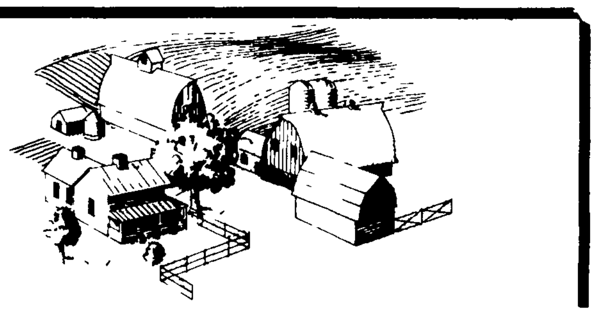

FARM MANAGEMENT

DEBT REPAYMENT CAPACITY

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Editor's note: This is the fourth of an eight-article series written by the five southeastern/central Penn State Extension farm management agents.

Debt management is an important key to the financial success of a business.

Back in your grandpa's day, people viewed debt as evil, and tried to pay it off as quickly as possible. Some who were not able to do so lost everything in the Great Depression.

Twenty years ago, it was suggested that lots of debt was the way to get rich. Recently Donald Trump and others have found that this philosophy can lead to major liquidity (cash flow) problems.

Fortunately there are ways to determine how much debt can be carried by each business operation. But be careful of common "rules of thumb" such as $3,000 per cow. These can be very misleading. To be safe in our estimations, we need to look carefully at our own business records and analyze them.

Tax records are the IRS system of accounting. They pay no attention to your actual or scheduled debt principal payments. In place of these they allow you to claim "depreciation" on some of your capital assets, but never on land. So we need to make some adjustments to our records to see the picture more clearly.

What is available to pay debt?

We can start with net cash farm income. This is calculated as cash farm income (and includes income from routine capital sales such as cull breeding livestock) minus cash operating expenses (without depreciation). To this we should add nonfarm income to calculate cash available. But first the family has to live on this income, so we deduct family living and deduct income tax and social security payments. Now we have cash available for principal payments.

Debt repayments normally include principal plus interest components. So now we must add back from our expense statement the amount of farm interest paid. This is now the amount available for principal and interest payments.

Operating loans

Since line-of-credit and operating loans have payments which must be met, these have to be considered. The operating expenses should account for the principal payments, so we only need to deduct operating loan interest to find out how much is available for our scheduled or amortized debt payments.

When capital items (machinery, etc.) are purchased with operating loans, it throws our accounting system and our formulas into a tither. Because this loan should be repaid in less than one year, we must further reduce the cash available for scheduled payments by the cost of the capital purchase. This often brings up the "sorry, no-can-do" signal.

Capital Leases

Leases of capital assets may bypass the bankers veto, but they still have to be paid. They can be treated as an operating expense, or they can be included with the scheduled debt payments. In both cases they will reduce the amount of money available for debt repayment.

Term Debt and Capital Lease Coverage

If we work through the above computations, we can calculate how much money is available to cover debt and/or lease payments. We can compare this with what is needed to cover these same payments and see if we have enough.

For some reason, analysts like to use ratios. So they divide the payment dollars available by the pay ment dollars required. If this results in a 1:1 ratio, there is no margin for drought, disease, or other management problems. The higher it is, the better.

If the ratio is less than 1:1, then refinancing is a temporary solution possibility. In many cases it may be necessary to liquidate assets to reduce debt.

Capital Replacement and Term Debt Repayment Margin

This is the last of the Farm Financial Standards Task Force's financial measures. It is used to make sure that the business generates enough cash to replace non real-estate capital items (machinery, etc.) as they wear out. Otherwise it will eventually grind to a halt.

To maintain a line of equipment with a 10-year turnover, every year the business should expect that 20 percent of the current market value should be in purchases made in that year. Some items will last longer and some will turn over quicker.

Estimate the replacement needs of your business at somewhere between 10 percent and 20 percent of equipment fair market value. If non real-estate principal payments exceed this amount, then there is enough cash-flow scheduled to cover this level of replacement. If not, the shortfall needs to be added as an additional capital requirement in the cash-flow projection.

The FINPACK long range budget calculates these cash flow, capital replacement, and debt repayment needs very nicely. If you need help with such computations, contact your equal opportunity extension office for farm management assistance.