

Quick Assessment of Ability to Survive to 2010



Presented by: Tom Kriegl
University of Wisconsin Center for Dairy Profitability and
University of Wisconsin Extension

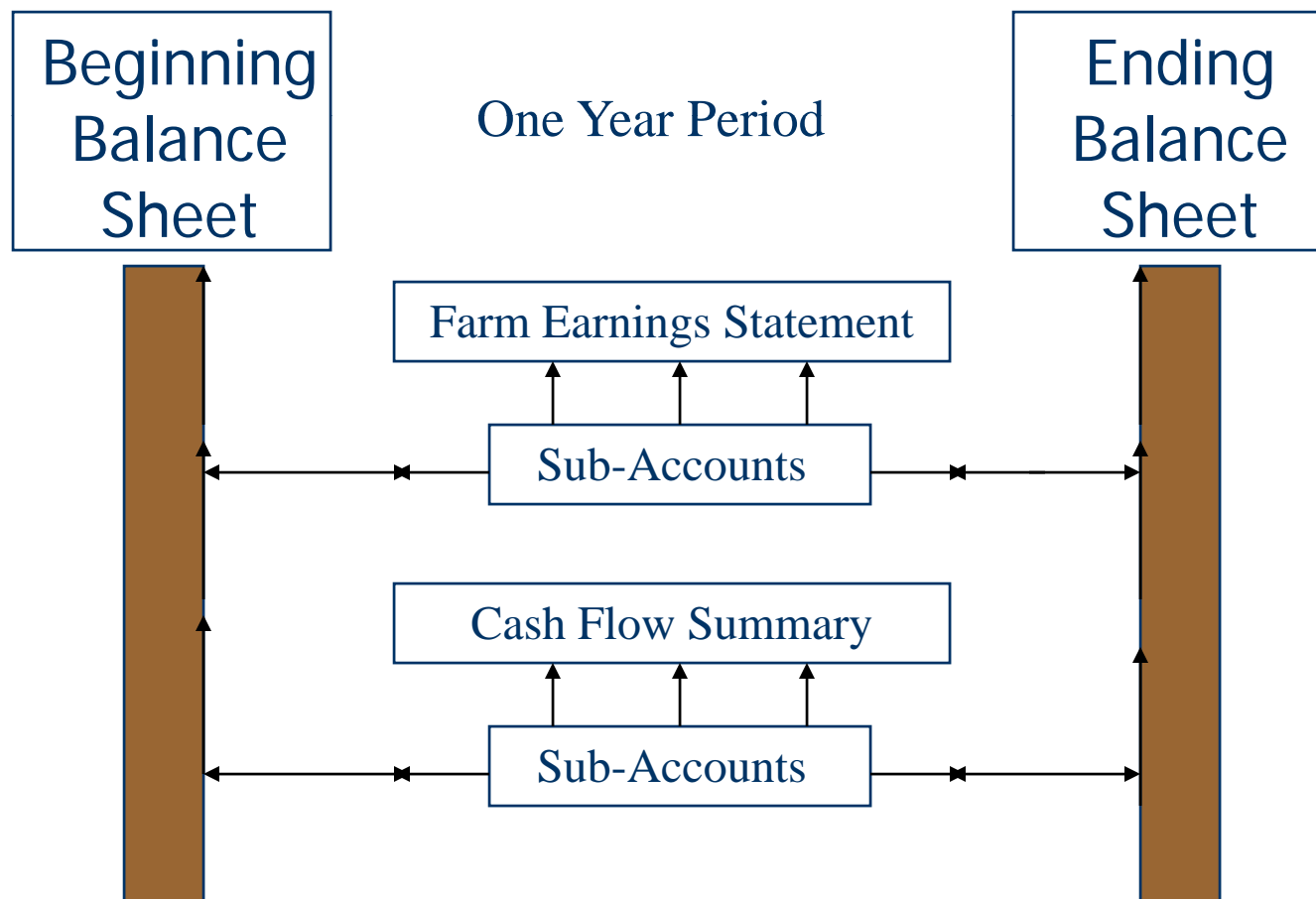
Dairy Topics ANRE Call

May 15, 2009
Madison, WI

To be economically successful in the long run, a business achieve the three goals of:

- **Profitability**
- **Solvency**
- **Liquidity**

Building A Financial Fence



Profitability-A Business Goal

- Generating enough income from operating the business to exceed operating expenses, annual fixed costs, and the unpaid opportunity costs of the business
- Use an accrual farm earnings statement to verify profitability.

