FCC Knowledge Podcast – Episode: Season 3, Episode 2

Title: Assess your financials to prepare for farm transition

PODCAST TRANSCRIPT

Interviewer: (N)
Guests: Andrea De Groot (AD) and Corey Henderson (CH)

N: From AgExpert, it's the FCC Knowledge Podcast, a show that features great conversations about the business of farming while guiding you down the pathway to transition.

AD: A generation ago, the transition plans were not nearly as complicated and the situations that we're dealing with right now really you need to understand the numbers and then you also need to understand the story about what's going on within that operation.

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N: Hello, and welcome to Episode 2 of our 9-part series on farm transition. In Episode 1, we went over the first step in the transition process, prepare and identify. This step involves gathering details and documents about your farm structure and estate while identifying who the specific key players are in the transition process. Today's episode is all about Step 2, which is assess your current state. We are joined today by FCC business advisors, Andrea De Groot and Corey Henderson. They're going to guide us through the process of summarizing and reviewing a farm's current financial position and structure. There's a lot of valuable info to come. Stick around.

AD: Hello everyone. My name is Andrea De Groot and I'm a business advisor with FCC. I am joined today by Corey Henderson, a business advisor with FCC. Welcome Corey.

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CH: Welcome everybody. I'm coming to you from down in the windy southwest corner of Saskatchewan in Speedy Creek.

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AD: I really like your term of Speedy Creek. I haven't heard that one yet. I'm coming to you today from Stratford, Ontario. We are representing the East and the West today.

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CH: Yeah, so today, we're going to be talking about a variety of topics, but the idea behind a lot of what we're looking at today is really just looking at the current state of your operation. Now, you might look at that and say, well, if we're talking about transition or preparing for transition, why are we looking at the current state? Because isn't that going to change? And really, what we're looking at here is, transition is a journey. So, similar to if I'm trying to find my way out to a farmer's home quarter, for example, I'm going to call for those directions. Similar, you might be looking for a little bit of guidance on your transition journey. And the first thing that the farmer is going to ask me when I ask for directions out to his place is he's going to say, where are you coming from or where are you right now, because those directions only really mean anything if you know kind of where you're starting. Well, the same thing goes for transition. If you need to know what next steps to take and where to go from where you are today, you've kind of got to know where you are today to figure out what those next steps are. So, that's kind of our goal today, is to help you determine where are you today in a variety of different areas. We're going to start by looking at your current management on your operation to date, and then we're going to move into some current financial ratios, some of the more important ones that we like to focus on. And then we're going to move into looking at some operational efficiencies. And then we're going to wrap it all up talking about some cash flow management. What are some of the topics here that you see as the most important right now, Andrea?

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AD: You know what? I think a lot of people can look at these four different categories and see that they're really interconnected. And what we've tried to do is to separate them out and take one topic at a time and really dive deep into each of these, because they overarchingly all do connect. But in order to talk about them in great detail, we're going to need to take one item at a time. And I would say that with agriculture getting a lot more complicated, we need to slow things down and to really break these items out to have a more detailed conversation. Because a generation ago the transition plans were not nearly as complicated, and the situations that we're dealing with right now really you need to understand the numbers and then you also need to understand the story about what's going on within that operation. And that's why we're going to start with management today. But I think overall, all four of these topics are incredibly important.

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CH: Yeah, I think you touched on something there, how things have changed over time. As we all know, the values are a lot different today than what they were in the past, but also the structures are a lot more complicated and potentially more people involved than there was in the past, and just a little bit more complex. So, it's not necessarily something to be afraid of, but definitely something that we have to continue to address and look at and be aware of, right?

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N: I imagine some of you listening might be having a bit of anxiety just thinking about assessing your current financial state. There are expert financial advisors out there for a reason. However, to those of you hoping to do some financial detective work yourself, Andrea and Corey suggest that it's probably helpful to slow things down and take it one step at a time. This topic requires careful analysis. Knowing the specifics of what's going on within your ag business is very important. This step in the transition process can enhance that understanding. Furthermore, it can be hard to know what steps to take without having a good grasp of the current state of your farm. So, the first thing Andrea likes to do with clients is ask them questions about how the farm is managed. I'll let her elaborate.

