PIFB Newsletter

Winter Edition: Succession Planning

Institute for Family Business
COLLEGE OF AGRICULTURE

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Included in this Issue:

The Purdue Succession Planning Team

This special edition of the PIFB Newsletter focuses solely on succession planning within farm and family businesses. Some members of the Purdue Succession Planning Team are featured as authors in this newsletter. Read about the team below and visit this [website] to learn more!

The Purdue Succession Planning Team, comprised of Extension Educators and Specialists, was formed in 2011 to address the needs of families planning the continuation of farm businesses. The team mission is to cultivate strong Indiana farm families through the succession planning process by providing educational opportunities and current resources.

The Purdue Succession Planning Team & PIFB recently won an award, the 2020 PUCESA Team Award. The Team Award recognizes innovative Extension programming by a team of Specialists and their allied partners. Some members of the Succession Planning Team are pictured above.

Renee Wiatt & Maria I. Marshall

To view the *Defining Your Dreams* webinar, visit the PIFB YouTube page.

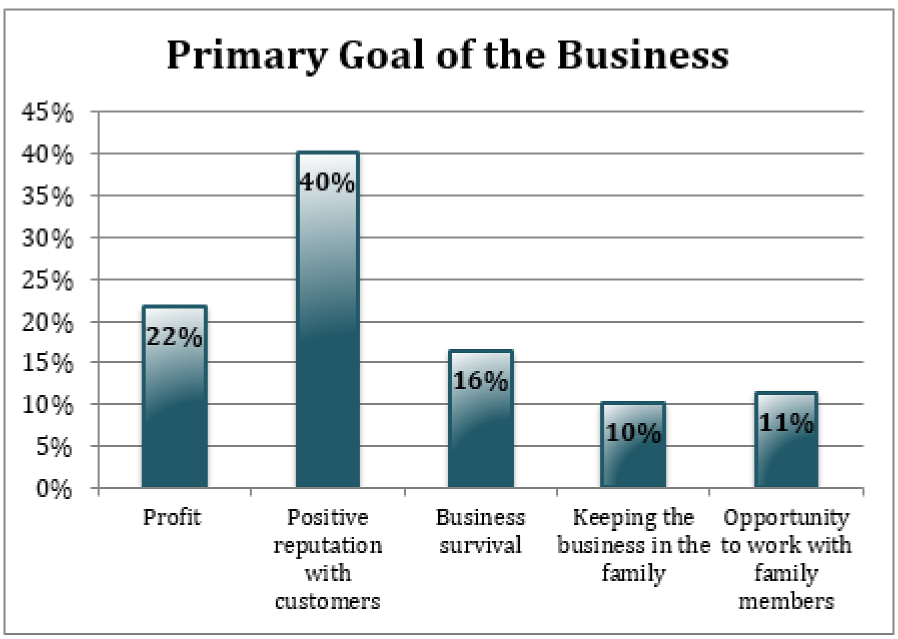
"If you don't know where you are going, you'll end up someplace else." - Yogi Berra

No matter what your business does or who it serves, the business (and its employees) need goals and objectives. Yogi Berra sums it up best – you need to have a target or you'll never make it there. Goals are general and can help to shape where you are going, where objectives should be concise and explain how you will get there. Action plans can subsequently be established to break down each objective into small, manageable projects (normally taking no longer than a week each to complete). Goals and objectives give you something to work towards, complete with timelines and metrics. When defining goals and objectives, make sure that they are SMART – smart, measurable, action-oriented, realistic, and timely. You can set goals, objectives, action plans, and associated timelines and metrics related to personal matters, business matters, professional matters, management succession, and ownership succession.

Example: Differentiating between smart and non-smart goals/objectives

Personal non-smart goal: I want to lose weight.
Personal smart goal: I will lose 20 pounds by the end of the year via eating 5 salads a week and working out for 30 minutes a day, 3 times a week.

Professional non-smart goal: I will grow our business.
Professional smart goal: I will grow the business by acquiring 3 new clients in the next 2 months, by maintaining the current client base, asking clients for referrals, and increasing the business' social media presence.



