# Evaluating Options for Change

Damona Doye
Extension Economist



Crop failures, low commodity prices and other changes in the economic environment contribute to farm financial difficulties. What can a farmer or rancher do to improve the business financial position when the need for change is recognized? Careful management, changes in the farm enterprise mix, changes in asset ownership, supplementing income with custom or off-farm work, debt restructuring, adjusting farm and family living expenditures, and liquidating part or all of the farm assets are alternatives. Giving up equity or increasing debt to cover a cash flow problem is generally not a cure. Often, a larger problem must be solved. Changes must be evaluated with respect to the source of financial difficulties. This OSU fact sheet discusses options for change and points out factors to consider in the decision making process.

## Identifying the Problem

Farm financial problems may be ongoing, recurring, or only occasional. They may result from cash flow difficulties, lack of profitability, low business equity, or a combination of these. To help determine the primary culprit, ask these questions:

1. Are bills and debts paid as they come due?
2. Could they be paid given an extended repayment period?
3. Does the farming operation generate income for family living or does the farm consistently lose money?
4. Could the money tied up in the farm business earn more in an alternative investment?
5. Are savings sufficient to weather one or two years of severe crop or livestock losses?
6. Could money be borrowed to cover cash shortfalls in the event of a business or family emergency?

The first two questions relate to farm liquidity. The inability to make payments as they come due is a sign of cash flow problems. Questions 3 and 4 probe farm profitability. The inability of the farm to generate adequate income or returns on assets can indicate longer-term, profit-based problems. If the answer to questions 5 and 6 is no, then low equity or solvency may be a concern.

## Considerations for the Decision Maker

Many factors must be considered in any decision to significantly change the structure or operation of the farm business. First, the change should be evaluated with respect to farm and family goals. For example, adding a dairy enterprise makes little sense for the family who values being able to take a two-week family vacation each year (unless substitute labor is readily available).

Evaluating changes should include long-range budgeting, estimating total receipts, total costs, and net earnings for each alternative to identify the best chance of achieving satisfactory levels of profitability, liquidity, and solvency. In developing the budget, list all ownership and operating costs and consider intangibles like reliability, timeliness, and pride. Ownership costs include depreciation, interest on investment, insurance, property taxes, and housing or storage costs. Operating costs include fuel and lubrication, repairs, labor, feed, seed and annual operating capital. If credit is needed to finance the change, consider the farm debt repayment capacity.

Determining which alternatives to analyze depends on the business' problems, the kind and amount of resources available, and the economic climate. To find out whether the business can survive a transition from one alternative to another, and to clarify risks involved, follow up long-range planning and budgeting with short-range cash flow planning. The experience with budgeting will reward you with a better understanding of your business.

In the budgeting and evaluation process, keep in mind the relative risks involved in an alternative. Switching to an enterprise in which no family members have previous production, marketing, or management experience is risky. Will a lender go along with the change or can financing be obtained if needed to make the change?

Also, be sure to consider timing aspects of a farm or ranch alternative plan. If new skills are required, is there sufficient time to learn them? If change is needed quickly, is there time to implement a new farm plan? If a new enterprise is added, will it require labor at peak or off-peak seasons?[1]

## Options for Change

### Improved Management

**Cost control.** An internal audit may be needed on the farm to determine if resources (land, labor, machinery, equipment, money, and management) are being used efficiently, effectively, and profitably. Farm records should be studied to ensure that inputs are being purchased as cheaply as possible and are being fully utilized. Look most closely at high cost items. Often they are interest, machinery costs, rent, feed, fertilizer, and labor.

Some costs may be relatively fixed; others may be negotiable or may be reduced by substituting inputs or using them more efficiently. Perhaps machinery costs can be reduced by custom hiring work done or by doing exchange work with other farmers.[2] High repair costs on machinery or equipment may signal the need for additional investment in new equipment or preventative maintenance. Custom hiring or leasing can be a good choice when high cost, specialized machinery and equipment is used infrequently. See that hired labor is fully employed, and minimize time being spent on makework jobs. If land purchase payments are crippling cash flow, consider leasing rather than owning real estate.

