Why Does my Lender Keep Talking About Working Capital?

By Michael Langemeier

Working capital or liquidity is one of the most important metrics that a business needs to track. Working capital is computed by subtracting current liabilities from current assets. Current liabilities include operating loan balances at the end of the accounting period, and term debt payments due in the next year on noncurrent (e.g., breeding livestock, machinery, buildings, and land) loans. Current assets include cash, fertilizer and supplies on hand at the end of the accounting period, crops held for sale, and market livestock inventories. Raised and purchased calves and feeders, raised and purchased pigs, as well as other non-breeding livestock inventories, should be included in market livestock inventories.

Though working capital by itself is an important liquidity measure, it is often more relevant to measure working capital in relation to gross revenue (value of farm production can also be used) or on a per acre or on a per livestock unit basis. These adjustments make it possible to make comparisons across different farm sizes and over time for a farm that has been aggressively expanding.

Now, let's turn to the title of this article. Why is working capital so important in today's environment? To start with, working capital represents a farm's first defense against financial stress. When cash flow is tight or even negative, working capital can be used to cover the gap or shortfall. Working capital is also needed to replace machinery and equipment, and to make down payments on land. Working capital increases a farm's flexibility in making these capital decisions. With respect to land, a strong working capital position, puts a farm in a better position to cash rent or purchase additional ground.

A stoplight analogy can be used to establish benchmarks for the working capital to gross revenue ratio. A working capital to gross revenue ratio below 0.20 would be in the red region. A ratio between 0.20 and 0.35 would be in the yellow region, and a ratio above 0.35 would be in the green region. The working capital to gross revenue ratio for U.S. farms has declined significantly during the last decade. In 2010, the ratio was 0.43. By 2015, the ratio had dropped to 0.19. The projected ratio in 2019 is only 0.13. Clearly, the low ratios exhibited in the last few years are concerning.

Recent studies by the author reveal large differences in working capital among farms. For example, working capital to value of farm production for farms in the Great Plains that had a ratio below and above the threshold level of 0.35 was 0.15 and 0.83, respectively. For a farm with a value of farm production of $500,000, this amounts to a difference in working capital of approximately $340,000.

This article briefly discussed why working capital is so important. A strong working capital position helps a farm withstand cash flow shortages and enables a farm to take advantage of opportunities as they arise, such as adding a key employee or family member, or leasing or purchasing additional land. More information pertaining to financial management can be found on the web site for the Center for Commercial Agriculture (here).