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The Danger of Refinancing

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Many farms have depleted working capital in the past several years. Now operating loan balances may exist that cannot be paid down with this year's cash returns from farming operations. Some farms may consider restructuring all or a portion of their operating balances as longer-termed notes. Refinancing may provide needed operating capital, but it also is a warning sign. If cash shortfalls continue and operating note balances build again, refinancing may lead to deeper problems in the future.

Situation

During the past several years, many farmers had cash incomes from operations that were not large enough to cover all the financial obligations of the farm. These financial obligations include paying income taxes, repaying debt, purchasing capital items, and providing for family living. Because of cash shortfalls, working capital has decreased over time. Working capital reductions include decreases in cash and other short-term marketable securities balances, reductions in grain inventory values, reductions in pre-paid expenses, and increases in operating note balances. On some farms, operating note balances may have become large so that they cannot be reduced with cash generated from farming operations.

At the same time, these same farms may have substantial equity positions. Farmland may be un-mortgaged and debt-to-asset ratios may be low. Farms in this situation could refinance their operating notes into longer-termed debt that is secured by farmland. Other farmers could use machinery or other longer-termed assets as collateral for a longer-termed loan.

The primary danger in refinancing is not addressing the underlying problem: The farm's operations are not generating enough funds to meet financial obligations. If cash shortfalls continue to occur, operating balances will again increase and the farm will erode its equity position over time.

For a concrete example, take a 2,000-acre farm that has 200 owned acres and 1,800 cash rented farmland. The 200 owned acres currently are valued at $10,000 per acre and are not mortgaged. There is $2,000,000 of equity in owned farmland which could be used to secure debt. This farm is projected to have $1,000,000 of operating notes that will not remain at the end of 2016. High operating note balance has occurred because cash rents on the 1,800 acres are too high. This farm could refinance this $1,000,000 taking a mortgage on the owned farmland. However, if cash rents are not reduced and commodity prices remain low, the farm will continue to generate cash shortfalls in the future. If this situation continues, eventually all equity in the farm could be exhausted and the operation would cease to be a viable entity.

Remedying Cash Flow Shortfalls

There are many reasons why a farm has cash shortfalls. Two of the more common reasons are 1) high cash rents and 2) high family living withdrawals.

High Cash Rents: Previous *farmdoc daily* articles discuss the need to reduce cash rents and other non-land costs (*farmdoc daily*, July 26, 2016; August 16, 2016). For farms with already eroded working capital positions, budgets for cash rents should be developed that use lower commodity prices that are likely for 2017:

- $3.50 per bushel for corn
- $9.00 per bushel for soybeans

While below long-run prices, the above prices could persist for several years. Costs should be cut such that the operation is sustainable at the above prices.

High Family Living Withdrawals: Family living withdrawals increased from 2006 through 2012 due to higher levels of incomes during this period. Many farms also added new, younger members to the operation. Budgeting to see if the farm operation can support current levels of family living should be done.

Using Refinancing to Bridge to a Period of Higher Returns

On some operations, refinancing may be thought of as a bridge to a period of higher returns. The $3.50 corn prices may increase closer to the long-run price likely above $4.00 per bushel. Predicting when corn prices could rise is difficult since the most likely event to cause a price increase is a yield shortfall someplace in the world (*farmdoc daily*, August 23, 2016). Price increases could occur next year, the year after, or be several years in the future.

Using refinancing to bridge to higher returns has risks because the timing of increases in prices is unknown. The rise in commodity prices could occur after the farm has exhausted equity. Budgeting to see how many years of low prices are sustainable seems prudent.

Summary

Many farms have the equity and debt-to-asset position such that refinancing remaining balances on operating notes is a possibility. However, the need to refinance is a warning sign that the farms are not generating enough cash to cover financial obligations. Before refinancing, the underlying cash flow problems should be addressed. More dire issues could be faced in the future if cash shortages are not addressed.

References

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