidation of the business. Beyond that point, they and the common shareholder(s), who might be the existing owner(s), would share in any other profits in proportion to their percent ownership of the business. In this way, family members could get involved in the ownership with a much lower investment, and yet still provide an infusion of equity capital. In such an arrangement the minority shareholder in a closely held corporation must be given guarantees as to the repurchase of his stock at a fair value. The corporate charter could include provisions for valuation methods and repurchases of outstanding stock which would meet the requirements of both parties. In any event, competent legal counsel is a must.

Outside equity capital also can be secured by working through investment intermediaries or directly with non-farm businesses. For example, the cattle feeding industry has acquired capital and shifted part of the operational risk to outside investors through contract feeding of cattle owned by limited partnerships. Producers of other commodities have gained capital and technology through production contracts, in addition to shifting part of their market risks.

Operating Leases and Custom Work

Since most farms have assets that are used for only a fraction of the year, farmers should investigate operating leases. With an operating lease, an asset is rented on an hourly, daily or weekly basis and the operator can use his own labor. Because of the savings in labor costs, operating lease rates usually are 50 to 70 percent of custom work rates on tillage equipment, and 70 to 75 percent of custom work rates for planting and harvesting equipment. Many farmers have not used operating leases because the rate per unit of time seemed too high, or because they like the idea of having the equipment there when they wanted to use it. These may not be sound reasons when a great deal of money is tied up in owning an asset that is used only occasionally.

Hiring custom work done also may be more economically practical than buying an expensive and infrequently used asset. If an asset is worn out, many farmers are going to find that credit for purchasing a

replacement simply isn't available. Hiring custom work may be the best or only option. If an operation isn't large enough to fully employ an asset, hiring custom work is often economically preferable to buying an asset.

Shared Assets

Trading the use of assets with other farmers is gaining popularity. For example, with hay or silage equipment, one farmer may own the chopper and a blower and another the wagons. They share the equipment and each provides labor at harvest time. This idea could be extended to other types of equipment. Rather than relying on an informal arrangement, farmers may need to form a corporation to own the equipment in order to limit liabilities. Sharing equipment in this way may help each farmer involved achieve optimal use of equipment and labor at a lower investment cost.

This concept also is applicable to limited use of specialized equipment such as scales, some types of spraying equipment, welders, chain saws, etc. Since most farmers need this kind of equipment only occasionally several farmers could agree that each would own a separate piece of equipment and share its usage. Responsibility for operating costs such as fuel, repairs and maintenance would need to be determined.

Joint ownership of major equipment is an extension of the above concepts. Since growing seasons vary with climate, the same equipment could be used by farmers in different geographic regions. For example, a cotton farmer in the Rio Grande Valley of Texas could use the same cotton strippers and module builders as a producer located farther north in the state. They might also have a labor sharing arrangement.

Mergers and Acquisitions

Mergers and acquisitions, either through partnerships or corporations, can allow maximum use of the different management and technical skills of the farmers involved. This can also be a means of reducing equipment needs and allowing smaller farms to capture some of the advantages available to larger farms. Each of the parties involved would contribute assets in return for a percentage of the ownership. If handled properly, the tax consequences triggered by a sale could be avoided. In one instance five farmers, each of whom was farming between 600 and 1,000 acres, merged to create a 4,000-acre unit. They found that they no longer needed additional hired labor, they were able to sell off excess machinery and each of them was able to specialize in areas in which they had particular skills and interests. This enabled them to focus their time and learning to do a better job in areas such as marketing, records and

accounting, irrigation and crop management, livestock management, equipment maintenance and purchasing. As a multiple-owner operation working with a knowledgeable attorney, they also were able to minimize the impact of the government payment limitation in the farm programs.

Obviously, the people involved in such an arrangement must be able to work well together. Many farmers have avoided this option because of the desire to maintain their independence. But, as a means of economic survival, it should be considered. Depending upon their contribution to the merger, some of the individuals involved will be employed as middle managers in a larger operation. They may find they are actually happier and better as managers when concerned only with specific areas of the business. Many of the farmers who are experiencing financial problems are extremely good at some operational area of the business, but not as good as general managers or administrators. In other cases their problems may stem from having too few resources to work with. If innovative business arrangements are not tried, we may lose not just the poor managers but also some of the young farmers with the greatest amount of management potential.

Joint Marketing and Purchasing

Many groups of farmers around the country are realizing significant economies of size through joint marketing and purchasing efforts. This is an appli-

cation of cooperative principles, but these groups usually are composed of just a few commercial-sized farmers. Such groups have been formed to buy inputs and to sell speciality commodities and breeding livestock. Others have been formed to employ the specialized services of nutritionists, bookkeepers, computer operators, farm management and marketing specialists, etc. These group efforts can range from formal associations to informal pooling arrangements.

Whatley Plan

Small farmers located near population centers or centrally located between several medium-sized communities might try what is known as the Whatley Plan. This plan involves full-time farming operations as small as 25 acres, which produce 10 or more valuable commodities such as berries, herbs, vegetables, quail, rabbits and honey bees. Seasonal diversification also is required to spread labor requirements and provide year-round cash flow. The key however, is the development of a pick-your-own club of at least 500 households from the nearby town(s). Club members pay annual dues of \$25 to \$50, and then pay only 60 percent of regular supermarket prices for the produce they pick. The membership fee generates income for the farmer and helps build loyalty among members, who exercise greater care because they come to think of the farm as their own. This plan offers an alternative to the "bigger is better" philosophy, but it also requires a high level of management and attention to detail.

