Profit Management

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Use earnings to accelerate debt payments during times of positive cash generation and higher earnings to help your dairy position itself for the next downturn or opportunity

Pay down debt to position your dairy for the future

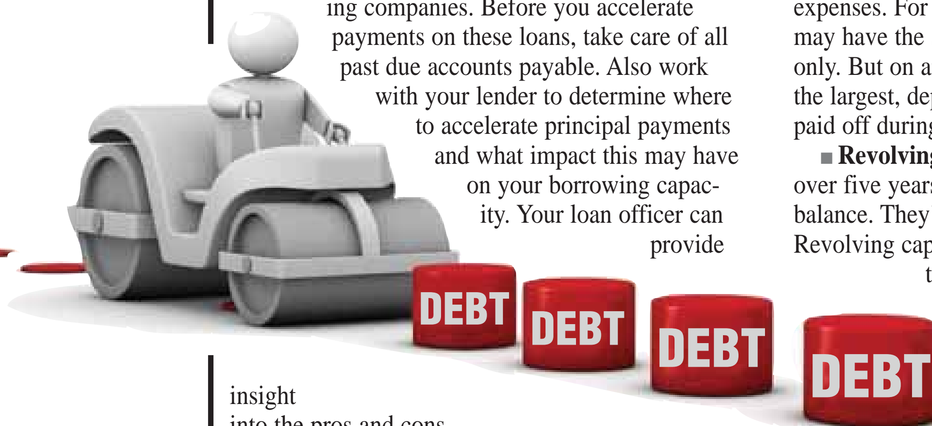
Borrowed capital is a valuable tool used by many businesses to take advantage of opportunities and pursue improvements. But borrowed capital can be double-edged. Due to internal or external circumstances, it can sometimes limit a business' ability to meet its goals.

With the increased variability in dairy's cash generation and earnings, how businesses manage debt is critical. During times of positive cash generation and higher earnings, using earnings to accelerate debt payments can help position a dairy for the next downturn or opportunity.

When accelerating debt payments, a dairy plans to accomplish some or all of the following:

- Build borrowing capacity.
- Decrease its total annual interest expense.
- Lower future cash requirements to service principal and interest.

This article focuses on debt held by lending companies. Before you accelerate payments on these loans, take care of all past due accounts payable. Also work with your lender to determine where to accelerate principal payments and what impact this may have on your borrowing capacity. Your loan officer can provide insight into the pros and cons of different debt structure and repayment scenarios.



Build borrowing capacity

Every business has a certain amount of borrowing capacity. It's based on such factors as asset values, existing liabilities, past earnings, current earnings, projected cash flow and earnings, and relationships with suppliers and lending institutions.

Since a dairy's ability to borrow capital is critical when it can't meet cash commitments or wants to invest additional capital in the business, managers must find ways to build borrowing capacity.

One approach is to lower total liabilities, or debt. By accelerating debt payments, debt reduction occurs at a fast pace, and a business will potentially be able to borrow a higher level of funds.

If your goal is to build borrowing capacity, determining which loans to apply extra principal to is important. Here are your options:

- **Annual Operating Loans** are traditionally 12 months or shorter in term, renewed annually with a borrowing limit and paid off during the year. Funds can be used throughout the year without going through a loan approval process.

Repaying an operating loan faster than scheduled doesn't build repayment capacity; however, it does make funds available soon to pay future operating expenses. For individual months, an operating loan may have the smallest payment, as it may be interest only. But on an annual basis, payments tend to be the largest, depending on the balance, as the loan is paid off during the year.

- **Revolving Capital Loans** are usually termed over five years or less and have a fluctuating loan balance. They're reviewed and renewed annually. Revolving capital loans also may have higher limits than operating loans.

As with operating loans, once revolving capital loans are renewed, you may borrow up to the limit of the loan for

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specific capital needs during the year without going through a loan review process.

A benefit of this type of loan is the minimum repayment is termed over a longer period, requiring less cash commitment over the short term.

■ **Term Loans** are usually associated with specific projects, such as a new tractor, barn or silo, and have lengths up to 10 years. Because of the longer term, these loans also tend to have smaller monthly payments than a similar amount borrowed on an operating loan. While principal payments on term loans can be accelerated, they're usually not set up to re-borrow the principal paid.

