

# **Making Your Idea a Reality Through Financial Planning**

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# Business Realities...

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✦ 2/3 start with <\$5,000...

✦ Majority funded by family & friends...

✦ Self funded...

- ✦ 26% line of credit...

- ✦ 6% mortgage...

- ✦ 14% equipment loan...

- ✦ 24% vehicle loan...

# Ways to Finance a Business...

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## ✦ **Venture Capital Equity...**

- ✦ Few businesses financed this manner...
- ✦ Want large growth ( \$10 million annual sales)...
- ✦ High annual returns (>30%)...
- ✦ Exit in 5 years or less...

## ✦ **Angel Investors...**

- ✦ Very hard to find...

# Ways to Finance a Business...

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## ✦ Angel Investors...

- ✦ Invest for humanitarian or social reasons...
- ✦ Annual sales \$100,000 to ½ million...
- ✦ Returns 20% to 25%...
- ✦ 10 to 15 year time horizon...

## ✦ Debt funding...

- ✦ Commercial or private banks...
- ✦ Credit Unions...
- ✦ AgStar...

# Ways to Finance a Business...

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## ✦ Debt funding...

- ✦ Asset based...
- ✦ Lines of Credit – tied to sales...
- ✦ Leasing – usually for equipment...
- ✦ Collateral – what the banker can resell quickly...
- ✦ Cash flow – ability to repay...

# Ways to Finance a Business...

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## ✦ Government funding...

- ✦ Generally overstated...
- ✦ Federal –
  - USDA-Value Added Ag...
  - USDA – Business & Industry Guaranteed Loans...
  - USDA – SARE Grant
- ✦ Wisconsin – Agricultural Development & Diversification Grant (ADD)...
- ✦ Local – Economic Development Grants...

# Ways to Finance a Business...

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## ✦ Government WHO TO SEE...

### ✦ Federal –

- Rosemary Ewoldt, USDA Rural Development 715-345-7615
- SARE, Paula Ford, 402-472-7081 or visit <http://www.sare.org/ncrsare/>

### ✦ Wisconsin -

- Mike Bandli, WDATCP 608-224-5136

### ✦ Local –

- Bob Bossany, Dunn Co Economic Development, 175-232-4009

# Agricultural Development & Diversification Grant (ADD)...

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## ✦ Eligible expenses...

- ✦ Salaries, wages & fringe benefits...
- ✦ Consulting services
- ✦ Supplies, materials...
- ✦ Equipment depreciation over time of grant...
- ✦ Travel expenses...
- ✦ Telephone expenses...
- ✦ Data processing...

# Agricultural Development & Diversification Grant (ADD)...

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## ✦ Ineligible expenses...

- ✦ Capital purchases...
- ✦ Indirect institutional administrative costs...
- ✦ Start-up or expansion costs, unless qualified on the basis of program criteria
- ✦ Paying off existing debt...
- ✦ Lobbying activities...

# Sustainable Agriculture Research and Education (SARE)...

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## ✦ Eligible expenses...


- ✦ Salaries, wages & fringe benefits...
- ✦ Consulting services
- ✦ Up to 40% of equipment cost
- ✦ Up to 33% of cost of permanent fencing
- ✦ Up to 25% of cost of perennial seed/plants
- ✦ Lease of facilities, equipment, etc.

# Sustainable Agriculture Research and Education (SARE)...

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## ✦ Ineligible expenses...

- ✦ Cost of construction or remodeling facilities
- ✦ Purchase of livestock or vehicles
- ✦ Food or drinks at field days, other meals
- ✦ Anything other than actual expenses incurred during the project period



**Success happens when  
opportunity meets the  
well prepared...**

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Andy Bensead, WWREC

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# Preparation...

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- ✦ A well prepared Business Plan...
- ✦ Five years worth of financials...
- ✦ Credit worthiness...

# Three Most Important Financial Goals

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**Liquidity**

**Solvency**

**Profitability**

# Three financial statements needed for planning and measuring performance

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✦ Balance Sheet

✦ Income Statement (also known as a profit and loss statement)

✦ Pro forma cash flow statement

# The Balance Sheet

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A snapshot of how funds are invested in the business (**assets**) and the financing methods used (a combination of **liabilities** and **owner's equity**) at a given point in time.