AD: When I sit down with people and we start talking about transition planning, these are four questions that I always start with. And on the surface level, they all seem rather simple. They're very easy questions. But as you start to dig deeper into them, there's actually a lot of complex issues that come from these questions. And so, we're going to impact each of these questions one at a time. Let's start with the first one of who is doing what. And this means more than the physical labour on the farm. This also means the bookkeeping. It means the human resources, so who's taking care of the employees. Who is doing the negotiation or does it matter on what kind of negotiation is actually happening. If it's something like purchasing a piece of equipment, that's one kind of person. Whether it's booking or selling crops, maybe that's another person. But who is doing the negotiations? Take some time to actually think through who are doing each of these tasks, because often in so many cases, it's getting done but not necessarily everybody at the table knows who's doing which task. And the next question that comes from who's doing what is how is work divided, especially when we have mixed enterprises or if there's more than one commodity within a farm, how is that work being divided out? Is it by commodity, is it by task, or is it all hands on deck? So, if it's a special time of year, then everybody is going to be joining in and really working through all of that work. The next question is, who is leading or who is deciding what? Before we get to the financials, it's important to recognize that these financial results are a direct connection from the people who are making these decisions. So, what is that decision-making process? Who is making the decision? Is it a group? Is it a consensus? Does everybody know what the decision-making process is for major and minor details within the farming operation? This is often where people get tense because they don't know that process or it changes and they don't know when it changes. So, recognizing and clarifying what that decision-making process is is really important. And in the last session, Joel and Annessa went into some detail to describe the importance of that asset ownership. So, taking the time to know who owns what asset and in what structure it's actually held. Is it in a corporation? Is it personally held? Is it a part of a partnership? Who owns those assets and does everyone at the table again have that same amount of information about who owns those assets, who needs what? We're going to start by doing this and asking this question at the beginning. When I think of who needs what, one of the core questions that we're going to come up with is that senior generation.

What does retirement mean? Do they want to still be involved? Do they want to reduce? Do they want to split some of their time? What kind of financial settlement or financial needs are they going to have in their retirement? That's one element of it. For that junior generation, understanding these expectations and these needs is really important, so it's a matter of what expectations do they have coming in? What kind of financial obligations are they making or are they going to need? These are important questions to ask at the beginning because then we know where people are starting at. They will change over time, but again, taking some time to really start and write all of these questions out and write how this is getting impacted in your business right now, this is a really important part of starting this financial conversation.

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N: Again, just to summarize, ask yourself these four questions about your farm's management structure. Who is doing what? Who is leading or deciding what? Who owns what? And who needs what? Now, let's listen to Corey share some real-world examples of how management analysis findings can vary.

CH: Yeah, I think why this management analysis is so important, you can kind of look at two different extremes. You can have one extreme where that younger producer is either not involved today but looking to get involved or is maybe involved in more of a hired hand capacity where they're providing labour, but maybe not as involved in any of the management decisions. And then the other end of the spectrum is a scenario where there's maybe that junior generation is running a separate operation on their own where they're sharing maybe labour and some equipment and maybe already own a bit of farmland or rent some of their own farmland. They've already got a relationship with an accountant and they've got a relationship with a financial institution, they're making some of their own marketing decisions, things like that. They're doing a lot of the same management tasks as their parents but just doing it maybe on a smaller scale. In those two different scenarios, you can see how the learning curve is a lot steeper for the first example than it is for the second example. And the confidence is also far greater in the second example than the first, because that producer is already, they kind of know what they need to do. They've been practising it. They've probably made a few mistakes along the way, which is a good thing, and learned from them hopefully on a smaller scale. Whereas that first example, they've got a lot to learn and it's going to take time for that confidence, both for that junior generation and for the senior generation in that case as well. So, I think that's a good illustration, in my opinion anyway, of why that management analysis is so important for us to look at when we're looking at this current state.

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N: Andrea and Corey provide some great insights about management analysis. Clearly, every farm has a unique management structure and it's vital to know everyone's experience level and role to fully value everyone's needs and expectations. So, now that

we have a good sense of how to start a management analysis on our own farm, how are decisions made on most farms? Corey has some valuable insight to share here.

CH: I guess what I find in a lot of our scenarios is maybe they say, well, we make the decisions by consensus, because that's always the dream, I think, is to make those decisions by consensus. But when push comes to shove and there's a disagreement, then how is the decision made, because I think that's a true tale of really how decisions are made. It's really easy to make decisions when everybody is arriving at the same conclusion. But it's when you're going two different directions that you've got to say, well, okay, what do we do then? Do we have a process? Does somebody kind of have the ultimate decision? In which case, then it is maybe a little more of the single person deciding. We're seeing people say consensus, but is it really a consensus in the end?

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AD: I can't agree more, because I often ask this question when we're at the kitchen table with families, and they will say consensus. And then you start to ask the question and and it seems to feel that one person really truly believes that this is a consensus, while the reality is it depends on the decision that's being made. So, if it's a larger decision, I would say that really truly, that's going to be pulling in more information. While when we're having maybe an equipment or a smaller scale decision, that's going to be that person who's most involved or maybe it's a time decision where something needs to be decided in a really short order.