Discussing goals takes time; the first goals discussion that you have may just be a fact-finding mission. Be realistic with your expectations; do not expect everyone in the business to have aligned goals. Some individuals may focus more on financial goals such as profit and others may focus on non-financial goals such as family harmony and keeping the business in the family. Farm and family businesses who were interviewed in the 2012 Family Business Succession Survey (FBSS) found that between businesses, the primary goal of the business varied. In the graph below, it is represented that 40% of businesses responded that a positive reputation with customers was their primary business goal. It is thought that all businesses are profit maximizers, but the graph represents that non-financial goals trump financial goals (such as positive reputation with customers, business survival, keeping the business in the family, and the opportunity to work with family members) among farm family businesses.

Even though different ideas of primary business goals may emerge though different perspectives in the farm and family business, try to come to a consensus on 4-5 goals for the business. Be sure to identify the time required to accomplish each task and objective. Set deadlines, both for short-term and long-term goals and place them in order of nearest deadline to stay on track. Tracking your progress can help you to maintain your momentum. Consider using a simple calendar, app on your phone, or reminders on your computer to stay on track. Remember, "If you don't know where you are going, you'll end up someplace else."

Financing Your Dream: Developing and Living within a Budget

Denise Schroeder

BUDGET – what a negative connotation that word has! But if you call it a spending plan, it sounds much more inviting. Why do you need a personal and/or business spending plan? The first answer should be – so you know where your money is coming from and where it is going.

By having a personal budget, you can better plan for upcoming expenses, be better prepared for emergencies, and identify any "trouble areas" where spending is unreasonable. For a business or farm, a budget allows you to be prepared for large bills that are unexpected, annual bills, and unexpected machinery repairs. Whether you are planning for your business or in your home, a budget is never a bad idea.

As we start to develop a spending plan, one of the first steps should be determining the difference between needs and wants. Needs are often simple and fall into the following categories:

- Housing
- Transportation
- Insurance
- Utilities
- Food

Wants can include: travel, entertainment, designer clothing, gym memberships, and dining out; among many other things. Once you have determined the difference between your wants and needs, you next need to determine how you are going to spend your money. It truly comes down to simple math:

Income minus needs= money left to service extra debt, savings, or discretionary spending (your wants)

Budgeting for your business/farm is very similar to budgeting for your household. One thing you can do to simplify business books is keep your business records and accounts separate from household records and accounts! This makes tax time simpler, discourages business from taking family funds and vice versa, and demonstrates a clearer picture of business finances to lenders.

As you are putting together a budget for your business, consider including the following categories:

- Income – list by product and include the quantity and expected price per unit;
- Variable Costs (Operating Costs) – fuel, materials, repairs, labor, custom operations, storage costs, etc.; and
- Fixed Costs (costs incurred whether or not production occurs) – Principal payments on land, buildings, equipment and machinery; cash leases; insurance; taxes etc.

To help you plan for business/fam expenses, plan on constructing an annual budget that includes all revenue and costs associated with production. This will help you summarize how your operation is moving forward financially. Once this annual budget is developed, it enables the farm to make decisions if something changes, i.e. revenue increases or decreases, or you purchase a new piece of machinery.

Additionally, you can construct a cash flow budget that projects when you will be receiving income and how that balances with when you have incurred expenses or payments due. A cash flow is utilized by lenders to make decisions on borrowing and repayment terms.

If you have multiple enterprises in your operation, it is beneficial to construct a budget and cash flow for each entity. This can be used for breakeven analysis and analyzing the best mix of products to produce. As you work on building your business budget and cash flow, work with your lender and accountant to ensure all pertinent information is included.

When trying to make your dream a reality, you may consider the following: acquiring new farm ground, starting a new family enterprise, buying equipment, or a range of other endeavors. These dreams may require you to consider getting a loan from your financial lender. You will want the meeting with the financial lender to go as smoothly as possible; therefore, it is a good idea to understand what will be discussed in the meeting and what documentation you need to bring.

When meeting with your lender, make sure you are clear about the goal you wish to achieve with the funds and that you communicate to your lender how this goal will impact your operation. One way you can ensure everyone is on the same page is by having a business plan with you. Your business plan should answer the following questions:

- What do you plan to do?
- Who will your customers be?
- Who will your competitors be?
- How will you market to your customers?
- How will you implement your idea?
- How will you fund this goal/operation/etc.?

