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The Secret Sauce

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On the speaking circuit, one of the questions that is frequently posed is, "What is the secret sauce for success in today's agriculture economic environment?" To make a long story short, the answer may lie with young farmers and ranchers who have less than 10 years of experience.

Last fall, Mary Thompson, a writer for Farm Journal and the Farm Foundation, requested one last interview before she retired. Her question was, "What is the plight of young farmers and ranchers, given the current economic cycle?" To her surprise, my response was that they are doing okay based on my travels and engagement with this segment of producers.

She then directed me to the FINBIN data from the University of Minnesota's Center for Farm Financial Management. Their analysis compared farm financials at the peak of the commodity super cycle in 2012 to data from 2018 amid the grinder post-super cycle. The FINBIN data was based upon approximately 2,500 farms with 10 to 40 years of business experience versus 750 to 850 young and beginning producers. Let's dig in and determine which differences equate to financial success.

Super cycle

In 2012 during the heyday of agriculture, most everyone was generating a profit. The experienced producers generated approximately double the net farm income compared to the younger segment. However, the operating profit margin (OPM) of these two groups was very similar. The debt coverage ratio, which was more than three to one, was also comparable. The market value return on assets (ROA) was double digits at 10.6 percent and 14.4 percent for the experienced and beginning producers, respectively. Both segments demonstrated strong working capital above 25 percent of revenue.

Fast-forward

Now, let's examine the data six years later in 2018 during the elongated downturn. Farm profits were modest for both groups in the $25,000 to $30,000 range. However, the young farmer group generated almost double the operating profit margin of the experienced group at 11.6 percent versus 6.8 percent. Return on assets, while not stellar, was 3.6 percent for young and beginning producers versus 1.4 percent for the experienced group. The asset turnover ratio was significantly higher for the younger group at 35.9 percent versus 21.5 percent for the older group. Many beginning producers rent and lease assets; therefore, the asset turnover ratio is often much higher. When the asset turnover ratio is multiplied by the operating profit margin, the result is the rate of return on assets.

Many lenders, farm management instructors, and young producers point to a combination of sound marketing and risk management followed by cost management to generate a strong operating profit margin to optimize net returns and ultimately be successful.

When considering the debt service coverage ratio, the more experienced group had insufficient cash flow to cover debt service requirements at 0.94. However, the beginning group had a strong debt service coverage ratio of 1.52 percent.

Another observation was the producers with less than 10 years of experience generally had significantly more nonfarm income. Whether nonfarm income is derived from W-2 wages, entrepreneurial revenue from side “gig” businesses, or a combination of both, this is a characteristic being observed nationwide. Multitasking is a key word in the vocabulary of the new and beginning young farmers and ranchers. Family living expenses and farm capital expenditures, both super cycle and post-super cycle, were more modest with the younger segment.

Machinery and equipment investment per acre was about half for the young farmers compared to the tenured segment. This may be the result of young producers renting and leasing equipment, collaborating with neighbors, or utilizing family equipment as a boost to get started.

The more experienced segment had one distinct advantage, the debt to asset ratio was 20 percent lower. Lower financial leverage provides an equity cushion in the case of financial adversity, which we have seen in recent years.

An alarming trend was observed with the term debt to EBITDA* ratio. For the more experienced group, the analysis found that this ratio increased 2.5 times from 1.10 to 2.59. This may have been the result of operating losses on lines of credit that were refinanced to term debt with no improvement of EBITDA. Others have surmised that the experienced group

continues to purchase long-term assets utilizing borrowed money with no improvement in profits.

The “secret sauce” is founded in the basics of business management. It is critical to focus on maintaining operating profit margins, execute on marketing windows, and protect the downside risk with cost and risk management strategies. Next, all assets, including both capital and human assets, must be productive. Modesty in family living expense and using one's talents to generate income outside the business can be diversification and growth strategies for both groups of producers.

For the young, entrepreneurial group, value-added or “gig” income can be an avenue for success. For existing family businesses, a well planned and executed transition plan can pave the road to success. When one integrates the equity, wisdom, and expertise of the senior generation with the energy and innovation of the youth, the business can go to the next level.

*EBITDA is an acronym for Earnings Before Interest, Taxes, Depreciation, and Amortization

**Mary Thompson’s issue report on the new generation of farmers and ranchers infusing U.S. agriculture can be found here: *https://www.farmfoundation.org/issues/issue-reports/*.