- **Assets** – Everything that is owned by or payable to the business as of the date the balance sheet is prepared
- **Liabilities** – All obligations owed by the business as of the balance sheet date
- **Owner's Equity or Net Worth** – Total assets minus total liabilities

# Useful information provided by a balance sheet

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- ✦ Liquidity – The ability of the business to meet its current (short term) obligations with current assets
- ✦ Solvency - The ability of the business to pay off all of its debts if it were to be sold tomorrow

# Liquidity

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✦ *Current ratio* – All current assets divided by all current liabilities

GOAL: The current ratio should be at least 1.0, preferably 2.0 or more

In other words, current assets should be twice as much as liabilities

# Liquidity

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✦ *Quick ratio* – Current assets minus inventory, divided by all current liabilities

GOAL: The quick ratio should be at least .5, preferably close to 1.

(The quick ratio eliminates the need to take a physical inventory of product on-hand.)

# Liquidity

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✦ *Working capital* – All current assets minus all current liabilities

GOAL: Personal comfort level based on average current liabilities

# Most Common Liquidity Problems

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Poorly structured debt - Paying for long-term assets as if they are current liabilities

High current liabilities forcing sales of inventory at unprofitable prices

Uncollectable accounts receivable continuing to show up as current assets on balance sheet

# Solvency

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✦ Debt-to-Asset ratio – All business liabilities divided by all business assets. It's the banker's share of the business, so to speak.

GOAL: Should be 30% or less. The higher the debt-to-asset ratio, the greater the level of financial risk.

# Solvency (continued)

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✦ Equity-to-Asset ratio – All business assets minus all business liabilities, divided by all business assets. It's the farm owner's share of the farm. It's the inverse of the debt-to-asset ratio.

GOAL: Should be 70% or more.

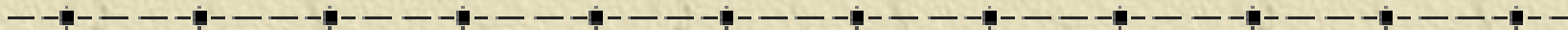
# Solvency (continued)

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✦ Debt-to-Equity ratio – All business liabilities divided by owner's equity.

GOAL: Should be 4.0 or less over the long run. It can be higher in the short-run, especially after a large capital investment in the business.

# Most Common Solvency Problems



Capital investments too high relative to potential income

Assets depreciating faster than the loan balances are being paid off

# The Income Statement

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A structured way of comparing one year's income and expenses, and determining how much of that revenue was retained by the business.

**Income** – Includes cash sales of products and any other business income. Also includes changes in the inventory of products and supplies.

**Expenses** – Includes all cash operating expenses including interest (but not principal) payments. It also includes depreciation.

# Useful information provided by the income statement

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## Profitability measures

- **Net farm income** – The return for your unpaid labor, management, and financial investment in the farm
- **Rate of return on farm assets** – The “interest rate” being earned on all of the investments in the farm
- **Rate of return on farm equity** – The “interest rate” being earned on your investment in the farm
- **Operating profit margin** – The operating efficiency of the business

# Useful information provided by the income statement

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## Profitability measures

- **Net farm income** – GOAL: Personal satisfaction level
- **Rate of return on farm assets** – GOAL: At least the rate of interest on borrowed money.
- **Rate of return on farm equity** – GOAL: Should be higher than the rate of return on farm assets
- **Operating profit margin** – GOAL: Should be at least 20%, but ideally 35% or better

# Most Common Profitability Problems on Dairies



Feed costs too high

Overhead costs too high

# How do we increase profitability?

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1. Reduce overhead costs (They aren't really "fixed")
  2. Improve gross margin
    - get more for your milk, cull cows, other farm products
    - cut variable costs
  3. Increase asset turnover
    - (Remember:  $\text{Asset turnover ratio} = \frac{\text{Value of farm production}}{\text{Average farm assets}}$ )
    - Increased production only improves profitability if variable *and* overhead costs stay the same

