RISK MANAGEMENT WORKSHOP SERIES

Center for Rural Affairs ‹› North Central Risk Management Education Center ‹› University of Nebraska, Lincoln

SUCCESSFUL FARM/RANCH TRANSITIONS

By Dave Goeller, University of Nebraska Transition Specialist

Successful farm/ranch business transition depends in large part on the farm's financial viability, especially the ability of the farm to generate adequate income to cover family living expense and debt payment. Following that, a successful farm transition involves the transfer not only of the farm assets but also the farm's day-to-day operations. The control of management, labor and income must be passed from one generation to the next. This "process" usually occurs in several stages and is typically stretched out over several years. Open communication between the parties is essential. Discussion of expectations and goals makes the transition occur more smoothly. Although the process takes time and effort, most would say the benefits make the effort worthwhile.

Passing a Farm or Ranch Down to the Next Generation

Successful farm transitions do not typically occur without thought and preparation. They happen because someone cares enough about their land, their family and their community to make the effort. Sure, there are the cases when a sudden death occurs and an heir may have to take over the operation quickly, but even then, if parents don't have a will or haven't thought through the planning process and made preparations, it may be difficult for the heir to be successful. Passing on a farm business can seem overwhelming. One thing to remember is that this is not an event -- it is a process. There are many factors to consider and numerous issues to think through.

Historic Trends (Slide 11)

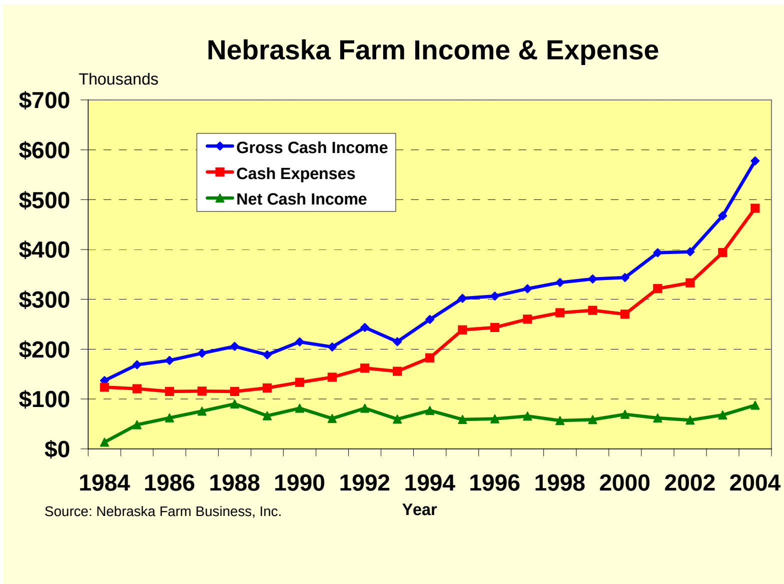
Age of Nebraska Farm Operators

Age	1982	1987	1992	1997	1997* Adj.	2002* Adj.
Under 34	13,436 22%	12,609 21%	8,877 17%	5,531 11%		3,782 8%
35 – 64	38,030 63%	37,056 61%	32,735 62%	33,532 65%		33,390 68%
Over 65	8,777 15%	10,839 18%	11,311 21%	12,391 24%		12,203 25%
Total	60,243 100%	60,502 100%	52,923 100%	51,454 100%	54,539 100%	49,375 100%

Source: Census of Agriculture, NASS

The National Agricultural Statistics Service data demonstrate the age distribution of Nebraska's farm operators. As can be seen in 1982, there were 13,436 operators under age 34, compared to only 3,782 in 2002. Stated as a percentage of farm operators there were 22% under age 34 in 1982 and only 8% in 2002. At the same time the number of farmers in the over 65 age group rose from 8,777 (15%) in 1982 to 12,203 (25%) in 2002.