Example Income Statement

Period Covered: _____ 19 ____ to _____ 19 ____

Farm Operating Receipts

Livestock and livestock products		
	Units	
_____	(_____)	\$ _____
_____	(_____)	_____
_____	(_____)	_____
_____	(_____)	_____
	Subtotal	\$ _____ (1)
Crop sales		
_____	(_____)	\$ _____
_____	(_____)	_____
_____	(_____)	_____
_____	(_____)	_____
	Subtotal	\$ _____ (2)
Other operating receipts		
_____		\$ _____
_____		_____
_____		_____
	Subtotal	\$ _____ (3)
Gross farm operating receipts (1) + (2) + (3)		\$ _____ (4)

Farm Operating Expenses

Seed	\$ _____
Fertilizer	_____
Chemicals and other crop supplies	_____
Machine hire	_____
Storage	_____
Feed Purchased	_____
Feeder livestock bought	_____
Breeding	_____
Veterinary	_____
Livestock supplies	_____
Fuel and oil	_____
Utilities	_____
Machinery repairs	_____
Other repairs	_____
Taxes, real estate, sales	_____
Insurance	_____
Rents	_____
Trucking and market	_____
Hired labor	_____
Farm interest paid	_____
Other	_____
Gross farm operating expense	\$ _____ (5)
Net cash operating income (4) - (5)	\$ _____ (6)

Adjustment for Changes in Inventory

	Crops and Market Livestock	Accounts Receivable	Supplies and Prepaid Expenses		Accounts Payable	Accrued Expenses	
Ending inventory (+)	_____	_____	_____	Begin	_____	_____	
Beginning inventory (-)	_____	_____	_____	End	_____	_____	
Net adjustment	_____	_____	_____		_____	_____	\$ _____ (7)

Net Farm Operating Income (6) + (7) \$ _____ (8)

Additional Adjustments

	Breeding Livestock	
Ending inventory	_____	
Plus sales	_____	
Subtotal	_____	(9)
Less Beginning inventory	_____	
Plus purchases	_____	
Subtotal	_____	(10)
Net capital adjustment		
(9) - (10)	_____	(11)
Depreciation	_____	(12)
Farm profit or loss (8) + (11) - (12)		_____ (13)
Gain (loss) on sale of capital items		_____ (14)
Off-farm income		_____ (15)
Total net income (13) + (14) + (15)		_____ (16)
Income taxes		_____ (17)
Proprietor withdrawal		_____ (18)
Addition to retained earnings (16) - (17) - (18)		_____ (19)

Example Cash Flow Statement.

	Jan.-Mar.	Apr.-Jun.	Jul.-Sept.	Oct.-Dec.	Annual
Cash Receipts					
1. Grain and forage	_____	_____	_____	_____	_____
2. Livestock and poultry	_____	_____	_____	_____	_____
3. Custom work	_____	_____	_____	_____	_____
4. Government payments	_____	_____	_____	_____	_____
5. Capital sales	_____	_____	_____	_____	_____
• Breeding stock	_____	_____	_____	_____	_____
• Machinery	_____	_____	_____	_____	_____
6. Nonfarm income	_____	_____	_____	_____	_____
7. Total cash receipts	_____	_____	_____	_____	_____
Cash Outflow					
<i>Operating expenses</i>					
8. Seed	_____	_____	_____	_____	_____
9. Fertilizer	_____	_____	_____	_____	_____
10. Chemicals	_____	_____	_____	_____	_____
11. Machine hire	_____	_____	_____	_____	_____
12. Feed purchased	_____	_____	_____	_____	_____
13. Feeder livestock purchased	_____	_____	_____	_____	_____
14. Breeding, veterinary, and livestock supplies	_____	_____	_____	_____	_____
15. Fuel and oil	_____	_____	_____	_____	_____
16. Utilities	_____	_____	_____	_____	_____
17. Repairs	_____	_____	_____	_____	_____
18. Taxes, insurance, and rents	_____	_____	_____	_____	_____
19. Hired labor	_____	_____	_____	_____	_____
<i>Other Outflows</i>					
20. Capital purchases	_____	_____	_____	_____	_____
21. Proprietor withdrawals including income tax	_____	_____	_____	_____	_____
22. Intermediate loan payments	_____	_____	_____	_____	_____
• Principal	_____	_____	_____	_____	_____
• Interest	_____	_____	_____	_____	_____
23. Long-term loan payments	_____	_____	_____	_____	_____
• Principal	_____	_____	_____	_____	_____
• Interest	_____	_____	_____	_____	_____
24. Total cash outflow	_____	_____	_____	_____	_____
Flow-of-funds Summary					
25. Beginning cash balance	_____	_____	_____	_____	_____
26. Cash receipts (line 7)	_____	_____	_____	_____	_____
27. Cash outflow (line 24)	_____	_____	_____	_____	_____
28. Cash difference	_____	_____	_____	_____	_____
29. Borrowing this period	_____	_____	_____	_____	_____
30. Payment on operating loan	_____	_____	_____	_____	_____
• Principal	_____	_____	_____	_____	_____
• Interest	_____	_____	_____	_____	_____
32. Ending cash balance	_____	_____	_____	_____	_____
Loan Balances End of Period					
	Balance				
	End of				
	Last				
	Year				
33. Long term	_____	_____	_____	_____	_____
34. Intermediate	_____	_____	_____	_____	_____
35. Operating	_____	_____	_____	_____	_____

Educational programs conducted by the Texas Agricultural Extension Service serve people of all ages regardless of socioeconomic level, race, color, sex, religion, handicap or national origin.

Issued in furtherance of Cooperative Extension Work in Agriculture and Home Economics, Acts of Congress of May 8, 1914, as amended, and June 30, 1914, in cooperation with the United States Department of Agriculture. Zerle L. Carpenter, Director, Texas Agricultural Extension Service, The Texas A&M University System.