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CH: We're going to go onto some tools you can use, I guess, to kind of help yourself make decisions, and one of those tools is financial ratios. What is a ratio? Basically, a ratio is just a way of comparing a certain financial aspect on your operation or some data on your operation to another financial aspect. And the value of a ratio is that it adds a little bit more substance to a number. And it allows you to compare your operation to say other operations in the industry or other maybe neighbours, that type of thing, even if you maybe are a little different structure or a little different size, that type of thing, because it kinds level sets, I guess, amongst these different operations. There are countless ratios that are out there. There's a lot that exists and you can even come up with your own ratios if you really want to measure every aspect of your operation. So, what we're going to focus on today is three key ratios that we see as very important for any farming operation, as well as if they're used pretty universally across business and across the different industries that we deal with. The first of which ratio, in my opinion, is one of the more important ratios, which is the current ratio. We like to complicate things. We use lots of different terms, of course. Another term for the current ratio is the liquidity ratio or working capital. So, if somebody says what's your working capital look like or what's your liquidity like, really they're all referring back to this current ratio. How do we calculate current ratio? The formula of it is fairly simple. It's basically current assets divided by current liabilities. Current assets are any assets that are either cash or expected to be converted to cash in the next 12 months. While current liabilities are

basically things that are payable within 12 months as well. So, current assets is cash, accounts receivable, inventory or potentially market livestock. While current liabilities would be things like balances on your lines of credit, your accounts payable for the year, as well your current portion of long-term debt, which is basically the payments you have due for that particular year. We all want more inventory and more cash than we want payables. So, the higher that ratio is the better, the stronger it is. And anything greater than 1 basically means that you have sufficient cash and inventory to meet the payables and things you've got to pay for, for that particular year. Anything less than 1 shows that there may be a shortfall in the amount of inventory or cash to meet those commitments for the next 12 months. And that may be a concern depending on your industry and depending on what the story is behind it, which is also I think a key thing to realize, I guess, with ratios is that really the story is almost as important as the ratio itself. So, if you find that ratio, that maybe you're higher or lower than a benchmark, don't despair. Look at, try to figure out why is that ratio different than maybe the rest of the industry, and then if it is a concern, then how do we change it, right?

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N: Well, for all the math lovers out there, this episode is definitely for you. However, just in case you need more clarity like myself, the current ratio measures your farm's ability to pay short-term obligation for those due within a year. In simple terms, do you have more assets than liabilities? The higher the ratio, the better in this case. However, as Corey points out, context is important. Perhaps there's a specific reason why your ratio is lower and it's important for you to analyze this within the context of your own farm and your specific industry. Now, let's let Andrea share some more information on how the current ratio can be influenced by fluctuating interest rates.

AD: So, in terms of when you're looking at these ratios, the concept can kind of feel foreign until you actually have the ability to take a real life scenario and work through it. And so, what I'm going to do today is talk through unfortunately a very real situation for everyone today, and that's the increases in the interest rate that we've seen from the Bank of Canada since the beginning of the year. So, the Bank of Canada, which is the overnight rate, has increased by 1.75% since the beginning of the year. So, when we're thinking specifically about the current ratio and we're talking about liquidity, that means that the cash in and cash out that you have in your operation. How does an interest rate increase like that 1.75% increase that we've seen so far this year, how does that actually translate, and what aspects of your current ratio would be impacted by that? So, as Corey just highlighted, your assets, that's going to be relatively independent of that. But we're going to be talking about the current liabilities. So, in the current liabilities and especially when you think of interest rates, a lot of people tend to go to long-term debt. So, whether you have that long-term mortgage payment or any of those kinds of situations, that's what they think of when they think of interest rate increases. How is it going to impact that debt? And that comes back in and is actually calculated in the current ratio through the current portion of your long-term debt. So, that's the debt payment in the next 12 months. That's going to take into account your principal payments as well as your interest costs. So, you have some of these debts already put

into fixed-rate costs. There's not going to be a change in those interest rate costs because you're going to know your blended payment. However, if some of your longer-term debt is actually on variable rates, this is where you're going to see that current portion of long-term debt go up, because your interest costs are going to be increasing over the next 12 months. So, that current portion of long-term debt is going to be going up as that impact of that interest rate is felt. Your payables is another part in your current liabilities where you're going to see some potential for impact from that interest rate increase. So, taking a look at if you're having to carry payables, what is the interest charge that's being charged on those and is that increasing with this interest rate increase?

N: For the non-accountants in the crowd, payables are money that is owed for services or products that are provided by other businesses or individuals, things like transportation, raw materials, power, energy, fuel, equipment, licensing, services, and the list goes on.