# Business Planning- Costs

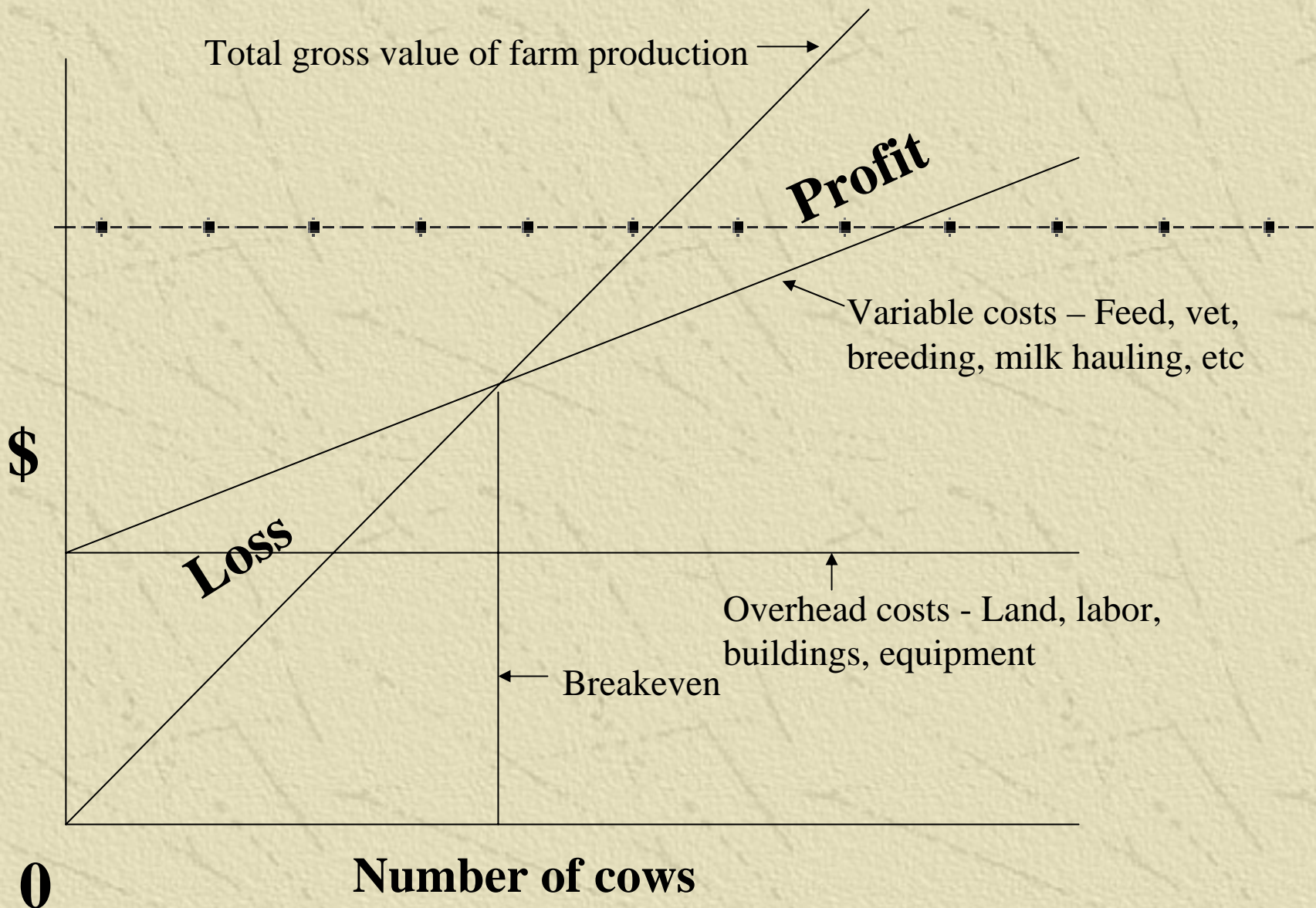
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## ✠ Overhead Costs

