

Working Capital – Why Do I Need It Now More Than Ever?

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Given the challenges the timber industry has been experiencing, the stress in your life is probably higher than you ever imagined. As the future continues to look volatile, you may find yourself asking, “How can I lower my stress and protect my business from this bumpy ride?” Dr. David Kohl, an Ag Economist specializing in Business Management and Ag Finance, put it best when he said, “The answer is getting back to the basics. Working capital reserves on the balance sheet protect against financial adversity.” Protection against financial adversity will go a long way towards stress reduction, with a greater and longer term impact than a day at a spa or a week’s vacation.

Lenders preach working capital; what is it?

Working capital is found on the top portion of your balance sheet. Defined as current assets minus current liabilities, financial analysts recommend that you put working capital into context by comparing it to your operating expenses or your revenue. Current assets are more than just cash or cash-like instruments such as bonds and CD’s. It can include assets like wood inventories, accounts receivable, pre-paid expenses (like fuel or stumpage down payments), or anything that can be converted to cash without disrupting the normal operations of the business. Current liabilities are defined as those payments on term debt and accrued interest that are due in the next 12 months. Operating loans, credit lines, credit card debt, and accounts payable are also part of your current liabilities.

Why is working capital important?

Everywhere you look today we see volatility; there is market price volatility, stumpage price volatility, fuel price volatility, volatility in counterparty risk (i.e. loss of mills/markets) and financial market volatility just to name a few. As volatility continues to loom on the horizon, maintaining liquidity is more important than ever.

We’ve all heard the statement that ‘Cash is King.’ Working capital embodies this statement by giving you the liquidity to take advantage of future opportunities but more importantly, in today’s environment, it gives you the staying power to weather the storm. You may think of it as your ‘rainy day’ fund.

A lack of working capital can be a serious problem especially considering the amount of capital required to run a logging operation today vs. that of 5 or 10 years ago.



Without working capital you may need to sell less liquid assets to meet obligations and create liquidity. Creating liquidity from sources other than earnings can be painful, because often it comes in the form of selling real estate to catch up on bills or borrowing money from your lender at higher rates of interest than you are accustomed to.

Having enough working capital helps you maintain a healthy independence from your lender. Working capital buys time until you can get back on your feet or until income returns to a more normal pattern.

How much working capital do I need?

The amount of working capital you need is dictated by your obligations, income stream and size of operation. For example, if your operation enjoys a steady demand for wood with little change based on the season (winter or summer) you might need less working capital than an operation with the majority of its production and income coming during the winter months.

At AgStar, we use Current Ratio as one of our core lending standards. Our threshold target for logging operations is a Current Ratio of 1:1. However, working capital needs to be increasing in volatile times like these. Given the current environment we encourage producers to maintain a Current Ratio of 1.15:1 or higher.

How can I build working capital?

Building working capital is possible. The most desirable and enjoyable way to build working capital is to make money. Even when times are good, building (and maintaining) working capital with excess earnings takes personal restraint and dedication. It rarely happens overnight, and may take discipline over a three to five year period to increase working capital reserves to the target level. Outlined below are things to consider as you look to grow and maintain working capital during volatile times.

- **Minimize capital expenditures.** New investments in land, buildings and machinery should be carefully evaluated. Be a student of your business. Are those purchases necessary to maintain the productivity of your operation or are they done to avoid paying taxes? Resist the temptation to make purchases solely to avoid paying taxes. Avoiding taxes may not be the right strategy during volatile times. According to Dr. David Kohl, "Many businesses go broke attempting to minimize taxes." If you do make capital purchases, consider financing them instead of using cash ... at least until you have a comfort level as to what your cash operating needs will be for the next year.



- **Minimize interest rate risk.** Look for ways to lock in the interest rate for the term of the loan or at least for a number of years. This removes some volatility in the credit markets and allows you to know your term payments and plan accordingly.
- **Do not pre-pay intermediate and long-term debt.** It may be tempting to pay down intermediate and long term debt. Before doing so, carefully consider possible future cash needs. If you have debt locked in at a low rate it might be better to invest your cash in more liquid sources. As markets stabilize and you find you have weathered the storm with excess cash, you can always pay down debts at that time.
- **Invest in short-term liquid assets.** Use excess capital to pre-pay expenses or invest into short term money market accounts or other liquid investments. AgStar offers a Farm Cash Management account tied to your operating loan as an alternative to checking or savings. Proceeds are first used to reduce your operating loan debt. Excess funds earn market rates that are state tax exempt and help to build reserves for your future needs. According to the June 1997 Farm Management Update for the Virginia Cooperative Extension, “Rainy Day Fund – Building Working Capital in Good Times,” the objective of your rainy day fund is not to maximize your return but to have a safety net available should revenue be reduced or operating credit becomes hard to find. While stated in 1997, it remains relevant today.
- **Reinvest intermediate or long-term assets into liquid assets.** Take a critical look at your balance sheet. Do you have assets that aren’t working for you? Do you have what Kohl often refers to as “killer toys” or “ego purchases?” Can you re-invest the money you spent on these into more liquid assets? Sometimes it’s a hard decision but eliminating non-essential items can help your business in the long run.
- **Manage risk of production loss.** Develop a comprehensive risk management plan. This should include life insurance, property/casualty insurance, disability insurance, etc. Unfortunately, unforeseen events can and do happen often without notice and at a time when stakes are high. Being caught without the right risk protection in all facets of your operation is similar to losing a leg on your three legged stool. You stand a good chance of collapsing and even if you are able to remain seated, it won’t be easy.

Are there other ways to build working capital?

Yes, while there are other ways to build working capital they are often less desirable both from your standpoint and the standpoint of lenders.

- **Restructure your debt.** Depending on your particular circumstances, you may be able to restructure debt, reducing the liability in the current portion of your balance sheet by spreading it out over a longer term. While this will build working capital, loggers and lenders should be cautious with this approach.



If corrective actions to maintain working capital are not taken and/or profitability is not improved, it will be a short time before the operation is back in the same situation and your future options become even more limited.

- **Look for equity partners.** Look for cash infusions through equity partners. However, this comes at a cost, most often as a loss of control or having to answer for your decisions to a new business partner.
- **Sell term assets.** This goes beyond the liquidation of non-essential assets and moves towards downsizing your operation. Doing this may limit your ability to take advantage of volume discounts and impede future growth.

What are common errors people make when they think about building working capital?

It's easy to think you have ready and abundant access to cash. Beware of the false comforts of ready credit. Here today and gone tomorrow isn't just a glib phrase, it's a reality all too often seen by borrowers. As an example, credit card lines and operating notes are NOT a substitute for cash reserves. Many farmers in the 1980's utilized multiple sources of operating credit, in essence robbing Peter to pay Paul which eventually caught up with them. It's a slippery slope to walk if you must rely on credit lines in times of need. Not only can they charge high rates of interest but they also can dry up quicker than you realize.

There are many ways to think about working capital; it's the rainy day fund, it allows you to live another day, it helps you absorb the shocks or ride out the turbulence. The bottom line is it's important to think about working capital. In today's environment, adequate working capital will be needed for long-term success and can help take the stress off of you and your operation.

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