AD: The last is the most significant, and that's your line of credit or revolving credit. I'm going to take a couple of minutes to actually talk through the impact of this interest rate increase on the line of credit specifically. One, is we're going to use some actual numbers because it's easier to actually follow through when we're talking with financial numbers. So, I'm going to use an example of $1 million. This line of credit or revolving credit line is for $1 million. And last year, I'm going to use the example that the interest rate on that $1 million line of credit was about 4%. This year it's 5.75% because we've had that 1.75% increase year over year. So, your actual cash costs have increased about 39%, 40% year over year. So, that means that your revolving credit line even if you've done it differently is going to be taking more. Your interest costs on that are going to be actually increasing year over year. And the reason I'm bringing up the line of credit specifically is because a lot of people don't necessarily pay attention when the interest payments are connected to their line of credit. It comes in and it goes out and it's all connected to that line of credit. But this is something that as it goes up, as your interest rates go up, your line of credit or revolving credit line, you can't put a fixed rate on it. So, it's completely exposed to whatever the Bank of Canada does. It's going to go up and it's going to go down. And again, the reason I'm spending a little bit more time on here is maybe not everybody in your operation understands how your revolving credit works. This is a time to use this as an example to talk through, especially with that next generation, how revolving credit lines actually work, because the year over year is going to increase. In this example, it's about a 40% increase in actual costs, but that's all going to be connected back to that current liability, and that's going to be depleting or reducing that current ratio, meaning it's taking more cash to service the debt that we have right now in our current liabilities. So, that's one example where interest rates and your current ratio are actually interconnected.

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CH: I think the key there is to be consistent, especially if we're measuring it at periodic times throughout the year and comparing it to the past. But quite likely, it's probably best to do that measurement kind of at the end of production cycle because it's a little bit of a cleaner time.

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N: It's pretty clear how a variable interest rate can impact your current ratio based on how the rate fluctuates throughout a year. Simply put, higher interest rates require higher amounts of debt servicing. Don't forget to factor in interest rates when calculating your current ratio. Now, let's let Corey elaborate on our second ratio, debt to equity.

CH: Another term for the debt-to-equity ratio is a leverage ratio. Once again, why do we care about the debt-to-equity or the leverage ratio and how do we calculate it? Your debt-to-equity ratio is calculated by taking your overall debt on the operation divided by the equity. So, your equity is your total assets minus your debt for your overall net worth number. We tend to want less debt. I say this as producers, I guess, and as a financial institution, usually less debt relative to the amount of assets is probably better. The lower your debt relative to your net worth the stronger that ratio is. If that ratio is 1, basically that means you have the same amount of debt as you have equity. If it's below 1, then you have more equity than debt. And vice versa, if it's above 1, you have more debt than you have equity. Why do we care? Basically, if you're a younger producer and you've been expanding maybe starting your operation, you haven't had that chance to build up the equity, you've probably been taking out some new purchases, maybe you're taking over an existing operation, you're likely going to have a little higher debt to equity. And that's okay, as long as the cash flow is there to meet all the commitments. Whereas if you're more of a mature operation, I would expect that debt-to-equity number to be a lot lower because chances are you've bought a lot of assets a number of years ago that have appreciated maybe over time or you've paid down debt over time and you've had that time to build that equity. Those numbers can vary drastically and they're both potentially acceptable as long as the cash flow is there. Our last ratio that I'm going to look at right now is the return on investment or return on assets. The way that we calculate your return on investment or return on assets is we basically take your net income from your financial statement and we divide it by the total assets. Once again you might ask, well, why is this important? To me the importance here when I look at a lot of operations is that agriculture is a capital hungry business. You need a lot of assets to generate revenue. And this just gives you an opportunity to be able to look on your operation. How efficiently are we using the assets we have and maybe are there any opportunities to generate more revenue with the same assets or are there other assets that could be leveraged to kind of add that revenue?

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N: After the break, Andrea and Corey are going to share some valuable tools available from FCC that can assist you in calculating ratios. They will also continue our discussion about assessing your current state. Math lovers don't go anywhere.

AD: And again, back to Corey's point of the numbers are important but the story is more important. When you understand what's going into these numbers that's when you can take the time to have the conversation with your next generation or even your farm

managers, and that's when we're going to see the increase in the financial literacy. You're going to understand the story and the why of what's going on to change these numbers.

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N: Welcome back. So far, we've had some pretty in-depth discussions about management analysis and about calculating some key ratios that help you assess your farm's financial state. These ratios include the current ratio, the debt-to-equity ratio and the return on investment ratio. It goes without saying that it's helpful to have a clear picture of your farm's finances whether you're going through a transition or not. However, some folks likely find it challenging to properly assess their financial situation. The ratios discussed earlier are highly effective tools that provide the needed data to help you properly assess your situation. What's even better is that FCC has ratio calculators available on their website. Head over to fcc.ca and search ratio calculators in the search bar. There you will find some simple online calculators available for all the ratios we noted earlier. Let's hear more from Andrea and Corey about these calculators.