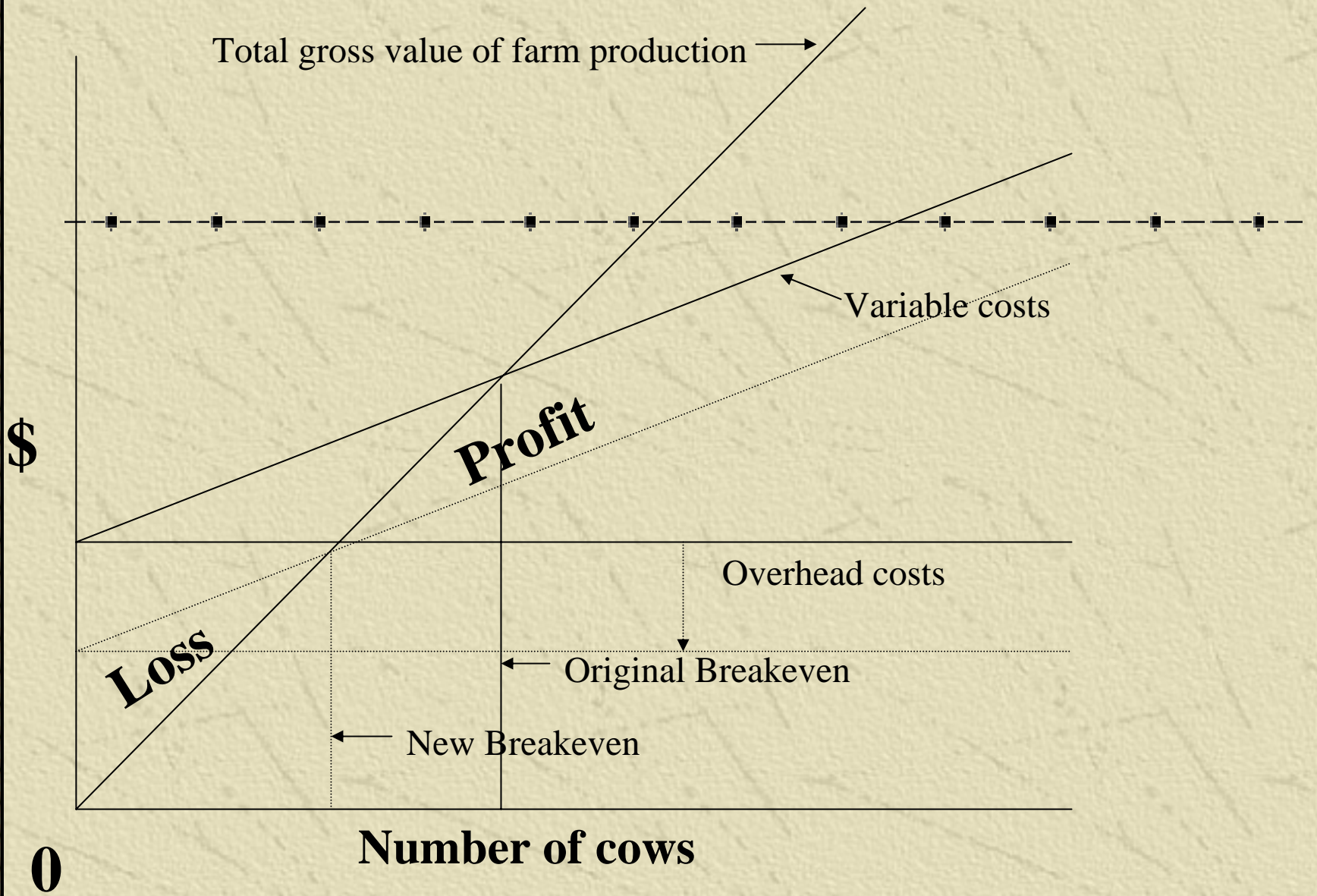
- Costs that exist on the farm whether or not anything is being produced
- Can include mortgage, taxes, depreciation, labor

