Utah State University COOPERATIVE EXTENSION

Cow-Calf Risk Analysis

RMA

Managing Financial Risk on a Ranch

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Cattle ranchers deal with a significant amount of uncertainty every day. From not knowing what the weather will be like this year to wondering if market prices will increase or decrease tomorrow, agricultural producers are forced to make decisions based on imperfect information. Born out of this uncertainty is the possibility of financial loss. Risk can be defined as the possibility of adverse outcomes due to uncertainty and imperfect knowledge in decision making. Each year ranchers face the risk of cow and calf diseases, production losses and unexpected changes in market prices.

Given the changing structure of the agricultural industry, managing risk has become vitally important to the success of agricultural operations. Among the risks ranchers face is financial risk. Financial risk exists because of the need to finance business operations and maintain cash flow levels adequate to repay debts and meet other financial obligations. The ability to secure necessary loans is vital to many ranch operations, but borrowing money introduces numerous risks. The willingness of lenders to supply loans now or to continue to supply needed funding in the future is uncertain and volatility in interest rates produces an added risk to borrowing. These risks are largely influenced by greater economic factors and changes in financial markets mostly out of the individual rancher's control. In addition, changes in market values of loan collateral could also adversely affect agricultural producers' ability to maintain a profitable enterprise.

Production and marketing risk also contribute to financial risk, relating directly to cash flows and the ability to secure and repay loans necessary for operation. Since production levels and commodity prices produce the revenue with which ranchers can meet financial obligations, it is significant to recognize how interrelated these different types of risks are, and to make managing these risks an important priority.

There are many tools available to help producers manage financial risk. Which tools a producer uses should depend on his individual ranch situation and risk-bearing willingness and ability. An understanding of the tools available for managing financial risk can help agricultural producers develop better marketing plans that can reduce those risks and increase profitability.

Records

A key to a producers reducing financial risk is to know their financial situation. By having good production and financial records, producers can evaluate where they have been, where they are now, and whether or not they are moving in the right direction. Good financial records allow producers to better understand their financial risks and in what areas they need to improve their financial situation.

By evaluating balance sheets, income statements, cash flow statements, etc., producers can more adequately evaluate their financial performance and make more financially sound decisions regarding their enterprises. By knowing their current debt-to-asset ratio, they can make better decisions when securing loans and can possibly get a lower interest rate on loans by lowering that ratio. Cash flow statements allow producers to see trends in revenue and expense levels that can help them ensure adequate cash flows to meet their financial obligations. These statements also provide relevant information to help them better manage marketing risks.

Increasing the net worth of the enterprise is also vitally important to managing financial risk, and producers' records allow them to see if and by how much their net worth is increasing each year. By examining financial records, ranchers can evaluate liquidity and solvency and decrease financial risk by maintaining adequate liquidity and increasing the solvency of their operation. In short, good financial records reduce producers' financial risks and guide them to take actions that will improve the overall profitability of their ranch operations and better secure its long-term success.

Smart Loans

If loans must be secured for large amounts of money or long periods of time, getting a fixed interest rate reduces the financial risk associated with the loan. A variable interest rate may increase in later years of the loan, making repayment difficult or impossible. While a fixed interest rate may be slightly higher at the beginning of the loan, the cost of the loan will not increase over the life of the loan.

Self-liquidating loans also reduce financial risk. Self-liquidating loans, essentially, are loans which can be repaid by the productivity of what the loan was secured to purchase, such as loans to purchase replacement heifers or operating loans for a year. An operating loan hopefully can be repaid each year when calves are sold. Yearly profits from replacement heifers' subsequent production of calves can be used to repay that loan.

Reserves

Maintaining liquid and credit reserves can also protect a producer against adverse effects of financial risk. A liquid reserve of cash or other liquid assets can be easily used if needed to weather financial difficulty. Similarly, many financial institutions offer various types of credit lines and many ranchers borrow amounts below their imposed credit limit. Such credit reserves allow the producer to obtain additional loan funds if necessary to continue operation under adverse financial situations.

Renting/Leasing

Renting or leasing land or machinery can reduce financial risk. By renting or leasing land, a producer can avoid the financial risk associated with a large land loan. It is important to note, however, that rental and lease agreement may introduce other human and legal risks of which the producer should be aware. In this case, diversification by setting agreements with various land owners can reduce the risk of one land owner's choices negatively affecting the rancher's enterprise.

Manage Marketing and Production Risk

To adequately manage financial risk, it is imperative that producers manage their marketing and production risk. The production and marketing of an agricultural product creates both expenses and revenue for a producer. By managing production and marketing risk, ranchers can reduce their risks of devastating revenue loss due to production loss or lower commodity prices. By managing these risks, ranchers better ensure they will be able to meet their financial obligations and secure and repay loans, thus reducing the overall financial risks they face.

Off-Farm Employment

To reduce financial risk, in some cases it is necessary and in other cases it is wise to secure some type of off-farm employment. Whether it is the primary producer, their spouse, or another family member who finds another job, off-farm employment ensures a cash flow that is unrelated to the ranch's success and that allows the family, and sometimes the ranch, to survive in difficult times. Further, off-farm employment may offer health insurance, a retirement program, life insurance, or other benefits that would be much more costly to the rancher to purchase on their own.

Given the recent financial turbulence in the overall economy, it is not difficult to see the importance of managing financial risks. There are many ways producers can manage financial risks, including: maintaining good financial records, evaluating their financial position, making smart loan decisions, maintaining cash and credit reserves, renting or leasing as opposed to owning land or machinery, managing production and marketing risks, and securing off-farm employment. By utilizing these and other risk management tools, ranchers can reduce the risk they face and develop a more stable and profitable enterprise despite the uncertainties inherent in the agriculture industry.

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