Cash Income and Expense Trends (Slide 12)

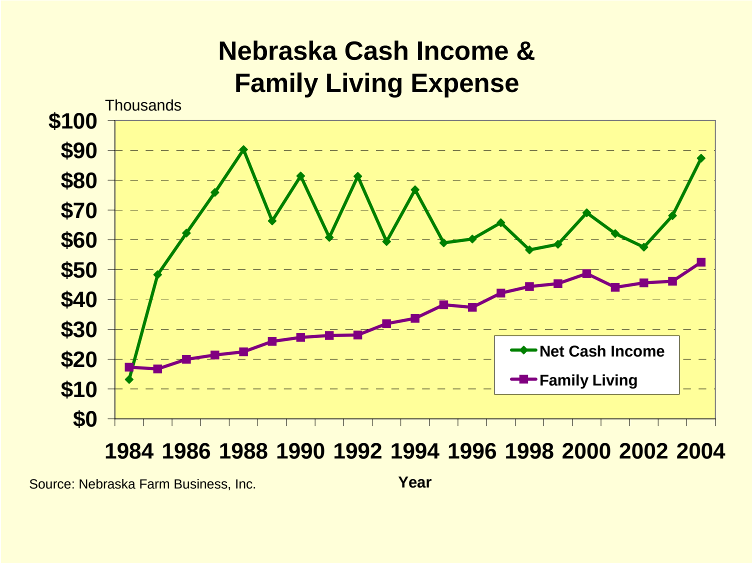


Nebraska Farm Business, Inc. data has been gathered from several hundred farm and ranch operators, mostly in the eastern third of the Nebraska. The blue line illustrates the average Gross Cash Income generated per farm. As can be seen, the gross cash income has had an upward trend from about $140,000 per farm in 1984 to nearly $600,000 per farm in 2004. This is expected based on the reduction in farm operators demonstrated by the last chart and the increase in yields, especially in corn, and the higher livestock prices.

The red line illustrates the Cash Expenses for the average farm. Notice the almost perfect correlation between the blue and red line. At least two factors contribute to this strong correlation: 1) Crop inputs companies tend to know what the market will pay based on economics of the situation; 2) Farm families tend to tighten their belts when cash is short, thus expenditures tend to follow the rise in cash income.

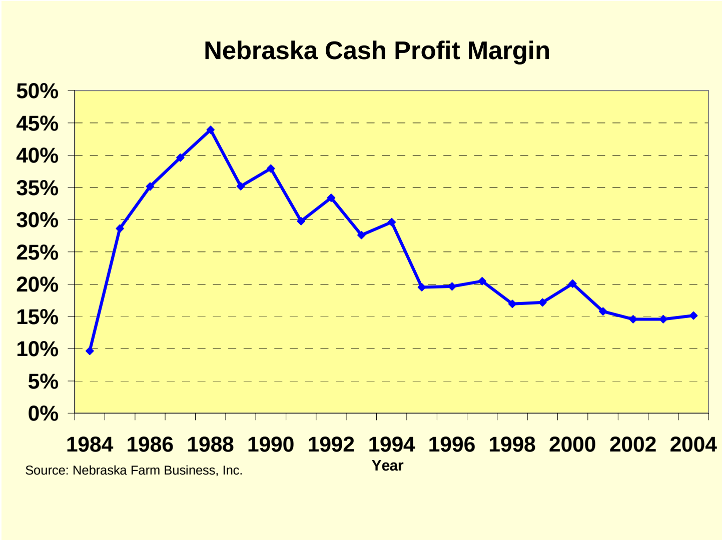
The green line represents the Net Cash Income. As can be seen, the trend of Net Cash Income has remained fairly flat. Net Cash Income, or Profit, is used in two major categories for the farm and ranch: 1) Net Cash Income serves as the source of funds to pay term principal payments and it provides the necessary capital for growth of the business; 2) Net Cash Income provides all, or at least a contribution toward some, of the living expenses of the farm or ranch family.