## ✠ Variable Costs

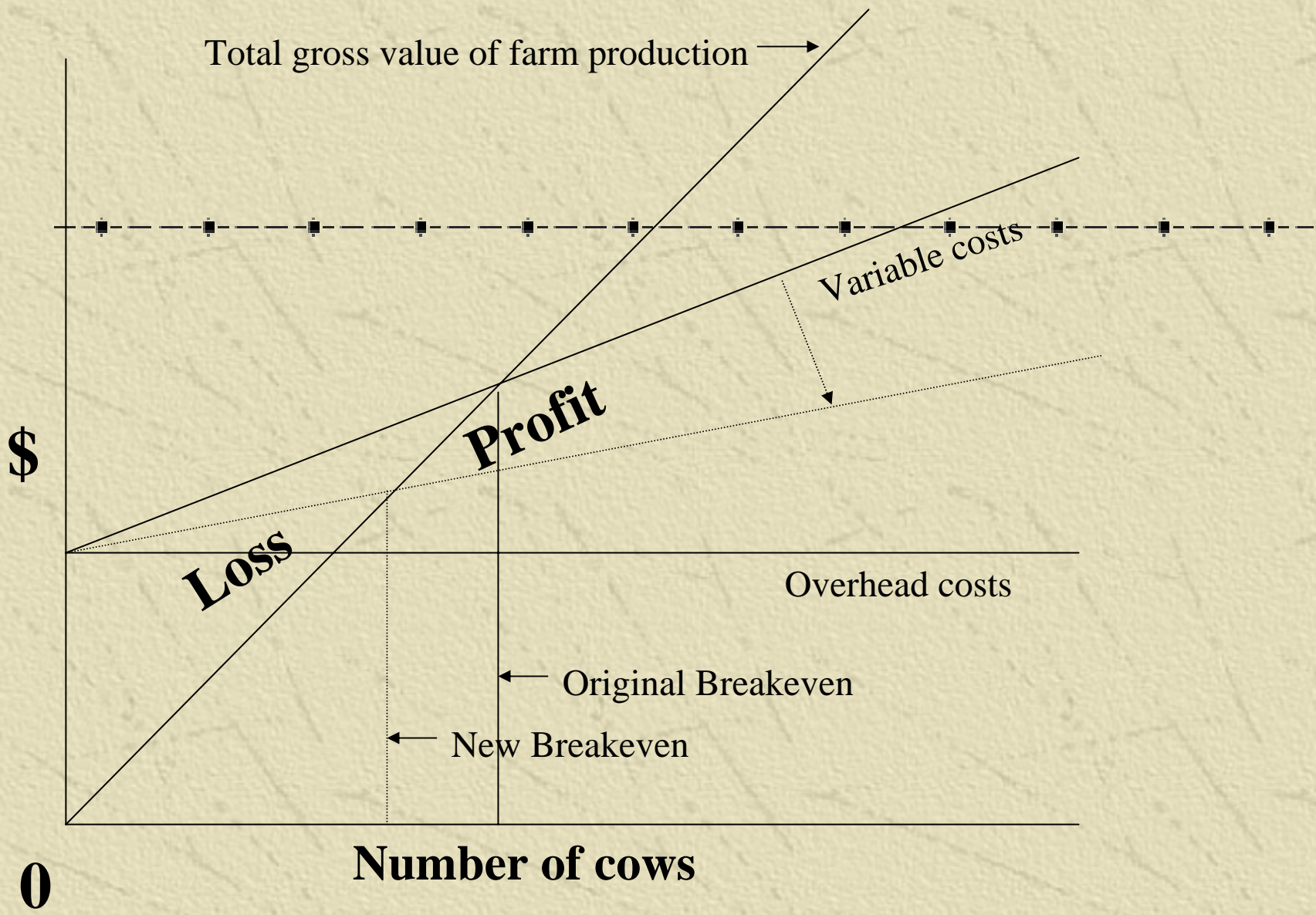
- Costs that increase as farm production increases
- Can includes seed, feed, fertilizer, vet expenses, utilities



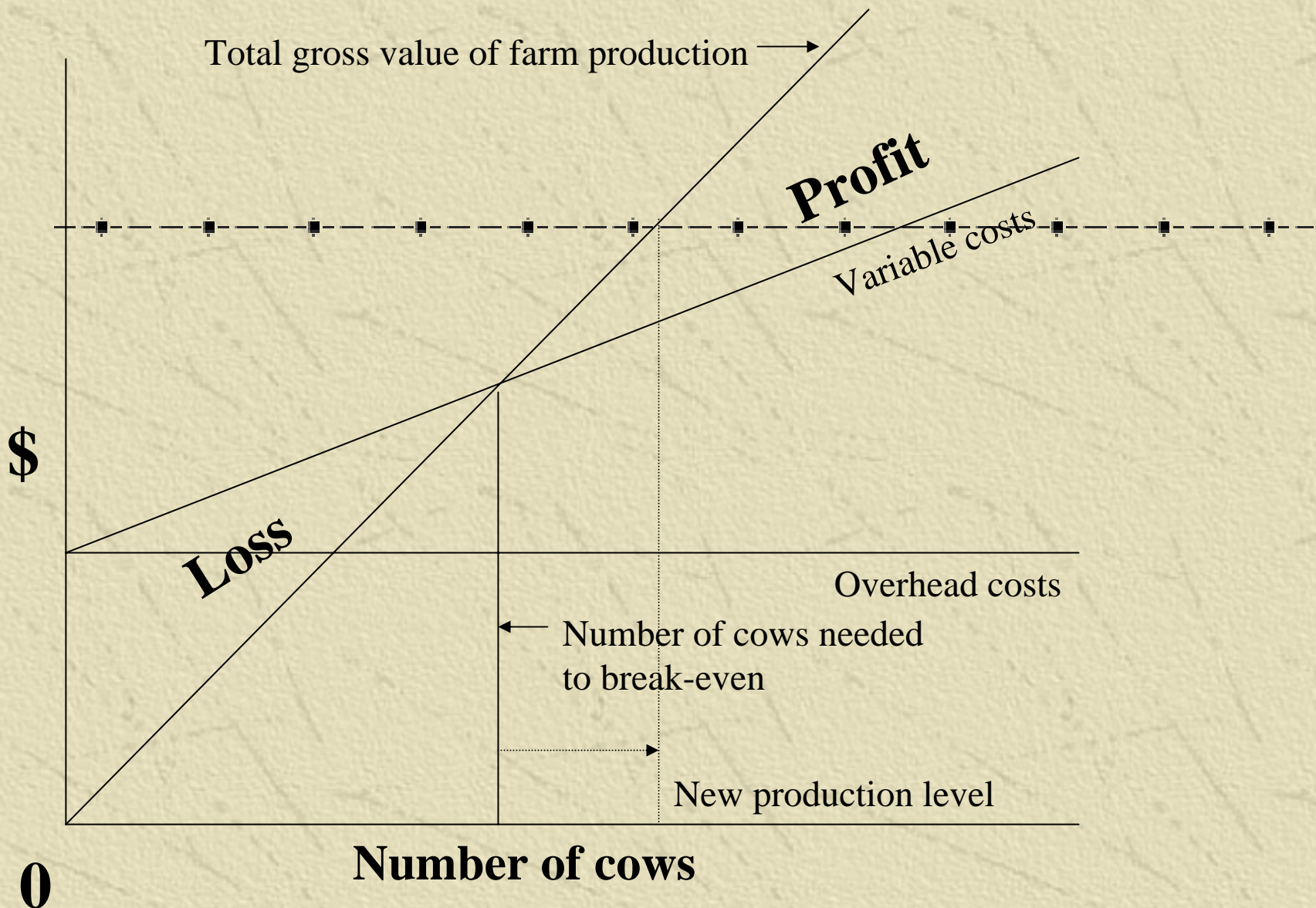
How overhead and variable costs relate to profit on dairy farms



