What's Your Burn Rate?

Brent Carpenter, Aug 2016

We're talking about *working capital*, defined as the near-liquid funds that the farm business can access to meet short term financial obligations. Working capital is the financial reserve that can be used to either temporarily buffer the business from financial stress or be available to quickly take advantage of an opportunity.

When losses are occurring or expected, the burn rate indicates how rapidly working capital is being consumed. This is a relatively new metric used by financial analysts.

The numbers to estimate working capital are obtained from an accurate balance sheet. Calculate working capital by subtracting total current liabilities from total current farm assets. Current assets include cash, accounts receivable, grain and market livestock inventory, prepaid inputs and investment in growing crops. Current liabilities are items such as, accounts payable, operating lines of credit, unpaid taxes, accrued expenses, accrued interest and principal payments on long term loans due within the year.

A farm with $400,000 in current assets and $250,000 in current liabilities has working capital of $150,000. Let's say the projected loss is $100,000. The burn rate is $150K divided by $100K, or 1.5 years. At this pace, working capital will be completely exhausted in one and one-half years. This is not much cushion and could be an eye-opener for this farm.

Like other financial ratios, there are some signposts that indicate financial strength or vulnerability. A burn rate over 3.5 is considered to be strong. Many analysts recommend maintaining a target of 2.0 or better.

On many farms, the first step to shore up working capital is to focus on protecting cash. This means when cash is generated from product sales it stays in the business as cash rather than being used to buy capital items or withdrawn for family or other uses.

There are some common pitfalls that cause working capital and therefore the burn rate to be overstated, giving a false level of comfort with liquidity. One pitfall is valuing unhedged grain inventory. When cash markets decline working capital can change quickly. The working capital metric can also be misleading if a high proportion of current assets are tied up as purchased inputs. Inputs do not really convert to cash for an ongoing farm. Also, don't forget to include family withdrawals and income taxes in the income calculation.

Farm financial management begins with a complete set of production and financial records. When times are lean, the ability to measure and monitor an accurate burn rate and other ratios can help you decide how aggressive to be with juggling assets and reducing costs.

Contact your regional ag business specialist for assistance with farm financial questions.