It is best to put your business expansion plan in writing. By having it in writing, you can ensure your thoughts are clear and concise. It will also allow you to answer any question your lender may have.

Besides bringing your business plan with you to the meeting, you will want to bring any financial information you have. Financial information would include your balance sheet, tax returns, and any financial projections you have made due to the proposed change in your operation. Your lender will go over your paperwork and help you understand any part that may not be clear.

Your business plan, financial information, and ability to interact with the lender will all contribute to your lender's analysis when making a loan determination. The lender's analysis is commonly referred to as the "Five C's of Credit."

The "Five C's of Credit" include:

1. **Character**
   Character involves a determination of your repayment capacity and intention.

2. **Capacity**
   Capacity involves the analysis of your financial projections to see if the proposed change in the operation will generate sufficient cash flow to repay the loan.

3. **Collateral**
   Collateral involves your balance sheet, including what assets you have available if needed for loan repayment.

4. **Conditions**
   Conditions encompass outside forces that could impact your operation (that you have no control over), including the economy.

5. **Capital**
   Capital involves the personal investment (or stake) you are putting directly into the operation to make it successful.

Ultimately, when seeking a loan to make your dream a reality, one of the best ways you can increase your chances of being successful is by being prepared. Allow yourself adequate amount of time to get your business plan organized and all of your financial documents in hand before scheduling your appointment with your lender. Make sure that you make the best impression when going up against the "Five C's of Credit."

Transferring the farm from one generation to the next should involve an assessment of skills, weaknesses and resources in the farm operation. A financial review is an important part of this assessment. With year-end market value balance sheets, a historical cash flow statement, and tax returns, a farm can compute accrual net farm income. A market value balance sheet shows changes in inventories of crops, market livestock, seed, fertilizer, and other supplies. Additionally, a market value balance sheet records changes in land values from year to year.

The following three key financial questions must be addressed:

- Does my farm have sufficient liquidity to repay current debt obligations and bring another family member into the business?
- Does my current solvency position (measured using the debt to asset ratio) allow me to expand?
- Is my farm profitable enough to compensate family members, replace machinery and buildings in a timely fashion, and expand?

The first question involves liquidity, which is the ability of a business to meet its cash flow obligations as they come due. The *current ratio* is a liquidity measure computed by dividing current assets by current liabilities. If a farm has a *current ratio* of 2.0, the farm has twice as many current assets as current liabilities, providing a cushion or safety net to mitigate low net returns.

Many lenders are focused on current ratios because they want to be sure debt payments can be made on a timely basis for the coming year. The University of Minnesota Farm Database (FINBIN) recently reported an average current ratio of 1.40. For many farms, liquidity has been affected by low net returns or profitability since 2013. There may be options to improve liquidity including refinancing current debt into longer term debt, slowing expansion, or liquidating assets.

The second question addresses solvency, which is examining the relationship between the assets owned and business debt. A farm with a *debt to asset ratio* of 0.25 owes money on one-fourth of all of its assets. In other words, the farm owns three-fourths of its assets. A benchmark *debt to asset ratio* is below 0.40. FINBIN reported for 2018 that 63% had a *debt to asset ratio* above 0.40 and 22% had a *debt to asset ratio* above 0.70.

For the final question, profitability measures the extent to which a business generates a profit from the use of land, labor, management, and capital. *Net farm income* is an absolute measure of profitability. For comparisons made between farms, it is common to calculate *return on assets* (net income divided by total assets). For greater accuracy, it is suggested to make accrual adjustments to account for the balance sheet changes (i.e. Inventories and accounts payable) that took place during the accounting period even though no cash exchanged hands.

In summary, if the average net farm income over the last 5 to 10 years has not been sufficient to compensate family members, repay debt, and replace machinery and buildings in a timely manner, then bringing another family member into the business may not be prudent. Farms may see an opportunity to expand by adding more land to increase revenue. A good rule of thumb is that it takes approximately $500,000 of gross revenue per employee (family member or hired employee) for a farm business to be sustainable. Using average profitability over time, each $500,000 in gross revenue will generate $100,000 in net farm income. A farm cannot make intelligent changes to the operation without first measuring financial position and performance. In other words, you can not control what you do not measure!