Solvency – A Business Goal

- Solvency is the ability of the business to meet all financial obligations in the long run
- Use a properly prepared double track balance sheet to measure solvency

Liquidity (Cash Flow-Working Capital) – A Business Goal

- Liquidity is having assets in a state that allows the transaction of business
- Cash is very liquid
- Buildings tend to be illiquid
- Shelled corn is more liquid than corn silage
- On a practical basis, the cash accounts tell much about liquidity

Factor That Forces Farm Families to Face Financial Stress Reality

– Lack of Liquidity

- For many farm families, the factor that forces them to re-evaluate, request help, etc. is a lack of liquidity.
- Lack of money in the checkbook and other cash accounts
- Inability to pay current bills

The Three Business Goals

- A business can be strong in meeting all goals
 - A business can be weak in meeting all goals
 - A business can be weak in meeting one or two goals and strong in the others
-
- Strength in a goal can somewhat substitute for weakness elsewhere **in the short run**

Current Situation

- The milk price drop from Dec. 2008 to January 2009 was like a company telling employees, your job is secure but you won't be paid for six months
- Most dairy farms aren't profitable on a current basis
- Many dairy farms may not be liquid on a current basis
- The dairy farms that are strongly solvent are best able to survive.

Two Different Cases

- If an illiquid farm has been profitable and is solvent, gaining liquidity is doable and advisable
- If an illiquid farm has been chronically unprofitable but still solvent, it may be advisable to seek another career and liquidated farm assets before asset values decline

Balance Sheet

- Also called --Financial Statement, Net Worth statement
- Inventory of what you own--assets
- Inventory of what you owe to others--debt

Assets=Liabilities + Equity

Assets

Equity

Liabilities or Debt

Balance Sheet Summary

Assets	HC	CMV	Liabilities
Current (1 year or less)			Current
Intermediate (1-10 years)			Intermediate
Long Term (10 years or more)			Long Term
Total			Total

Calculation of Equity or Net Worth

Assets minus Liabilities=Equity or Net Worth

Other Notations

such as contingent liabilities

Liabilities

- A liability is something that you owe to someone else
- A liability is a future financial obligation
- Many liabilities are loans governed by legal contracts. The cost basis and current market value basis of legally enforceable loans are usually equal.
- **Accounts payable are often overlooked.**

Contingent Liabilities or Deferred Liabilities

- **Contingent Liabilities should be calculated in the CMV track** to reflect the cost of converting assets into a more liquid form if their value is to be removed from the business or converted into another form.
- Sales commissions, auction fees 6%
- Taxes 0-30%
- Other ?

Asset Valuation Influences Analysis Results

- Asset Valuation Methods
 - 1) Historic Cost or Tax Basis (HC)
 - 2) Current Market Value (CMV)
 - 3) Worldcom Method
 - 4) Enron Method
 - 5) AIG Method

Asset Valuation Influences Analysis Results

- Historic Cost (or Tax Basis)
 - Equals the price paid minus depreciation
 - Produced Assets basis technically is zero

Asset Valuation Influences Analysis Results

Current Market Value equals what a willing buyer would pay a willing seller when neither is under duress.

How Much Solvency is Needed?

- Up to 40% debt manageable for most
- Between 40% and 60% debt requires careful management
- Over 60% debt will challenge most managers
- Risk varies with the strength of profitability and liquidity of the business.
- **What asset values are used to calculate % of debt?**

How Solid is Current Market Value?

- Unless major assets were acquired in the last few years, the Cost Basis is likely much lower than Current Market Value
- **But how solid is Current Market Value**, given that CMV changes quickly?

Judgment must be exercised on how solid CMVs are today and into the future.

- Compare Cost Basis to CMV
- Be as realistic as you can with CMV
- Be aware of trends
- Consider several levels of CMV
- Don't forget contingent liabilities

Example of Adjusting CMV to Test Solvency

- Average price of farm land in Wisconsin in 2008 about \$3,000
- If debt/A is \$1,500 then percent of debt is 50%
- If CMV declines 25% to \$2,250/A how much does solvency change?
- \$2,250/A CMV versus \$1,500/A debt is 67% in debt