AD: Now, I do understand that some people at home don't quite enjoy doing the math and doing the calculation quite as much as Corey and I. And so, Corey went through a lot of the details of what these financial ratios are and how you're going to use them, what they mean and why we want to care. And with all of that good information, now we need to talk through how can we actually do this and how can we do some math at home. And we have three different calculators here. We have liquidity, which is our current ratio. We have solvency, which is our debt to equity. And then we also have profitability, which is that return on investments or return on assets that Corey just spoke through. So, how do we get these numbers to input into this calculator now? And oftentimes we see that when you get your accountant prepared statement, so at the end of the year you have all of this information and either your banker or your accountant will sit down and will have these ratios already calculated for you. But what do you do during the year? How do you get the information to make sure that you can go and actually, figure out your current ratio during the year just as Corey was talking about, that cash flow cycle? So, what I'm going to talk through is a bit of the step by step process on how you can calculate some of these financials using these calculators during the year. If you're going to be going and using your internal bookkeeping systems, and I'm going to use an example like AgExpert, what you're going to need to do is once you've updated maybe even on a quarterly basis, you're going to have all your income and your expenses for that quarter in there. Then you're going to want to run a balance sheet. In that balance sheet, you're going to have your current assets and your current liabilities. You're going to take those two numbers and you're going to input it into this calculator and that's

going to give you the number, and it's also going to give you some ratios of maybe where you want to hit in terms of a benchmark. However, we're going to take a moment because Corey was just talking about the importance of using consistent numbers. So, before you input those numbers straight from your AgExpert or from your internal bookkeeping, take a look at them. Are they realistic numbers? When you're looking at your inventory, is this carryover from your last year-end and you maybe haven't updated your inventory? Because not everybody always keeps their internal bookkeeping for their inventory numbers right up-to-date. Take a look at the value that you have there, and is that a realistic reflection of what's going on in your farm right now? And I would also encourage you, if you're going to be using these ratios during the year, write down what you included. So, is it per corporation or is it your entire business, maybe some corporate farms and some personal as well? What's being included, what's being recorded in these numbers? That's important so that as you're moving forward, you can come back and you compare. And when you have that information, you're comparing apples to apples, because this information, this is for you. We're not calculating these numbers for the banker or for anyone else. This is for your own management. And again, back to Corey's point of the numbers are important but the story's more important. When you understand what's going into these numbers, that's when you can take the time to have the conversation with your next generation or even your farm managers. And that's when we're going to see the increase in the financial literacy. You're going to understand the story and the why of what's going on to change these numbers.

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N: These are some powerful tools, and as Andrea expressed these tools are there to support you in managing your own financial situation. The ratios provide a great peek into your financial state. And the stories behind these numbers are just as important as the numbers themselves. Don't forget to analyze your ratios in the context of your own farming situation. Again, you can find the FCC calculators at fcc.ca by searching ratio calculators in the search bar.

CH: I know for myself when we're talking about ratios, we're joking about being as excited as we are, I guess, about it. What interests me is really, how these ratios all work together. And then to kind of see that potential or in a lot of cases, even when I talk to a client about here's something that I see in your operation, it looks like maybe your liquidity ratio is a little bit tight. They're like, totally, it seems like we're always living hand to mouth, that type of thing. So, it's funny how when you bring up the ratio, they kind of know it but they don't necessarily see the ratio itself, or they haven't really calculated themselves. So, hopefully, this kind of helps everybody put some knowledge about what these ratios mean.

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AD: Absolutely, and I do tend to see that if we can use a common language, that definitely helps. So, when we're talking about liquidity or working capital, we understand when we say current ratio. We know how that math is done, and so then, we can understand how

the changes are actually going to impact that change in the math or that change in the ratio. And I find that people will be using the ratios at year-end or when maybe they're going to be making a larger purchase, they lean on their banking or their accountant for those larger ratios. But it's not something that they use day-to-day in their everyday kind of decision-making process. It tends to be driven by bigger events like that year-end or large expansion. And when we can get used to and incorporate these kinds of decisions, it's really important, and it increases that financial literacy, which is ultimately, what we're trying to do here.