Family Living Expense Trends (Slide 13)



In the above graph, Net Cash Income (the green line) has been placed on a smaller axis, therefore the increase and decreases can be more clearly demonstrated. Even with the increase in income seen in 2003 and 2004, the steady rise in the cost of Family Living (the purple line) is growing dangerously close to the Net Cash Income. When one considers that term debt payments also need to come out the Net Farm Income, it is easy to see why so many farm and ranch families have supplemented their situations with an off farm job.

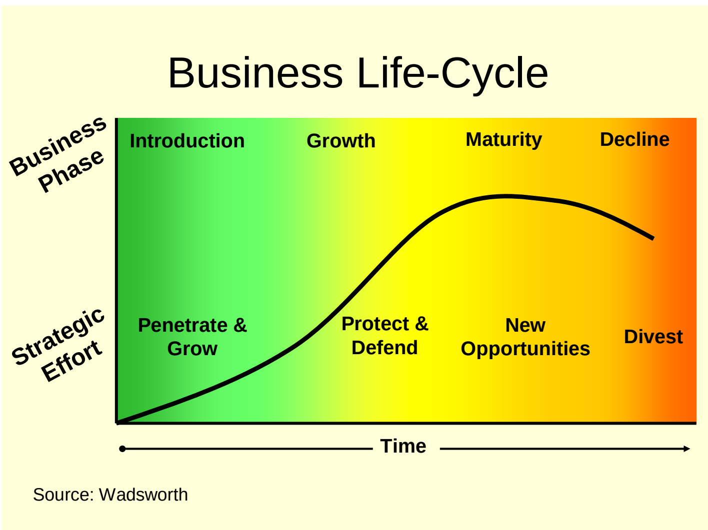
Cash Profit Margin Trends (Slide 14)



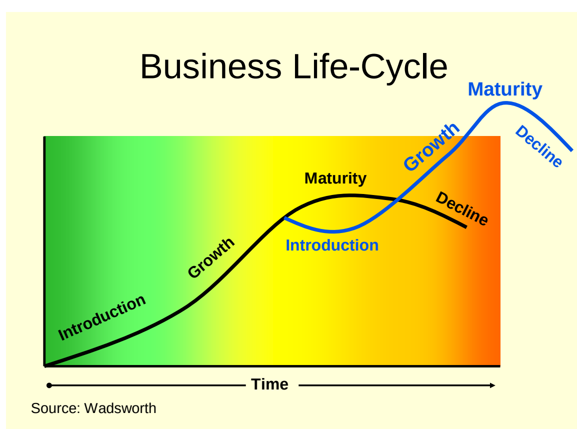
Cash Profit Margin is calculated by dividing the Net Cash Income (the green line) from slide 12 by the Gross Cash Income (the blue line) from slide 12. The result is a percentage that indicates how much of the sales dollar is available to the average farm or ranch to pay for term principal payments, growth of the business and family living. As can be seen, the range peaks out in the late eighties at about 45% and has seemed to stabilize at around 15% the last few years.

Let's look at an example. If a family spent $20,000 per year for family living expenses in 1988 and they had a Cash Profit Margin of 40%, they must have $50,000 of Gross Cash Income to meet the family living obligation. If they had $10,000 of term principal payments, that would require an additional $25,000 of Gross Cash Income, totaling $75,000 Gross Cash Income needed to meet obligations. Fast forward to 2004: we see family living has increased to $50,000 while at the same time Cash Profit Margin has decreased to 15%. The needed Gross Cash Income equals $333,333. If we consider the same $10,000 of term principal payments (and prices of most capital items have not stayed the same), we would require an additional $66,667 of Gross Cash Income totaling $400,000 compared to $75,000. Do you think it is easier or more difficult to start farming today versus 20 years ago?