If rental rates are out of line with the market, talk to the landlord and see if a new rate can be negotiated. Renegotiating a cash lease to lower the payment will reduce current expenses. Also, changing a cash lease to a share lease will reduce cash outlays and improve liquidity, particularly in poor yield and low price years. Flexible leases can be used to share production and price risk between the tenant and landowner. Flexible leases can be developed in many forms including a combination cash and share lease. In lease agreements for machinery or other equipment, the payment amount, number of payments, principal and interest rates, and end date of lease purchase agreements are variables to evaluate.[3]

**Increased returns.** In addition to cost control, farm returns may be increased by improving marketing and production techniques and by wisely managing underutilized resources. Consider all available marketing alternatives, for instance, selling at harvest, storing and selling later, and hedging. Learning new marketing skills may require an investment in terms of time and money. Go slowly until comfortable and confident with new skills. Dont expect to get rich quick or save the farm through futures trading. Instead, use marketing tools wisely to manage risk.

Another way to increase returns per acre or per head is to increase the yield (or reduce production losses). Are you using the most productive seed variety in your crops? Are you managing livestock so that death losses are minimized? Keep in mind that producing more is not always better if the costs incurred in increasing output outweigh the returns to higher yields.

Identify resources not currently being used which have income potential, and identify underutilized assets. If range, brush, or timberland is not currently being used, could hunting leases be sold? If opportunities exist, increase asset use through custom farming or renting machinery to other farmers. This helps increase machine utilization and increase cash income. Crop share leasing may be an option to generate cash income from owned land that has limited value.

If operating funds are not available for planting a crop or producing livestock, rent the farm out and use proceeds to pay debt obligations.

**Insurance Protection.** To protect against losses, consider insurance. Financially stressed farms often cannot afford a loss which might lead to delinquent loans or more borrowing. Federally subsidized crop insurance is an alternative for many crop producers in Oklahoma. Crop insurance helps control adverse events largely outside the producers control. It presents an opportunity to substitute known costs (annual premiums) for unpredictable and irregular yield losses. Crop insurance can stabilize the farms cash flow and improve financial liquidity. Liability, property, and life insurance are also means to protect farm assets. Insurance policies should be reviewed both from a protection and cost standpoint.

## Change in Enterprise Mix

If cutting costs, improving marketing skills, increasing yields or outputs when economically feasible, and gaining insurance for potentially devastating losses have not remedied problems, then a change in the whole farm plan may be needed. A particularly profitable enterprise might be expanded to use a greater proportion of the farm's resources. For profitable enterprises, additional land could be rented instead of purchased to allow production on a larger scale. Consider dropping an enterprise which has been unprofitable or adding a new enterprise which shows promise.

One way of determining the proper enterprise combination is to analyze the relationship between land and labor in the business. If land is scarce relative to labor, then labor-intensive enterprises (for instance, dairy, feeder pig, or horticulture crop production) may increase returns. When labor is scarce relative to land, more capital intensive operations or land-extensive enterprises (for example, cash grain crops) may be more suitable.

Before adding a new enterprise, think about how it fits in with the rest of the farming operation. Does it complement, supplement, or compete with present activities? A complementary enterprise will not affect the returns to existing enterprises. A supplementary enterprise will enhance profits in an existing enterprise and generate income from the new enterprise. A new enterprise which competes with existing enterprises for resources may lower the profitability of the existing enterprise. Are the expected returns to the new enterprise enough to compensate for potential losses?

A decision checklist for evaluating new enterprises includes:

1. Have goals been determined?
2. Have facilities, equipment, and the necessary number of acres been listed?
3. Have investment guidelines been developed including how much can be invested up front, how much can be invested annually, and how long a negative cash flow can be maintained?
4. Do the necessary skills for making it a successful enterprise exist or can they be acquired?
5. Does a market exist for the product?
6. Have production costs, likely profit, and sensitivity of profit to yield and price variability been budgeted?

## Change in Asset Ownership

The liquidity of assets and the way they are controlled is referred to as the structure of assets. Real estate (land and buildings) can be controlled by owning, leasing with a multiyear arrangement, or renting on an annual or short term basis. Machinery and equipment can be owned, leased, or custom hired while breeding stock can often be leased or owned. Renting or leasing an asset reduces the investment capital commitment while increasing the cash flow and possibly the operating capital needed.

The sale or transfer of assets changes the asset composition of the farm. If sale proceeds are used for debt reduction, the sale may change the debt load and composition as well. Often, farm cash flow alone will not make asset ownership feasible, even though potential price appreciation makes ownership seem rational.