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CH: So, we're going to move on to talking about operational efficiencies. Once again, I'm going to touch on a ratio that we use when we're talking about operational efficiencies because we love our ratios. So, that particular ratio that we're going to discuss is the operating expense ratio. The way that you calculate your operation expense ratio is you take your variable expenses or your operating expenses, which are basically any expenses that are kind of directly related to the production of whatever commodity you're producing. And they tend to vary with the size of your operation from year to year and they don't usually include any overhead items. So, they don't usually include land rent or payments for the year or depreciation or those type of things. They do include things like your inputs, like your fertilizer, your chemical, maybe the wages for a hired hand, fuel, repairs, that type of thing I guess. You calculate operating expense ratio. You take your total operating expenses or total variable expenses and you divide it by your gross revenue. So, to give you an idea of kind of where different industries stack up as far as an average is concerned, a grains and oilseeds operation on average would be probably somewhere around 65% operating expense ratio. Dairy would be 65 to 70%. And say a feed lot would be quite a bit higher at about 95%. So, for a grains and oilseeds operation, for example, at 65%, what that means is for every dollar that that operation is generating of gross revenue, they're spending about 65 cents in variable expenses or operating expenses, which leaves about 35 cents to cover overhead, to make loan payments and to pay living expenses and that type of thing. In our current environment with inflation on the rise, that's going to get even more important because inflation tends to impact the expenses more than the revenue. So, if your operating expense ratio … I would expect there's a good chance that it's going to get higher as time goes on if the expenses are going to grow at a faster rate than revenue. When you're looking at your operating expense ratio, similar to what we were saying before, the story is as important as anything. So, when we're looking at a mixed operation or maybe depending on your structure, that may impact your operating expense ratio as well. So, if you're a mixed operation like I said a feed lot and maybe a grain operation, I would expect that to be a little higher operating expense ratio. The same thing if you're like a cow/calf producer or a dairy that owns a lot of your land base and grows your own feed, I would also expect that operating expense ratio to be a little bit better than average because you're basically growing your own feed and you're not having to buy that feed. Now, that operating expense ratio has to be a little bit better in that situation because you're also likely making a little bit more loan payments than what another operation would have that's buying that feed, right? Once again, it's the story behind it and that's what's important.

So, the final ratio that I'm going to talk to as far as the operational efficiencies is just looking at your profit drivers. So, like I said before, there are a lot of mixed operations out there. There are also a lot of operations that have got a lot of irons in the fire. And oftentimes we don't actually look at what aspects of our operation are the most profitable or the most efficient per se. It's just overall our operation is making X amount of dollars. So, what I mean by profit drivers is really looking at, okay, this aspect of my operation is generating this return on assets or return on investment, so back to that ratio that we said before. Whereas this area of our operation is maybe generating higher or lower depending, that may help us make that decision on maybe where we focus our efforts, where we spend more time or where we expand, depending on opportunity. So, that profit driver's very important if you're looking at how can we be more profitable going forward or where can we expand to add more cash flow?

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N: Identifying your operational efficiencies is another key piece of assessing your current financial situation. Having a clear picture of how much money it takes to make a dollar is vital to knowing your profitability as a whole. It also provides a benchmark for yourself to compare to. Whether it's comparing your own progress year over year or comparing to an industry benchmark for operational efficiency, your operation expense ratio provides some crucial data for comparison. So, how does your operational efficiency compare to other local producers in your industry. Well, FCC has a tool that helps you make this benchmark comparison. Let's let Andrea explain.

AD: This is a new initiative for FCC and right now, this is available for dairy and for grains and oilseeds. Let's talk about how this actually works. Understanding your current operation is really essential to know how and if you can change your operation and what options you have going forward. Let's talk about how you're going to get access to this report. What you would do is if you have a relationship manager, reach out to them, and if you're not an FCC client, then you can just reach out to your local FCC office. You're going to need to prepare two years or provide two years of your accountant prepared statements, and this is going to provide a report of similar-sized operations in your geographical area. And it's going to highlight there's actually five different areas that it's going to break down. And the first one is going to be revenue. And expenses are all broken into in this example with the dairy. So, there's dairy expenses that are directly connected to producing milk, your fixed expenses which is more like your overhead costs, and then your variable. And then at the end, it's actually going to give an output of some actual profitability. So, you're going to be talking about a few different ratios. So, let's get into a little bit more detail about what's included within this benchmark or report. So, when you actually pull up the report, milk before deductions has the benchmark, which is the group average. It's then going to have your operation followed by the rank. So, when you provided the last two years of your accountant prepared statements, that's going to give three years, and you can start to see trends. You can see trends in the industry because of that benchmark, that group average, and you can see trends within your own farm. And by going through and having different dairy expenses, which would be feed, breeding, live stock purchases, any of that kind of stuff, your fixed

costs are going to be larger like your depreciation, land rent, property taxes. Those kinds of fixed costs that are not determined are not necessarily determined on how much output you're going to be making. And then those variable costs are going to be those building and repair costs, your fuel costs. These are the ones that for this particular year we're going to be seeing some inflationary pressures on these items. But with having a three year, you get to see the changes in your operation year over year and compare to what that average is. This isn't just coffee shop numbers. These are actual numbers from other people's financial statements. So, there's some credible information that is being provided. The last page is your profitability page. So, we're going to talk about net income per kg. After all this expense, what's left over? We're going to talk about term liability. So, in that situation we're going to be talking about your debt per kg, which is a common benchmark that a lot of people use. And the last part of that report is going to have an average amortization, so that average length of everyone's amortization. So, this report is available and I would encourage you if you're interested and you're in the dairy the grains and oilseeds industry, to reach out to your local RM, relationship manager, or your local FCC office and provide your financial statements as well as a production in terms of how many units of production you have. And you'll be able to get this report. Personally, I've been using this report as part of a knowledge gap assessment for the next generation. There's a lot of information in these reports and it's really nice to see where you are in your operation in comparison to other people.