Business Life Cycle (Slide 15)



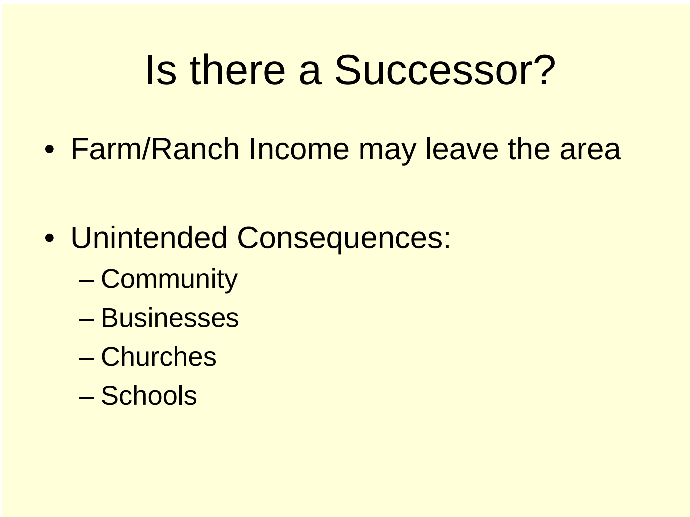
Let's consider the life cycle of a business. It could be any business, a farm or ranch or even a hardware store. The left axis represents the success level while the bottom axis represents time. As a business begins, many start out with very little. The survival rate tends to be lower in the green section. If we were to consider a typical farming operation the age of the operator might be thought of as 20's to 30's in the green section. As we move toward the yellow section there is usually fairly rapid business growth occurring. Age of operators might be 40's through 50's. As we move toward the light orange color the business tends to reach maturity. One of the main factors contributing to the maturation of the business is the attitude of the operator toward risk. As we get older we don't want to take the same risks we were willing to take when we were 25 years old. We know we don't have the time to recover if we fail and thus many businesses tend to cease growing and, as depicted by the bright orange, can actually begin to go into decline. Many operators coast the last few years of the business cycle, and why not? It is their business to run any way they see fit.



Business Life Cycle (Slide 17)

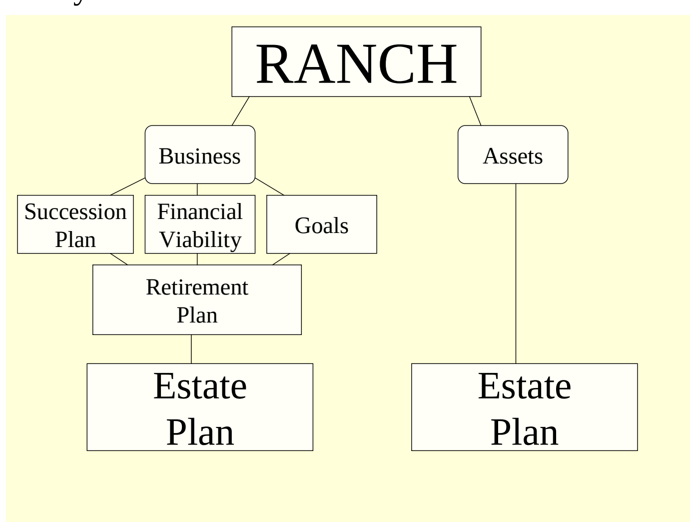
If a successor is desired and found, and done so in a way that the owner generation can minimize their risks and ensure an adequate income for retirement, the business can continue to grow. The younger generation will also have a much better chance to establish a profitable business than if they started at the bottom.

Is There a Successor to Your Business? (Slide 18)



Is there a successor for your business? If not, what is likely to happen? Eventually, through the passage of time, our heirs will own the farm or it will some day be sold. Dr. John Baker of Iowa State University recently did a survey of Iowa farmers and he asked the question: Do you plan to retire? Nearly 2/3 of those responding indicated that they never, or only partially, planned to retire. If we never consider retirement what are the odds that we will find a successor? If we have no successor what will happen? Well, the fact that we grow a day older each and every day cannot be disputed. If we are typical, eventually our business will slow and we may rent out the farm. Many will rent or sell to the individual who can pay the top dollar. That is not likely to be a beginner, as we all know. If the farm goes to the biggest neighbor down the road, there will one less family living in the area. What impact does that have on the local schools, the churches, the business, and the community as a whole? The unintended consequence of not planning for a successor is certainly contributing to woes of many of our small communities. (For more information go to http://www.agecon.unl.edu/Cornhuskereconomics.html. See the article dated 2-9-05 titled "Is there a Successor to Your Business?").