One way to increase profitability: Reduce overhead costs



Another way to increase profitability: Reduce variable costs



A third way to increase profitability: Increase production, keep all costs the same

# Business Planning

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- ✦ First, set your lifestyle goals
- ✦ Business plans need to match the type of lifestyle you want, not vice-versa
- ✦ Put your goals and plans in writing
  - ◆ Write it for yourself, not for your banker
  - ◆ Think broadly about the assets you can use in the farm business to move you towards your lifestyle goals

# Business Planning-Lots of Assets!

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Financial

Farm location

Land

Personal  
abilities

Buildings

Livestock

Soil quality

Rainfall

Good  
neighbors

Solar  
energy

# Business Planning- Liabilities

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✠ Mortgage

✠ Taxes

✠ Other bills

✠ A variety of risks

- ◆ Sales lower than expected
- ◆ Price increases for inputs
- ◆ Lower than expected profit margins
- ◆ Loss of production
- ◆ Drought
- ◆ Personal injury
- ◆ Problems with livestock health
- ◆ Machinery breakdowns
- ◆ Fire

# Business Planning

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## ✦ Conventional agriculture

- ✦ Limiting factors are product prices and production costs
- ✦ Accept declining profit margins as inevitable
- ✦ As profit/unit declines, add more units
  - More acres of land
  - More cows
  - More labor
  - More assets
  - More liabilities
  - More risk

# Business Planning

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## ✦ Value-Added Agriculture

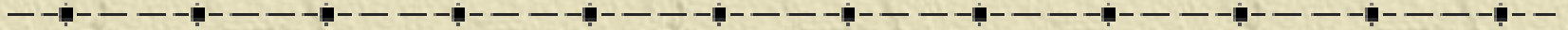
- ✦ Limiting factors (to a certain extent) are land, labor, and liabilities
- ✦ Won't accept declining profit margins
- ✦ Always striving to increase profit margins
  - Increase sales per customer
  - Increase prices
  - Change product offerings

# Business Planning

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- ✦ Most value-added agricultural business owners are trying to take full advantage of all of the assets at their disposal...
- ✦ ...And, are trying to reduce their liabilities as much as possible

