Critical Data Points and Assessments

At a recent state bankers' conference, several relevant points emerged during an open discussion session. As expected, most of them related to the economic reset and the onset of its fifth year. One banker made an observation, which was quickly supported by others that producers appear to be going in one of two different directions economically. Some producers are making cost and revenue adjustments and using working capital built during the recent times of record profits. This segment of producer is in the position to generate a profit. Others are stymied by multiple years of losses and no working capital, and now are burning through equity in land. The discussion then turned to ways to determine the direction a business is headed, which included critical data points and assessments that can be business bellwethers. The following are some of the more popular points that one might consider in working side-by-side with the lender, accountant or farm management consultant.

Operating margin

One critical data point comes from ascertaining how much it costs to generate one dollar of income, excluding interest and depreciation. Examine the trend in this ratio year-over-year. If increasing or decreasing, identify the major reasons for the variation. When this ratio exceeds 85 percent, either business expenses must go down or business revenue must go up, and preferably both. For example, outside the business, family living costs could be reduced, or off-farm income could supplement the business. Today, most producers still generating a profit usually exhibit an operating margin between 70 and 80 percent. However, in economically good times this ratio has been as low as 60 to 70 percent.

Critical assessment

When calculating this ratio, one should use accrual adjusted income statements. The exact numbers are not as imperative in this assessment as the direction of key items which appear on the current portion of the balance sheet. In the year-over-year assessment, determine the direction of inventories including crop and livestock, accounts payable, accounts receivable, prepaid expenses, and accrued expenses. The answers to these questions will help pinpoint business status: in a position for opportunity, needing to refinance, or planning a partial or total liquidation.

Accounts payable and operating lines

Another critical data point inside assessment is the direction of accounts payable, and debt owed to suppliers and vendors. Divide the total amount owed into total expenses. If this ratio is under 5 percent at this point in the economic cycle, you are probably at low risk. If this ratio is above 15 percent and is increasing, one must examine long-term viability and the changes required to turn the business around. The most common sign of a business failing financially is a sudden rise in accounts payable debt.

Next, examine the operating lines of credit. Can they be paid down? And is there enough inventory to offset the balances of each line of credit? Interestingly, many lenders commented during open discussion on refinancing requests that were not for business losses. In fact, several stated that up to 50 percent of their requests were to support lifestyle choices and habits.

Working capital

Of course, one of my favorite metrics, working capital to expenses ratio, is another critical data point in the assessment. Specifically, it is net working capital divided into expenses, including depreciation. Again, examine the trend in a year-over-year assessment. Next, benchmark the ratio to peers. If the number is above 30 percent, the business has the agility to position for opportunity, as well as the resilience to serve as a secondary source of payment if cash flows and profits turn negative.

It is important to notice that expenses include depreciation. During discussion, one banker pointed out that many producers are not in the position to replace capital assets, or are living from depreciation. While this may work in the short run, this is not a viable or sustainable strategy long term and crucial conversations need to take place.

Term debt / EBITDA

Lenders closely examine coverage ratios, or the measure of repayment ability and capacity to service debt commitments. To calculate, divide your term debt by your margin (EBITDA) or earnings before interest, depreciation, and taxes. This measure examines the debt load and debt service over a period of time. If this ratio is under a 3:1 average over a three-year period, the business is most likely in a strong position for growth or resiliency. Any ratio above 6:1 indicates a debt load that may exceed the repayment ability of the business over time. Even one hiccup in business earnings can seriously jeopardize a business in this position.

Debt to asset ratio

Finally, the financial leverage ratio is a heavily weighted metric. If the debt to asset ratio exceeds 50 percent and is increasing, proceed with caution. At this point, a business must exhibit modest living, solid working capital, and a strong marketing and risk management plan that is executed.

In any assessment, the strength of one factor can offset another's weakness. This is one reason lenders use several ratios to measure business health and direction. Thus, a balanced approach of data assessment is warranted in determining the future for any business.

Management tip: Schedule an appointment with your lender, advisor team, or accountant for the critical data point assessment. Sometimes another set of eyes can be very valuable in an accurate assessment.