**Renting real estate.** Renting is one way to expand the land base without a large capital outlay. Common types of rental arrangements include the cash lease, crop or livestock share lease, and the flexible cash lease. Successful leases combine the resources—land, labor, capital, and management—of the landlord and tenant efficiently and share the returns equitably. Both legal and economic components of a lease should be evaluated carefully.[3]

With a cash lease contract, the farmer/rancher pays a specified cash amount to the landlord annually. The tenant assumes all price and yield variability risk. With a share lease, the tenant and landlord share both the income and expenses associated with the crop or livestock production. With the share lease, the risks of low prices and yields are shared between the tenant and landlord. The flexible lease may specify payment as a fixed percentage of the variable production or yield. Or, a flexible lease may require a base cash rent plus an additional payment based on changes in the price or yield of the commodity. Again, the risk of price and yield variability is shared by tenant and landlord.

**Leasing machinery or equipment.** Leasing is an alternative to acquire use of other farm assets as well. Operating leases are usually short term rental arrangements with rental costs based on use, either number of hours or number of acres. The owner of the machinery or equipment usually pays for repair and maintenance; the farmer is responsible for fuel costs and labor. The cost of the lease to the farmer can be deducted for tax purposes. Machinery availability may be a risk for the farmer with short term or seasonal operating leases. A financial lease is a long-term contract, usually for the useful life of the machinery or equipment. Because the farmer has exclusive rights to use the asset, the long-term agreement is similar to ownership. Under a financial lease, the farmer pays all repair, maintenance, and operating costs. Options at the end of the financial lease can include the right to:

1. purchase the asset for an amount specified when the lease is signed,
2. purchase the asset at fair market value,
3. renew the lease, or
4. return the equipment to the owner/lessor.

**Custom hiring.** Another alternative to owning machinery and equipment is to hire work done.[4] With custom hire, ownership costs are avoided. Capital and labor can be channeled to other uses. Specialized operations may benefit from the experience of skilled operators. Jobs may be completed faster using several machines and machine use can be readily adjusted to changes in crop mix and market conditions. However, service may not be available at the best time, reliability of custom operators may be unknown and rates are variable.

**Sale or sale/leaseback.** For some farms and ranches, the cash flow costs of ownership are excessive given the original purchase terms and the current economic environment. One means of generating cash to reduce liabilities is through the sale/leaseback of assets, most commonly real estate. The sale/leaseback may be implemented in one of two ways:

1. The property can be conveyed to the lender (a deedback or voluntary conveyance) with the borrower leasing the property back from the lender.
2. The property can be sold to a third party with a leaseback agreement and the proceeds of the sale used to reduce the debt load of the farm.

In either case, the farm's cash flow may improve while farm equity is unchanged (assets and debts are reduced equally).

Farmland may be a particularly attractive candidate for sale/leaseback because annual debt servicing requirements (perhaps ten percent of an earlier land value) can be traded for lower cash rental rates (about six to eight percent of the land value). Leasebacks with crop share rental arrangements result in even lower farm cash flow requirements. Similarly, machinery or equipment can be sold and the farm work done by custom operators. A variation of the sale/leaseback of livestock facilities is the shift from feeding livestock on farm to custom feeding.

Choosing which assets to sell depends in part on family goals. Some operators may be willing to quit farming and either retire or obtain off-farm employment. These farmers or ranchers may want to sell machinery, equipment, and breeding stock while maintaining ownership of part or all land for its potential rental income or as a base for future operations. Other farm operators may place a high value on continuing to operate a farm business. These operators may want to sell assets with low cash return assets such as land, especially if similar land can be rented at competitive prices.

The potential tax liability associated with the sale or transfer of an asset is an important factor to consider in choosing which assets to sell.[5] The sale or transfer of assets may result in taxable income or the recovery of investment tax credit. A tax specialist should be consulted for assistance in evaluating potential tax liabilities associated with asset sales.

Once assets to be kept are selected, the next step is to develop a plan to maintain control of the desired assets and dispose of others to achieve the maximum proceeds. The borrower with real estate loans on several parcels has several opportunities for asset restructuring.

**Merger/acquisition.** The merger/acquisition option is frequently used in the business world, less frequently used in agriculture. In the nonagricultural sector, a firm may have an established market position, reputation, and customer goodwill which can be at least partly transferred to another owner. Most farmers' market position or customer relations is of little value to another farmer (large corporate farms are an exception).