If the term loan has a fixed interest rate, there may be a prepayment penalty that limits making accelerated debt payments. Generally, a dairy would have to go through a loan approval process to tap into the equity built through extra principal payments made on a term loan.

■ **Mortgages** are traditionally the longest term loans with the smallest monthly payments per $1,000 of debt. They're secured with a mortgage on real estate and can have either a variable or fixed interest rate. If fixed, there may be a prepayment penalty that would limit the ability to make accelerated principal payments. Additionally, re-borrowing to access equity built up by making extra principal payments generally requires approval of a new loan.

Decreasing interest expense

Decreasing the total annual interest expense associated with debt lowers your cash commitment for future months. And you increase your ability to meet cash commitment needs from operations in those months.

There are two primary ways to lower the total cash interest expense for the year:

1. Lower the total principal due. With less principal due, the interest expense each month will be lower.

2. Target loans that have the highest interest rates. The benefit of paying off high interest rate loans first is multiplied as you reduce the principal and the average interest rate across all loans.

Generally, accelerated payments are targeted on the debt that has the highest interest rates. However, the type of loan and the ability to re-borrow on the equity built up by making additional payments may change where extra principal is applied.

Cash commitments to service debt

By accelerating principal payments on outstanding debt, the total debt declines. Depending on what loans are accelerated, and how a business works with its lender, the normal monthly debt service requirement may be lowered.

If a business zeroes out its operating and revolving lines, its monthly debt service automatically is reduced.

Accelerating payments on term loans can have two results:

1. Monthly payment stays the same but the length of the loan gets shorter.

2. Minimum payment decreases with the term staying the same length.

If you're trying to build borrowing capacity to pursue opportunities, you may want to reduce the length of the loan. If your goal is to position your business for another down cycle, you may want to keep the length of the loan the same and decrease the minimum monthly payment.

Capital debt term

When looking at a dairy's future borrowing capacity, lenders often consider the business' blended capital debt term (BCDT). This is the average length of time for a business to pay off all term debt.

A short BCDT may give a business the ability, if needed, to lengthen the term of some of its debt to lower monthly payments and be in a position to weather a downturn better.

If the BCDT is long, a dairy may have less room to change its debt structure to make payments lower during a downturn.

As with all uses of earnings and cash, you must consider potential tax implications. Focusing all your efforts on reducing debt may produce unintended tax consequences as the earnings used to pay the principal are considered taxable earnings. Consult your tax planner on how this fits in with your other tax strategies.

By building borrowing capacity and/or impacting the minimum monthly debt service payment, a dairy increases its ability to handle price and earnings variability and pursue opportunities for future growth.

As 2011 comes to a close, it's important to work with your lender to evaluate different debt structure and payment options. Determining how these options best fit your dairy's goals should be a priority as you move into 2012. ❒

Budget for better decision making

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■ Use causal logic in estimating each receipt and expense item. LaDue and his colleagues provide some excellent advice:

"Do not just mindlessly multiply each item by the percentage change in cows or acres. … Multiplying all expenses by the change in cow numbers in that case is sure to result in errors in the projections." Be sure to adjust for inflation.

■ Livestock farms that grow forages or concentrates should carefully assess their forage and concentrate balance whenever there are significant changes in the size or composition of the herd or cropping program.

■ Conduct sensitivity analysis and ask, "Are transition year projections warranted?"

■ Seek critical review of the projections to enhance the usefulness and validity of projections.

Consider the projected cash inflows and outflows in **Table 2** on page 23. The purpose of the analysis was to project what flows would look like for the 2009 calendar given expectations for relatively low milk prices and other factors in late 2008. Projections were generated using the CASHPRO tool.

A projected accrual income statement complete with estimates for all receipt and expense items underlies the total cash income and total cash expenses projections. In some cases the projected value is the same as the base value.

With budgeting there's no need to go blindly into the future. Whether partial or whole farm, you can answer: Is a proposed change profitable and will it help my business better meet cash obligations? ❒