The Planning Process (Slide 20)



Farm transition is a process, not an event. One of the first questions one should consider in the process is ‘Do I want to pass my farm/ranch on to my heirs as an ongoing business, or do I want to equally divide it, as a group of assets, to be cut into pieces like a pie?’ If you want to pass your farm on as a group of assets, not an ongoing business, then the diagram on the right demonstrates a path of action. The farm assets can be divided simply through an Estate Plan by which we determine who will get what and when and how will they get it. If, on the other hand, your goal is to pass an ongoing business to the next generation, the process involves creating a Business Succession Plan. The Business Succession Plan includes the following steps: Financial Viability, Goals and Expectations, Succession Plan, Retirement Plan, and finally an Estate Plan.

One of the first considerations to make when creating a Farm Business Succession Plan is to ask the question: What is the financial viability of the farm business?

Financial Viability:

- Farm Efficiency (Slide 21)

Farm efficiency is one of the keys to a profitable farm business. What is the relationship of cash farm expense and cash farm income? Where are you spending your money? Are you shopping around and making competitively priced purchases? Are you getting the most bang for your purchase buck? When you are spending $1 are you getting at least $1 in return? Are you taking advantage of buying in quantity, possibly combining purchases with a relative or neighbor to create an opportunity to buy in bulk? What about early pay discounts?

On the income side of the equation, how is your production? Can you make improvements in your operation that will result in more production or perhaps a better quality production? What about marketing? Most know, after the fact, that they could have done a better job. Many have found that forward pricing a portion of their crop in the spring has proven to be a profitable tool for a portion of their production. There may be contracts available for livestock production that may be a plus for income.

Nebraska Farm Business, Inc. looked at several years of data considering the question: What makes the top 1/3 of the producers consistently more profitable than the lower 2/3? Three factors were considered: 1. Controlling expenses; 2. Production (yields, in the case of grain production; and selling weights, weaning percentage etc, in the case of livestock production); 3. Marketing (selling price/unit). The correlation between the high profit 1/3 and controlling expenses was very high. There was a much lower correlation between production and marketing and the high profit 1/3, suggesting a long term strategy of cost controlling as a proven tactic for higher profits in farming.

Financial Viability:

- Farm Efficiency continued (Slide 22)

Successful Farm Transitions:
Financial Viability

- Farm Efficiency
  - Assets earning their "keep"
    - ✓Investments paying their interest
    - ✓New paint disease

Another factor regarding financial viability involves capital investment and the question "Are the assets earning their keep?" Investment in machinery varies from operation to operation. The amount of investment in machinery per acre can be compared from location to location. In a strictly row crop setting a lean-and-mean operation will be in the \$125/acre to \$150/acre range. Some operations have as high as \$750+/acre invested in machinery. However, there is also an inverse relationship between machinery investment per acre and the amount of repairs expected. There needs to be a balance worked out. You may have a very low investment/acre in machine cost but have a very high repair bill and be broken down at crucial times of the year.

Financial Viability:

- Farm Debt Structure (Slide 23)

Successful Farm Transitions:
Financial Viability

- Farm Debt Structure
  - Long term vs. short term loans
  - Interest rate
  - Principal payments

Farm debt and the structure of that debt are also very important elements of financial viability. Obviously operations that are carrying large amounts of debt have increased the challenge, especially when facing reduced profit margins. Close attention to the current ratio -- the relationship between the current assets and the current liabilities -- is very important when bringing a successor into an operation. If farm debt is long term debt with a fixed rate of interest, the risk of rising interest is controlled throughout the fixed period. Many times refinancing shorter term debt, and its associated higher term principal demands, over a longer term can help create some of the needed money to bring a successor into an operation. If possible, negotiating a "no pre-payment penalty" clause for long term debt is recommended.