Merger or acquisition may be an alternative when a smaller (perhaps part-time) operation can be completely absorbed by a larger one. For instance, parents who own a larger farm or ranch might acquire the farm assets of a daughter or son (or daughter-in-law or son-in-law). The newly merged agricultural business might or might not include all the former operators. A common problem on farms is that they cannot support all the people involved. The younger generation might choose off-farm employment, leaving management to the parents. Or, the parents might choose to retire, leaving the younger generation with management responsibilities.

### Supplemental Income

Farm income can be supplemented through income from an off-farm job, a home-based business, or from custom work done for other farmers. Recent surveys of farmers in Oklahoma indicate that on average off-farm income exceeds farm income with nearly all farmers indicating some off-farm revenue. Deciding if anyone and who should take an off-farm job may depend on the skills of family members, age, and the need for their expertise on-farm.[6] Job opportunities may be limited in rural areas.

### Debt Rescheduling or Restructuring

To ease cash flow problems, many farm borrowers facing large interest and principal payments work with their lenders to reduce the payment due within any one year. This can be done by rescheduling or restructuring the loan. Rescheduling changes the term (or length) of a loan and/or the timing of payments. Restructuring the debt changes the amount due. Rescheduling debt repayment is likely to be preferred by the lender as it implies that all interest and principal will be paid over time.

Restructuring and rescheduling debts can help keep total principal and interest payments in balance with a firms repayment capacity and keep current and noncurrent debt in balance. Farmers carrying more debt than can be serviced with the current income generating capacity of the business may find these methods are insufficient to solve their problems.

In restructuring a loan, the borrower and lender agree to change the total amount of principal and/or the interest rate being paid. The borrower is able to erase debt, which results in a financial loss to the lender. Thus borrowers are likely to favor restructuring, and lenders will favor rescheduling. Negotiations between borrowers and lenders often result in a combination of restructuring and rescheduling.

The process for restructuring and rescheduling liabilities will be different for almost every farmer or rancher who uses it. The action chosen will depend on the lenders flexibility, the degree of illiquidity or insolvency of the farm, and the improvement desired or needed.

**Rescheduling debt.** Rescheduling can help the borrowers cash flow problem by spreading the principal payments over a longer period. Rescheduling reduces the principal repaid per period and hence, the payment per period. Rescheduling debts improves the liquidity of the farm and may solve a temporary cash flow shortfall. Reamortization is most available to farmers with large current liabilities, affecting their ability to make payments, and low long-term debt, relative to the value of their assets.

Farmers with enough long-term debt servicing capacity can use rescheduling to reduce short run cash commitments. Rescheduling brings the debt structure in line with the farm's ability to pay liabilities. The loan repayment schedule can also be changed with an agreement between farm borrower and lender that only interest payments are to be made, with principal payments postponed. Some lenders might agree to amortize missed payments over a period negotiated between the lender and farmer for several months or even years. If, however, principal and interest payment shortfalls reflect substandard profits, measures must be taken to improve farm profitability. Otherwise, shortfalls will recur despite restructuring or rescheduling.

**Restructuring loans.** Another means of changing the loan repayment requirement for a given year is to restructure the loan. Negotiating a principal write-down from a lender and renegotiating contracts of deed are two major methods of decreasing principal while retaining ownership of an asset. Sometimes, an interest rate write-down is used in conjunction with, or instead of, a principal write-down. Lenders may be willing to consider these alternatives when the value of an asset has declined to a level below the debt commitment or the repayment capacity is less than the debt service requirement.

The lenders willingness and ability to negotiate may depend on the lenders financial condition and regulations governing their business. A lender may be willing to make concessions if doing so corrects a borrower's debt structure imbalance and makes repayment of the remaining amount highly likely.

The Internal Revenue Service views forgiven debt as taxable income, making the potential tax obligations of a principal write-down formidable. Under current law, forgiven indebtedness is considered taxable income, unless the debtor qualifies for a specific exclusion. Since the tax issue is a complex one, expert legal and tax advice should be sought to help in the evaluation of potential debt forgiveness.[7]

Another potential negative repercussion of negotiated debt forgiveness is in future business dealings. For instance, if a fee dealer writes down part or all of an account payable, the dealer may require cash payment for future purchases, if he is willing to do business at all.