Transferring Operations or Ownership to the Next Generation: Handoffs to First Time Farmers and Non-Relatives

Julia Valliant

"Everybody dreams about passing the farm to the next generation. In our case, the next generation just isn't directly related to us, and that's just fine." – Nebraska farm owner

"For us it's important to give a beginning farmer a chance, and not just make a big farmer bigger. It's really a joy to help someone get started." – Kansas farm owner

The Purdue Institute for Family Business (PIFB) is finishing an advisory role to a study led by the Indiana University Sustainable Food Systems Science initiative and funded by USDA NCR-SARE. This project combined a focus on incoming farmers and ranchers, and retiring agricultural landowners and their heirs. We looked at the land access opportunity that is presented when a family farm/ ranch comes to the end of a family line, and transfers operations or ownership to a non-relative operator or owner.

Land transactions across families, rather than within families, are common. The U.S. Department of Agriculture reports that most agricultural land is acquired from a non-relative, and that 25% of transfers of *ownership* are between non-relatives. At the same time, most incoming farmers and ranchers need to look beyond their own families to secure land, either through rental or purchase. These entering farmers and ranchers are at a major disadvantage in competing for land with established farmers/ ranchers and other established landowners. However, it is clear that new farmers' and ranchers' participation in agriculture, whether they are from a multi-generational farming family or they are a first generation farmer, is good for farms' economic performance, rural community prosperity, and sustainable agriculture. To facilitate their land access, several types of programs and policies have been launched since the 1990's by private, state, and federal service providers to foster farm/ranch transfers to entering producers. This project looked at those efforts in the 12 states of the U.S. North Central Region (Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, and Wisconsin) and surveyed farm/ranch owners who might transfer out of family and farm/ranch seekers.

Some findings of use for Midwestern farm owners, heirs, their advisors, and Extension educators are:

- PIFB research finds that 39% of farm owners who expect to liquidate would actually prefer to avoid liquidation. This study's findings agreed that owners, and especially their professional advisors, need to understand alternatives to liquidating, and opportunities to transfer operations, assets, and/or real estate to new farmers. This Indiana farm owner figured out one such opportunity: *"I had this notion that I wanted to maintain our property as an entity. So when I first approached [the First Time Farmer], I told him that my choice would be to sell my equipment to him, and have him do our farming, as opposed to just having an auction, and disposing of everything, and looking for the highest bidder on rent."* Service providers should aim to educate professionals who regularly advise farm owners, especially tax preparers, lenders, financial advisors, accountants, and attorneys, about approaches to transitioning in an entering farmer.

Comparing the offers of farm/ranch owners who might transfer the farm out of the family versus needs of farm/ranch seekers, we found:

- **Housing**: Few owners offer an on-farm residence, which is a top need of seekers. Seeker demand for on-farm/ranch housing is over three times what is offered by owners.
- **Land**: Many service providers observed that seeker demand greatly outpaces owners' offers of the smallest (under 40 acres and under 10 acres) and largest tracts of land (over 500 acres). **Recommendation**: A priority for research, policy, and programmatic innovation needs to be placed on unlocking opportunities for owners of parcels under 100 acres, and especially under 40 acres, to transfer to an incoming seeker. Owners with the largest landholdings would be another priority subgroup, to support transfers to incoming grain farmers and beef ranchers. The state beginning farmer tax credit programs of Iowa, Minnesota, Nebraska, and starting in 2020 in Kentucky and Pennsylvania, all provide owners with a financial incentive to transfer operations or ownership to a beginning farmer.
- **Products**: Many incoming farmers and ranchers aim to produce row crops, beef, and hay. Their numbers are about equal to those of offering owners who produce these products. However, many more incoming seekers desire to produce specialty crops, dairy, and hogs/poultry (outdoor or indoor) than offering owners whose farms currently produce these products. **Recommendation**: Targeting farm transfer support to existing specialty crop, dairy, hog, and poultry operations is another priority. As an example, the Dairy Grazing Apprenticeship provides one such model.

Brief reports of findings are available at this IU website and for free online at the Journal of Agriculture, Food Systems, and Community Development and Land Use Policy. Questions or comments? Contact IU researcher Julia Valliant at jdv@indiana.edu or (812) 856-5029.

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