For example let's look at a farm that has Gross Cash Sales of $500,000. At a 15% Cash Profit Margin there would be $75,000 of Net Cash Income available for family living contribution and term debt payments. If the operation has $140,000 of intermediate debt financed at 7% interest amortized over 5 years, the payment (principal & interest) would be $34,144 annually. In year one, interest on $140,000 @ 7% would be $9,800. Subtracting the interest from the annual payment gives us $24,344 of term principal payments. If family living costs are $50,000 then $50,000 + $24,344 = $74,344, creating a positive cash flow of only $656.

The factors to be considered when bringing a successor into an operation are: 1. Are there any ways to increase the Gross Cash Sales of the operation? 2. Are there any "Off Farm" sources of income to supplement the farm's contribution toward family living? 3. Can the debt be restructured to reduce the amount of term principal payments, thus lowering the obligated annual amount and helping free up needed cash income?

Let's go back to the example above. Let's assume that for the initial phase of transition that we do not want to increase the size of the business (option 1.). Let's look instead at increasing the available cash (option 2) by exploring "Off Farm" sources such as adding Social Security benefits to the equation, or maybe a part time job for the younger generation or a combination of the two. Assuming $30,000 annually from these sources, we can increase the total dollars generated from $75,000 to maybe $105,000 annually. If we also restructure the debt of $140,000 @7% over 20 years (option 3) the payments would be reduced from $34,144 to $13,215. The portion of the payment that is interest would remain the same $9,800 but the term principal amount for year one would be reduced from $24,344 to $3,415. Without increasing the size of the farming business, we have created a financial plan that will generate $105,000, with expenses for family living of $100,000 and term debt principal payments of $3,415, thus establishing a positive cash flow of $1,585. No two situations are alike. Each farming business must look at the mix of available options and determine if there is a way to make bringing a successor family into their operation work. Most of the time, the numbers side of a transition plan is easier to work out than the personal side.

Financial Viability:

- Family Living Costs (Slide 24)

One of the other variables directly associated with financial viability is that of family living expenditures. The cost of family living varies greatly, probably more than any other single factor. Some families spend very little, as low as $10,000/year while others spend in excess of $100,000 annually. At a 15% Cash Profit Margin it takes $666,667 to generate $100,000 in profit annually, not to mention any term debt principal payments. When considering family living for two families the importance of this factor doubles.

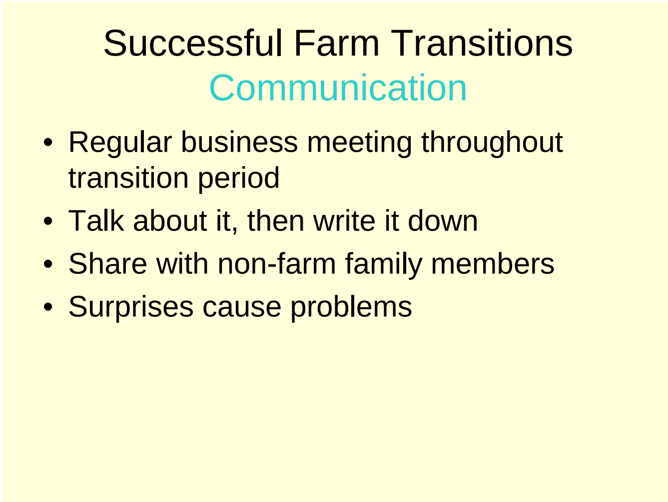
Goals and Expectations (Slide 25)

Successful farm transitions do indeed depend on the financial aspects of the farm or ranch. Successful farm transitions most definitely also depend on the personal aspects as well. Common goals are crucial when trying to create a team heading in the same direction. Both generations need to be on the same page. The owner generation needs to consider where their money will come from. How much will they need? Are there "Off Farm" sources to supplement income or does it all need to be from the farm? What life style do you expect -- $100,000 or more annually? Where will you live and if it's different than where you presently live, about when will you be considering moving? If you intend to have a successor how will you treat your non-farm heirs? If you treat them all 'equally', will there be adequate income remaining to support your successor? If your farm is not large enough to support all heirs plus a successor will you consider insurance or non-farm investments to help even up the non-farm heirs somewhat? What are your expectations regarding your successor getting to work in the mornings and quitting at night? What about vacations or ball games, etc.?

