

The Business Of Farming – Credit Crunch

It is not the situation but what you do about it that determines the future

By S. D. Parsons

Not surprisingly in talks I give around the country one perennial question concerns high interest rates and what to do about them. Over the years my clients and I have developed a few common sense ideas about how to cope.

Our ultimate conclusion was:

When the business is economically viable it pays to borrow money but when the business is unprofitable borrowing only increases the loss. The greater the degree of gearing (borrowings relative to equity), the greater the loss will be.

Quite obviously the first requirement is that the business must be profitable. Harking back on my last two articles remember that economics and finance are two different subjects. Economics concerns profitability. That means the gross margins on each enterprise must be positive and the total gross margin must be great enough to cover the overheads.

The second and equally important question is one of cashflow. It is possible that a business is profitable but nevertheless unable to meet payments when they come due. In that case even a potentially profitable business goes bust. Interestingly one farmer I met claims that Zimbabwe has the cheapest “real” interest rates in the world. Technically he is correct. If the real rate of inflation is 70 percent i.e. all prices go up by 70 percent each year, and the nominal interest rate is 64 percent, the real cost of borrowed money is minus six percent and therefore one should use credit to the max! But, and of course there has to be a but, the price you receive for your product must increase by 70 percent, AND the business must generate enough CASH income each year to pay off the principal and the interest when it comes due.

What he claims will work provided inflation continues to soar, but it can be disastrous to borrow at high rates on a falling market. I am reminded of a train trip back to school one year. As the old steam engine puffed up a long hill one of our more daring macho types hopped off the train to show that he could walk faster than the train. Unbeknown to him however, the engine had crested the hill. As it picked up speed on the down slope our hero was left far behind. Beware the turning tide.

But back to cashflow. Assuming that the cashflow looks a bit tight there are several things you can do. Step one; examine every single asset you possess. Is it earning money? Is the rate of return greater than inflation? Be RUTHLESS, sell it and replace it with an asset which will return more.

Step two: avoid cash dependent enterprises or resources. In the early 1980's United States farmers were faced with inflation and interest rates of around 20 percent. Modest by our standards today. Many of them had purchased fixed assets (land, machinery, breeding stock) on short-term credit and those who could not meet repayments ended up swelling the ranks of the homeless that populate American cities.

It was a sad situation but in contrast to the high technology modern farmers, the Amish, who stick to the farming methods of the last century with horse and buggy,

kraal manure and non-hybrid seeds said, "Inflation? What inflation?" When everyone else was selling off they added to their wealth of the best farms in the country by paying cash for more land. The traditional farmer in the communal land not dependent on purchased inputs is similarly unaffected by inflation. That doesn't mean you have to be a peasant to survive, but take a leaf from those who do, and apply the principle to your business – avoid enterprises heavily dependent on purchased resources.

Step three: make sure that you stay on top of the financial situation. Calculate gross margins and overheads in advance. Use your cashflow as a monitoring tool. Sit down each and every month to compare what actually happened with your planned cashflow budget.

I know that those are common sense actions and that there is nothing new in what I'm suggesting. The trouble is that few of us actually do what we should do. The best way to survive the current credit crunch is to spend a few hours with pen and paper looking at your business with the dispassionate eye of a hard headed creditor. You can't starve a profit into a business but there are very few businesses that cannot be improved both economically and financially with a little thought. Finally make sure you keep your banker informed

In my next article I will discuss the subject of management. What is it and how does one improve it.

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