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N: If this benchmark tool has your interest piqued, please reach out to your local FCC office. They can help you access the information described earlier. Having solid benchmark data to compare to is indispensable in your decision-making process and in assessing your current situation. Sometimes understanding what those around you are experiencing can help you assess how well your own operation is functioning. The next area of your financial situation to look at is cash flow management. Let's hear from Andrea on this topic.

AD: So, this is one of those areas that for a lot of people it causes a lot of stress. Cash is king is a key word that we find often in agriculture. So, when we talk about cash flow management, we're going to start with a couple of different ratios and a different concept. Well, not really a different concept but a concept that I find a lot of value in. And that's the cash flow budget. So, maybe leaning on your last year's financials and understanding when your cash cycles come in and what's going on in your operation. Understanding when the money comes in and when the money comes out. This is an area that takes a lot of mental load in terms of the person and typically that's one person that's going to be doing a lot of this work to understand how much money you have available for the operation to meet your monthly obligations. But if you can take that back up and actually look at an annual process and say, what's coming in, what's going out, and share that information with other people, you're sharing that mental load. And this is something that's really, really important as we're talking about moving the operation forward and moving that management forward. Does everyone understand what it takes to form a cash flow perspective for that money in and money out? When we talk about cash flow

management, one of the most common ratios is debt service capacity. So, that usually relates directly back to the term lending. And what it means is it measures the operation's ability to service the debt. So, for every dollar of debt payments it has, how much cash does it have to service that debt? So, the actual formula for this is that you take your net income from your farm and you're going to make a couple of adjustments. So, you're going to add back in taxes, term interest, depreciation, maybe take out those living costs, and you're going to divide that by the debt service or the requirements that you have on your operation. And that's going to give you that ratio of how much debt servicing you need and how much cash you have available to service that debt. Again, knowing the numbers and knowing the math is a big part of this. Taking that back and sharing that information and understanding the rest of the story is really, where we're going with this. So, I'm going to put it back over to Corey and he's going to talk about some of the different changes and some of the other ways that we can manage our cash flow management.

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CH: One common theme that I hear on a lot of operations when we're talking about transition is, so the next generation is quite eager to start building equity and wanting to be involved and taking over some ownership of the operation. But the senior generation may be looking at we don't have an abundance of cash, and they're really finding that there's only capacity to pay their existing debts and there's not a whole lot of extra for that next generation to come into. And what that comes down to in a lot of cases is at that stage of their operation there's a good chance that a lot of their debts are nearly paid off. So, they probably only have a few years left on them or maybe even some of the existing debts that they have, they maybe have taken a more aggressive amortization on to try to get them paid off faster. Oftentimes I hear the senior generation say, you know, I'm not going to transition anything until I have my debt fully paid because that's going to give that capacity for the next generation to be able to come in and take over and it's going to give them a bit of a break. That may be a good option in the end, but I also would encourage you to look at what is your existing average amortization on your debt? So, if you have an operation that has a $1 million worth of debt, for example, at an average amortization of eight years, so meaning there are some debts that are going to be longer and shorter, but the average is eight years at 5% interest, you'd have payments of about $155,000 per year. Now, if you took that same debt at 5% once again, and you stretch it out over say 25 years, which may seem extreme, but I'm trying to articulate I guess how much of a difference it can make, that would drop the payments per year down to $71,000. So, that's a difference of $84,000 per year. Well, that $84,000 could free up the cash flow for potentially some sort of a payout for that senior generation if the junior generation is wanting to buy a part of the operation. It also can provide some living expenses for that next generation if they're wanting to be involved but they're afraid of the capacity to provide their living expenses. Now, I will caution you on this as well that everything you're looking at there's usually a side effect and one of those side effects is interest costs. So, stretching out to the way that the payments work on these longer-term loans is, the bulk of your payment upfront on a longer-term loan is going to be interest on a lot less principal. So, as interest rates increase, the interest cost can add up awfully