The younger generation must consider the lifestyle expectation as well. How much do you expect to make on the farm? Will you be satisfied if the classmates you graduated with are making more than you are? Can we establish a way to grow the business at a rate that you are happy with while at the same time minimizing the risks for the owner generation? How will you provide the financing or credit for your business? What are your expectations regarding family time and work time? Generational differences definitely exist regarding the expectations of family time and work time. The older generation tends to have a much more blurred definition of the two while the successor generation sees a clear distinction. If expectations and goals are not openly discussed, chances of a successful farm transition, regardless of the financial viability, will be greatly reduced.

Goals and Expectations:

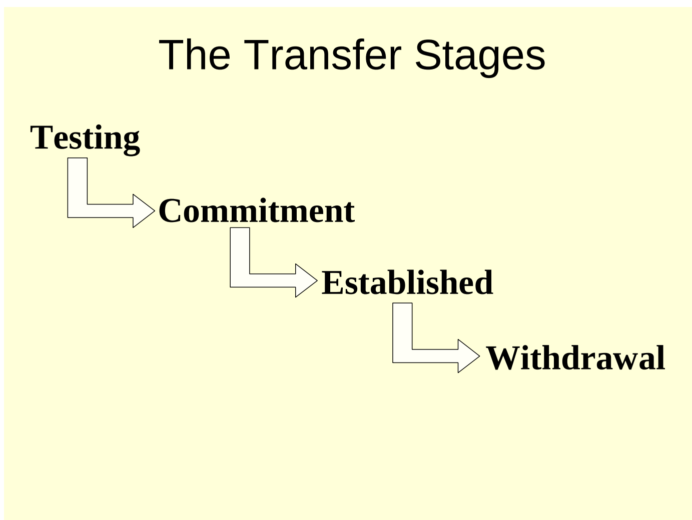
- Communication (Slide 26)



Communication is extremely important in the transition process. Men, in general, have the tendency to not be great communicators. If the transition involves a parent and child, you may need to work on improving old habits of communication styles and patterns in order to facilitate a smooth discussion format. One way to do that is to schedule regular family meetings. There needs to be an agenda including old and new business, a financial review, possibly reports and updates, as well as planned priorities for the next work period. Someone needs to be in charge. Sometimes mothers can fill this role quite handily. Meetings should not last for a long period of time and should not turn into “gripe sessions” -- discuss the issues. Record the discussion in writing and share it with all members of the business. Some families may have non-farming members that have an ownership interest in the business. If that is the case, they need to be kept informed as well.

When considering a successor it may be helpful to think of yourself more as a coach or teacher rather than a boss or employer. There is one thing we can be absolutely certain about: the next generation will make some mistakes. If we can be there to help give advice, not orders or “I told you so”, we can assist the development of our successors and the continuation of our business.

The Business Transfer Stages (Slide 27)

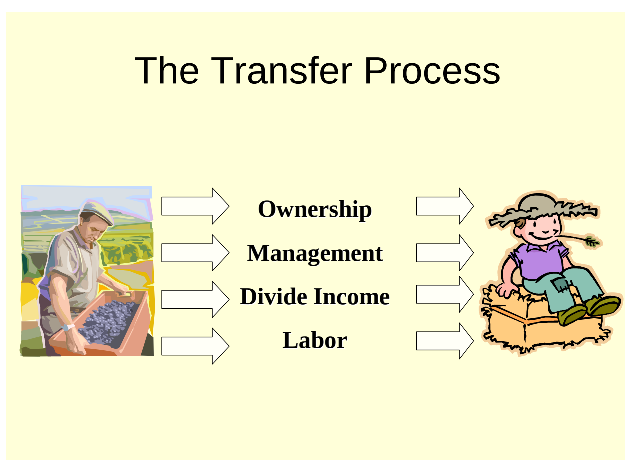


Transferring a business can seem overwhelming. One way to get a handle on the process is to break it down into stages. Let’s think of the first stage as a “testing stage”. We are simply trying out this arrangement on a trial basis for a period of time. Maybe there is a wage involved during the testing stage, or a wage plus an incentive. How long will this stage last? What are the expectations of both parties?

