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Planning readies ranchers for farm economy downturn

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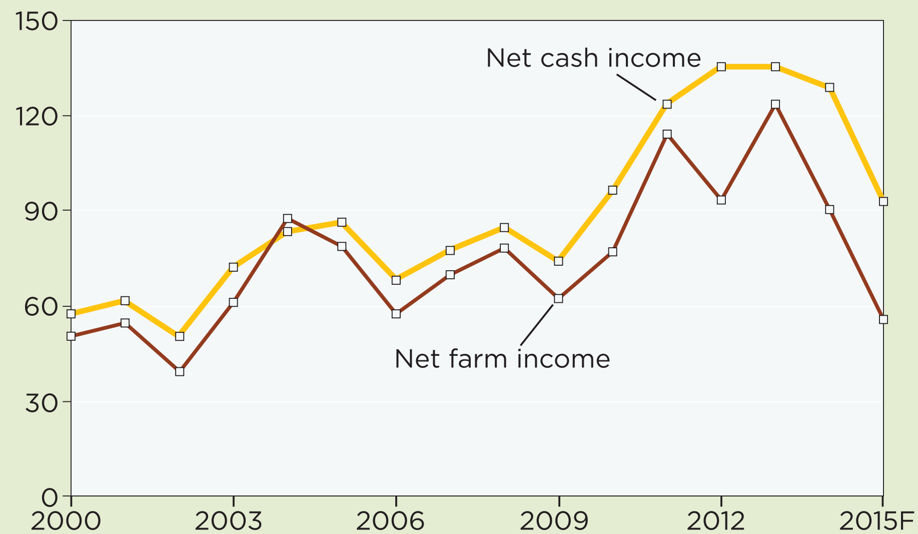
The United States Department of Agriculture is forecasting net farm income in 2015 to be $55.9 billion, a 38.2 percent drop from the previous year. This is the single largest year-over-year drop in net farm income since 1983. Back in 2013, net farm income was a record $123.3 billion. The 2015 forecast is 55 percent lower than in 2013. I do not want to sound like Chicken Little and say the sky is falling, but the agricultural sector of the United States economy is transitioning to a substantially lower level of profitability and prosperity. What can agricultural producers do to position their operations to survive the downturn in profitability with as little stress as possible?

Net farm income and net cash farm income, 2000-2015F

$ billion, nominal



Note: F = forecast.
Source: USDA, Economic Research Service, Farm Income and Wealth Statistics.
Data as of November 24, 2015.

The first step is to be sure you know what your individual net farm income is. This information does not generally come from your income tax return. As farmers and ranchers, we are pretty savvy at managing taxable income, although the last few record income years has challenged us a bit. Many producers have a year or two production of raised grain in storage or have deferred cull cow and/or calf crops into the next year to defer income. Some producers may also have paid ahead expenses to reduce income. Therefore, looking at the 2015 income tax return may still show normal or above normal income if some extra grain was sold, part or all of last year's and this year's calf crop was sold, or fewer expenses were paid ahead. The tax return will give a false indication of the true profit of the farm business if these tax strategies were employed. Caution must be observed to be sure accurate profit is known so management decisions can be made to position the farm business for sustainability into the future. Without knowing one's correct net farm income, marketing and purchasing decisions may be made on false information. An accrual adjusted net farm income statement can provide the correct profit amount when completed accurately.

A second step is to manage the debt load. During prosperous times, producers tend to purchase assets for a number of reasons such as upgrading to a newer model, improving efficiency or maybe to reduce the tax bill. Oftentimes, profits pay for most of the purchase price of the new asset and the rest is added to debt. During periods of lower profitability, as is forecasted for the next few years, it becomes harder to service debt. The United States Department of Agriculture Economic Research Service is forecasting both real estate and non-real estate debt to increase in 2015 – each by more than 6 percent with non-real estate debt to outpace real estate debt. When combined with a decline in asset values of both real estate and other farm assets comprised mainly of inventories and machinery/vehicles, farm sector debt-to-equity ratios will rise. Strategies for the next few years may include selling any unneeded machinery, justifying any purchases with strong supporting financial forecast and keep making timely payments with extra principal when possible. Cash seems always to be king but in periods of volatility and lower commodity prices, a strong liquidity position can reduce the financial stress and prepare the farm business to be ready to take advantage of the next rise in profitability.

There are many ways to position the farm business in anticipation of lower profitability, but the last step discussed here is to spend a bit more time analyzing. During the last few years, essentially all beef producers had to do to make money was to own cattle. The beef industry is building the cow herd, increasing the calf supply and producing more beef per cow. The price outlook for calves and feeders is to trend lower. It is easy to get addicted to \$200 to \$300 or more per head profits. There are profits to be had in the next few years but likely not at the levels per head experienced in recent years and likely only after some detailed enterprise budgeting. A friend of mine summed it up best by stating that cash flows are going to turn into cash trickles. Keep in mind what got you to where you are now. We are known by our work ethic, our word, our belief in our Maker and respect for our fellow man, and as trusted caretakers. These virtues have served us well. The sky is not falling, but more challenging times are ahead. Best wishes for a happy and prosperous new year. ■