quick. To show that impact, you could take the same $1 million that we just discussed that we said over 25 years is paid down. The payments were $71,000 per year. Now, if the interest rate increases from 5% to 7%, that increases the payment to $85,000. That doesn't seem that substantial. I mean it's $14,000 regardless. But when you look at actually what percentage increase in payment that is, that's a 20% increase in payment. So, you can imagine over the course of that 25 years how much extra interest that is that you're going to be paying. Although changing the structure of your debt can maybe make room for that next generation and it may be the right option for you, I would just say to exercise some caution and really try to find what's the right mix to remain viable but also to minimize that interest cost long-term. The other thing I would say to you as well when we're looking at interest rates, is really looking at your operation and saying, okay, how much of an interest rate increase can we afford with this transition? And really looking at if you can only afford a small increase in interest rates, what are our options to mitigate that risk? Can we look at some fixed rates, are those fixed rates affordable, that type of thing? Whereas if you're in an operation where you can afford quite a substantial increase in interest rates, maybe you don't have to be quite as concerned about those risks in the end.

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N: Yes, I'm sure you've heard before that cash is king. And understanding your debt service capacity is a big part of your business decision-making process. You need enough cash flow to keep things running while also servicing your debt. But, as Corey cautioned, you have to make sure your lending arrangements work for your specific situation. Risk mitigation always has to be top of mind with important decisions. And it can't be understated how important it is to consult advisors to help get additional perspectives and advice about your business.

CH: We're just going to start wrapping up here right now and we're going to talk about how to use your financial ratio. Once again, I can appreciate not everybody here is going to be as interested in ratios or as comfortable with ratios as Andrea and I are. But what I would say is that you have a lot of professionals around you that are comfortable and you can leverage to help you interpret the ratios on your operation. One of those professionals that I would encourage you to reach out to is your accountant. The other professional I would encourage you to reach out to is your FCC relationship manager. If you provide your FCC relationship manager with up-to-date financials each year for different lending needs that you're looking at, they already have a lot of that information inputted that they can look at and they can give you some feedback on what they're seeing and what are the ratios on your operation given that financial statement. And maybe even give you a third party opinion on where are some opportunities they see or maybe where are some concerns? So, I would really encourage you to reach out to both those professionals if you're not as comfortable maybe with calculating the ratios yourself or interpreting them yourself. The other thing I would encourage you to do is to set some time aside to talk with your family about where you're at with your financials on your operation and where your ratios are at today. Oftentimes there is somebody in the operation that is comfortable with calculating these ratios and is comfortable with

interpreting them, but are they sharing them? So, a regular meeting, whether it be depending on your operation, the size, complexity, who is all involved, maybe that's an annual meeting, maybe it's as frequent as a monthly or even a weekly meeting if you're a larger operation with lots of people involved and lots of moving parts. But basically, you'd want to calculate those ratios in advance, send them out to everybody who is going to be present for the meeting, give them a chance to look at them and review them. And then sit down and meet and say, where does everybody see, does anybody have any concerns, and really share where everybody is at. With that, I'm going to turn it back over to Andrea and she's going to wrap us up today.

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AD: Thanks, Corey. So, we often find that transition planning really does get kind of stuck or focused in on the financial challenges of the operation. So, one of our goals today was to highlight some of the ratios that you can use to really bring the conversation and bring everyone who's at the table using a common language and also to have another group of people that you can understand how to get this information and really how to move it forward. We also need people at the table and understanding where the operation is going and what kind of focus you're looking to into the future.

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N: Thanks, Andrea and Corey, for sharing your knowledge and passion for farm finances with our audience. I hope those of you listening heard some valuable and digestible information about assessing the current state of your farm's financials, and I hope this inspires you to start assessing it in a more effective manner. For those of you who have already identified a lot of the data discussed throughout this episode, hopefully, you'll revisit your farm state with some further clarity. So, what are some key things to take away? Well, we started by talking about management analysis. It's important to ask questions like, who is doing what, who is leading or deciding what, who owns what and who needs what? The answers to those questions will help you get a clear understanding of everyone's roles and expectations on the farm. These answers will also help you better understand your current decision-making process. Assessing your financial situation is a big part of assessing your current state. Many transition-based decisions involve refinancing loans and reorganizing assets. You need a good grasp of your financial situation to work through this. Learning how to calculate things like your current ratio, your debt-to-asset ratio, your return-on-assets ratio, your operating expense ratio and your debt service capacity ratio will give you real world data. This data will also provide you with some valuable baselines to compare to. Thankfully, FCC has a lot of tools available to help you make some of these calculations. There are also plenty of advisors at FCC willing to answer your questions. Always remember that this info is there to serve you and enhance your decision-making abilities. Don't forget to pay attention to the stories behind these numbers, because in the end, it's your own farm journey that counts in transition. Well, that's all we have time for today. Thanks again for checking out the podcast. Don't forget that this is Part 2 of a 9-part series, so join us next time

when we discuss Step 3 in the transition process, set values, visions and goals. Until next time, dream, grow, thrive.

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