How Are You Deploying Farm Profits?

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While the tight farm economy has many farmers focused on generating profits, it is also important to consider how profits, regardless of how small, are being deployed. How a farm deploys, or distributes, profits across current and non-current assets can be an important consideration, especially when financial conditions are tight.

As a quick review, a farm's annual profits result in an increase to the farm's equity position on the balance sheet. This equity can have two forms: non-current or current.

Non-Current Equity

Profits deployed to non-current equity can be used to 1) purchased non-current assets or 2) pay down non-current debt. Non-current assets can include equipment, buildings, grain bins, or farmland. In farming, it is common for producers to deploy profits to non-current assets by purchasing equipment. Tax-saving strategies, such as accelerated depreciation and Section 179, can make this very a valuable strategy.

The challenge with deploying profits to non-current assets (or equity) is that these assets are, by definition, less liquid. This makes the equity harder to tap into, or access, in the event of a future hiccup or tight-year. Furthermore, profits deployed to purchasing machinery are subject to deprecation over time.

Current Equity

Profits deployed to current equity can be 1) increases in current assets or 2) used to pay-down current debt. Increases in current assets often take the form of increased grain/livestock inventories or prepaying expenses for the upcoming year. Another form of current assets is cash-on-hand or savings.

What makes current assets attractive is that they are, typically, readily available to deploy. If 2018 turns out to be a difficult financial year, grain stored and held over from 2017 can be sold to meet the farm's financial obligations. Even in good times, current assets – especially cash – can be used to take advantage of good opportunities that might come along.

Warren Buffet, who is known for keeping large piles of cash handy at all times, likes to call his cash an "elephant gun."

The challenge with current assets is that they rarely generate a strong rate of return. Over the long-run, cash in the bank will generate a much smaller return than what a farm might generate from farmland.

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Furthermore, it is not helping generating revenue, like equipment or other farm capital assets. Other forms of current assets, such as stored grain, could be subject to large swings in values if unpriced.

Maintaining a War Chest

Building and maintaining a war chest of current assets can be helpful in two ways. First, it can help absorb financial blows from the uncertainties of production agriculture. Second, it can add flexibility for farms looking to seize good opportunities that might come along.

On the other hand, a large holding of current assets – especially cash – could limit a farm's growth over the long-run.

Each farm's preference for allocating profits to non-current and current assets (or equity) will vary, but this is a topic that management teams should regularly consider and discuss. Both have advantages and disadvantages. In today's financial climate, producers should carefully manage this distribution process and carefully monitor their current assets.

This topic was part of a broader presentation by the author, Dr. Michael Langemeier, and Dr. Jim Mintert at the 2018 Purdue Top Farmer Conference.

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