# Thinking About Assets and Liabilities



**Our textbook definitions:**

**Assets** - Everything that is owned by or payable to the business as of the balance sheet date

**Liabilities** - All obligations owed by the business as of the balance sheet date

# A Different Way of Thinking About Assets and Liabilities

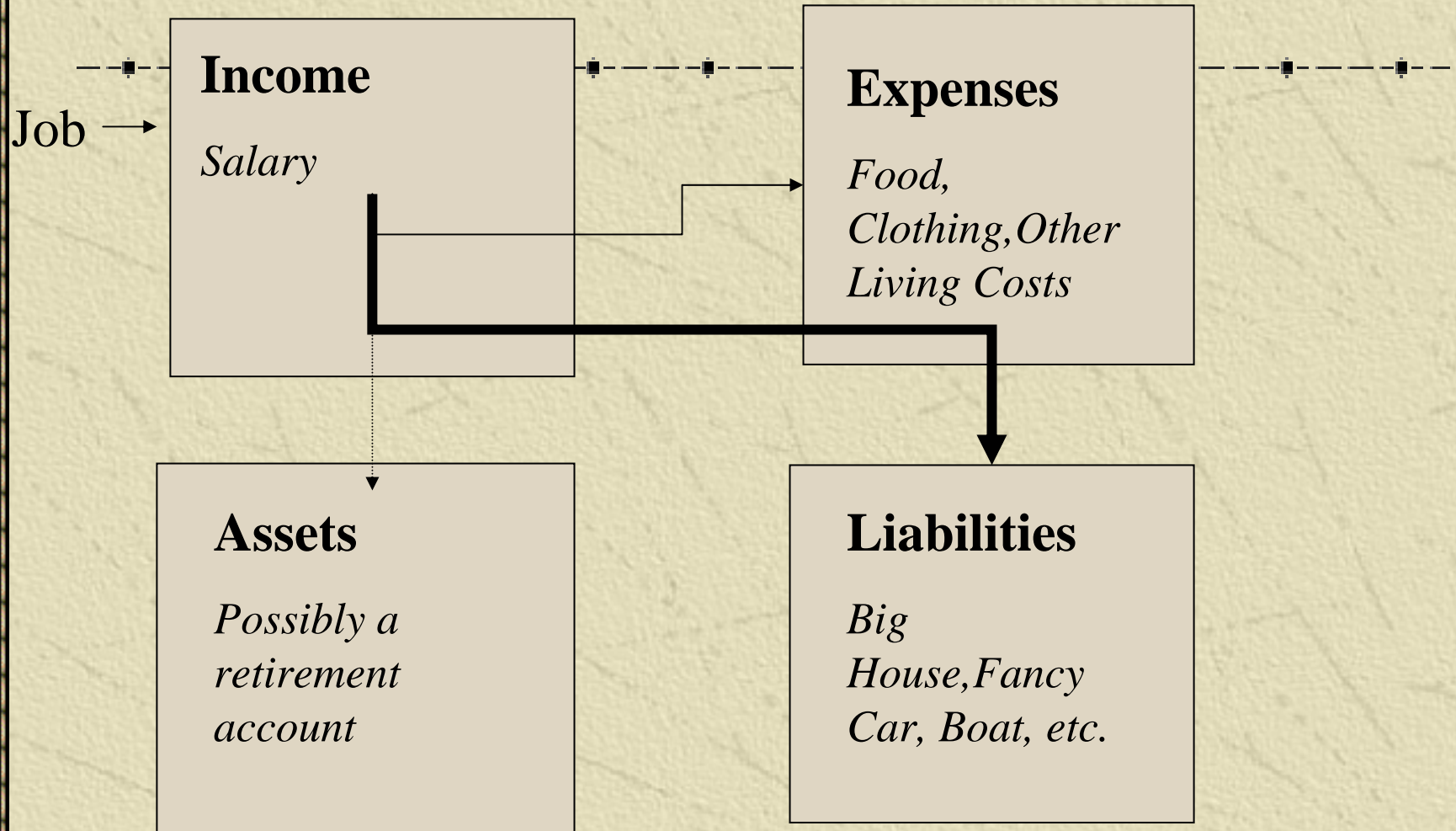
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Definition from Robert Kiyosaki, author of Rich Dad, Poor Dad:

