Is the credit limit on your operating loan the same every year? If so, you may want to ask why.

Put simply, an operating line of credit is necessary if you have a seasonal business. There might not be a more seasonal business in this world than grain farming. If you think about a normal crop cycle, the first input expense is typically cash rent paid on March 1st, or even prior to year-end if you are prepaying inputs. As the year goes by, several other expenses related to the crop are paid as well, including seed, fertilizer, chemical, crop insurance, repairs, etc. Additionally, family living costs are present throughout the year as well...unless you don’t plan to eat. In many cases, there isn’t any income until beans are sold in October or November at the earliest. The crop is sold several months later in some cases, creating the need to borrow money on an interim basis until the income is received. Once the grain is sold and income begins flowing back into the operation, the operating line can be reduced and paid in full if all grain is sold prior to the beginning of the next operating cycle.

Operating credit needs are primarily driven off of the liquidity of the operation and the timing of grain sales in relation to input costs. If every year were the same from a timing and profitability standpoint, the same credit limit would suffice from year to year. As we know, this isn’t a realistic scenario. All things being equal, if a farming operation is profitable from one year to the next, operating credit needs will be less so long as the earnings of the operation are retained and used to build working...
capital. Conversely, with tighter margins and occasional losses from the farming operation, operating credit limits can and should be adjusted upward to absorb the additional cash needs.

So how can one determine exactly what size of operating credit is needed for their operation? A detailed monthly cash flow projection which shows the cash inflows and outflows each month can help to reasonably predict the peak operating needs. From this, an appropriate credit limit can be established to accommodate those needs, while considering possible modifications to this as a result of timing differences in grain sales along with cash expenditures.

Preparing a detailed monthly cash flow projection has other benefits as well. In addition to using the cash flow projection as a tool for determining how much of credit limit is needed, the tool can also be useful in assisting in tax planning well in advance of the end of the year. This can help to determine how much grain can and should be sold prior to year-end in order to most efficiently manage the farms tax burden. We recommend consulting your tax preparer to be sure.

Lastly, the preparation of a cash flow projection and establishing a credit limit tailored to that projection will allow the user to be able to track their actual operating balance from month to month compared to their projections and quickly be able to identify any areas that may have gotten off track.

On the cover it may seem like a daunting task or fruitless effort to put together a cash flow projection. I’ve heard some say over time that farming is unpredictable and it certainly is. However, with proper planning and by using the things we know prior to planting, such as land costs, seed, chemical and fertilizer, we can count on about 90% of the total expenses related to grain farming. On the income side, we can make reasonable assumptions by using proven yields and futures prices. Before you know it, you have a tool that can assist you in making informed decisions about your operation. For assistance in putting a projection like this together, give one of our Ag lenders a call.