### Recapitalization or Equity Infusions

An infusion of equity from outside the farm, either by a lender or outside investor, can significantly improve the financial structure of the business. The lender may exchange a loan obligation for an equity position in the farm. An outside investor (including an off-farm heir) may provide money to reduce indebtedness in return for a share of the business. An equity infusion supplied by an outside investor increases the cash and liquidity position of the farm. It also reduces financial risk by increasing the equity capital base. It may improve both the balance sheet and cash flow of the farm when some equity is used to repay debt. An equity infusion means sharing business returns or repaying the outside investor in some other fashion.

### Adjustments in Farm or Family Withdrawals

Often, some flexibility exists in the amount of money reinvested in the farm or used for family living expenses. Financially stressed farmers may delay investments and machinery and equipment purchases. Automobiles can be driven longer and new home furnishings and home improvements delayed. These adjustments may be enough when financial stress is not severe. They buy time for the operator to make other operational changes. However, equipment, machinery and buildings eventually need to be replaced. In some cases, expectations of what the farm can generate must be adjusted to realistic levels; off-farm income may be needed to meet family needs.

### Business Liquidation

If the financial situation of the farm or ranch is not repairable, the best choice may be to end one business and start another. The business may be liquidated voluntarily, or involuntarily if loan repayment delinquencies are severe. Bankruptcy is generally considered a last resort and refers to the termination or reorganization of a business. Chapter 11 is for reorganization of a debtors business affairs, and Chapter 12 is specifically for family farm or ranch bankruptcies. Bankruptcy provides the legal vehicle for implementing debt and asset adjustments that cannot be implemented on a voluntary basis.[8]

## Summary

Farm or ranch financial problems can be characterized by lack of profitability, inadequate cash flow, and/or low equity. An adjustment strategy should be directed at the source of the problem. Be as creative as possible in brainstorming to generate alternative farm plans.

If liquidity appears to be the main problem, potential solutions include increasing and speeding up cash inflows while decreasing and slowing down outflows (including reducing family spending). If principal and interest payments are part of the liquidity problem, study alternatives to restructure the level and timing of debt repayment. When profitability is the weakness, consider alternatives that improve production, marketing, and financial efficiencies.

If solvency is a problem, but profitability and liquidity are not, the situation may correct itself over time. If the solvency position is not tolerable in the short run, investigate giving up ownership of some assets and renting them back or soliciting outside equity capital.

Farm profitability can be improved by adopting alternatives that favorably impact volume, price per unit, and cost per unit of production. Farm net worth or equity can be increased over time by increasing profits, carefully planning for family spending, and managing income taxes.

A key to survival for many operators is fixed asset utilization and management. If fixed costs are not being spread over adequate levels of production, the farmer or rancher must reduce fixed costs by liquidating assets or by expanding the business.

The potential impact of an option for change should be analyzed before a decision is made. While planning and budgeting may seem like a great deal of work, the analysis should enhance the likelihood of successful change. Any analysis of the potential impact of an adjustment on the profitability, cash flow position, or solvency of a farm is only as good as the information used. A planned change must be reasonable, given resource constraints. How much risk is involved? Is management ability there? Can you sell the plan to lenders?

## Publications

http://www.osuextra.com

## Notes

1. See OSU Extension Fact Sheets F-206, Goal Setting for Farm Families; F-751, Developing a Cash Flow Plan; F-139, Budgets: Their Use in Farm Management; F-174, Agribusiness Management Series: Effective Time Management Helps Avoid Crisis Situations; and F-790, Evaluating Financial Performance and Position, for additional information.
2. See OSU CR-205, Oklahoma Farm and Ranch Custom Rates.
3. See OSU Extension publications CR-216, Oklahoma Pasture Rental Rates; CR-230, Oklahoma Cropland Rental Rates; F-214, Developing Cash Lease Agreements for Farmland; F-215, Developing Share Lease Agreements for Farmland; and F-941, Tax Consequences: Cash vs. Crop Share Leasing.
4. See OSU Extension Fact Sheets F-140, Oklahoma Farm and Ranch Custom Rates and F-940, Tax Aspects of Leasing.
5. See OSU Extension Fact Sheets F-939, Deferred Taxes.
6. See OSU Extension Fact Sheets F-196, Farmers in Transition: Finding a New Career, for more detail.
7. See OSU Extension Current Report CR-776, Insolvent Farmers Receive Alternative Minimum Tax Relief.
8. See OSU Extension Fact Sheets F-766, Bankruptcy: Definitions, Rules and Regulations and F-197, Farmers in Transition: coping with the Partial Reduction or Loss of the Family Farm, for other information.

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