Assets - Items that earn income

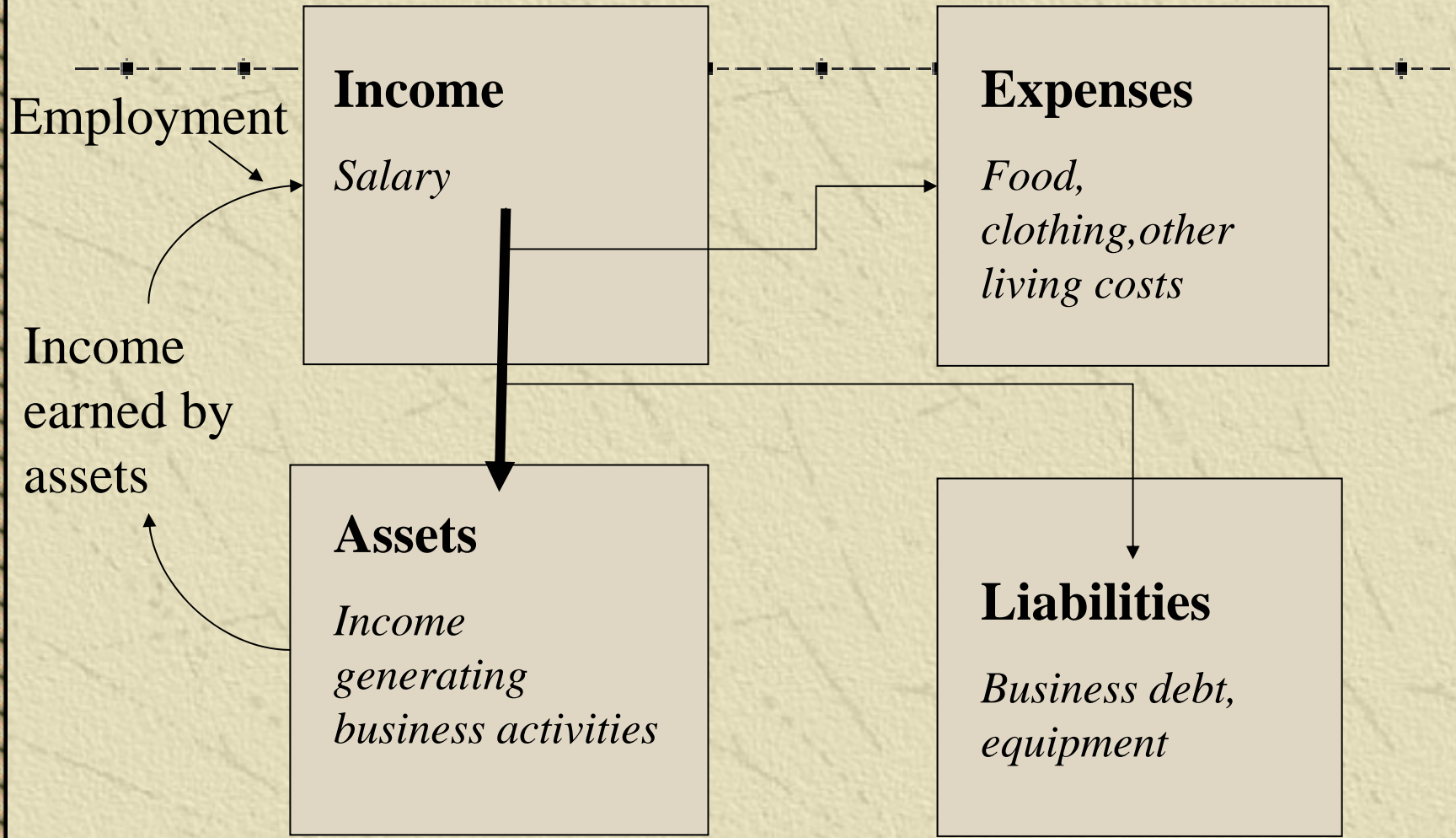
Liabilities - Items that do not earn an income

# Kiyosaki's definition illustrated




**Typical middle-class person with a non-farm job**

# Kiyosaki's definition illustrated



**Business owner who is building wealth**



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There is nothing wrong with  
farmers building wealth,  
particularly if it is moving you  
towards your lifestyle goal!

# Who are the Wealthy in the U.S.?

## Seven Characteristics of Successful Wealth Builders\*:

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1. They live well below their means
  2. They allocate their time, energy, and money efficiently, in ways conducive to building wealth
  3. They believe that financial independence is more important than displaying high social status
  4. Their parents did not provide economic outpatient care
  5. Their adult children are economically self-sufficient
  6. They are proficient in targeting market opportunities
  7. They chose the right occupation

\*From The Millionaire Next Door (1996) by Stanley & Danko

# Who are the Wealthy in the U.S.?

More Characteristics of Millionaires (more than \$1 million net worth)\*:

- 2/3 are self-employed
- Average annual taxable income is less than 7% of net worth
- 80% are first-generation wealthy
- Wear inexpensive clothes, drive older vehicles
- Most are meticulous budgeters, planners, and investors
- On average, invest 20% of taxable income each year
- Most could live on investments for ten years without working
- Wives are more frugal than husbands

\*From The Millionaire Next Door (1996) by Stanley & Danko