- What time of day or night does the job begin?
- What time of day or night does the job end?
- What are the job responsibilities?
- What will the job pay?
- Are there any fringe benefits?
    - Insurance
    - Meals
    - Housing
    - Vehicles
    - Other
- If a minor emergency arises, how will it be handled?
- Will there be any vacations?
- Will the job transition into more than just a job and if so, when?
- What are the expectations regarding “family time” vs. “work time”?

When the testing stage is completed, it is time for the successor to decide if he or she is ready to make a commitment. Is this where they want to be and what they want to do? If so, how then will things change? After a period of time the successor will become established. How will that affect the duties and responsibilities? Eventually, the owner generation will begin to withdraw from the business. When will that be and under what terms will that take place?

Segments of the Farm Business (Slide 28)



At the same time we are thinking about stages we can also break our farming operation down into four separate areas: Labor, Income, Management and Ownership. During the testing stage what are the requirements regarding labor? Will there be any management duties? How will the income be distributed? Ownership likely will not begin for the successor until well beyond the testing stage, but when will the opportunity arise?

Once committed to the transfer, will there be changes in the various areas of the business? Management is one of the most difficult areas to transfer. So much of our self worth and personal identity are wrapped up in our farms. It can be very difficult to relinquish control. Narrow profit margins and high stakes farming don't allow for large mistakes to be made. During the "commitment" phase it's important to gradually allow the successor to manage portions or areas of the business. This provides an opportunity to learn and acquire valuable experience with the safety net of the owner generation still being available for support and advice. If a mother and father take the hands of an infant as he is learning to walk, but never let go, will that infant, when he grows up, be able to walk or run on his own? The same is true with learning to manage a business.

Farm Business Succession Plan (Slide 29)

Business Succession Plan

	Testing	Commitment	Established	Withdrawal
Labor				
Timeline				
Management				
Timeline				
Income				
Timeline				
Ownership				
Timeline				

During the "established" phase of the business succession plan, labor, management and income should be shifted heavily to the successor. Ownership may begin to transfer as well, depending on the estate plan and the desire for control by the older generation. During each phase make sure to consider a timeline. Set dates and goals. It is important for all involved parties to understand the expectations of each other.

Retirement Plan (Slide 35)

Successful Farm Transitions
Retirement Plan

- Timeline of farm involvement
- Where will money come from?
- Where will you live?
- How will you account for non-farm heirs?
- What will you do?
- Your will is your contingency plan

Do you plan to retire? If so, what does retirement look like for you? Many say that retirement is simply 'doing the things I want to do on the farm and not having to be there to do all the day-to-day work'. Reducing the responsibilities but continuing a less prominent role in the farm may be retirement for some.

Remember that someday, someone else will be farming your farm. Is it desirable for you and your business to gradually turn over the reigns of control while you are still around, so you can be available to guide the next generation and share your valuable years of experience with them?

Estate Planning (Slide 38)

Five Key Notions to Keep in Mind

- Minimize Tax
  - Federal estate, gift & generation-skipping taxes
  - Unified credit
  - Marital deduction
- Avoid Probate
  - Wills v. living trusts, joint tenancy, Basis Adjustment
  - Time-of-death transfer
- Basis Adjustment
- Long Term Care
- Contests

The estate planning portion of the succession plan is a crucial element. Who will inherit what and when and how they will get it, can be a critical factor to the future success of the business operator. How will you deal with non-farm family members that will not be part of the business? Will there be insurance policies or non-farm assets available to help balance the equation? Do you want each child to inherit equally, or is it more important to pass the farm on in a way that the successor has a better chance to financially succeed? What about taxes? How long do you want to maintain control of your assets? Are there business structures that provide for ease of transition? What about long term care? There is not a right or wrong answer to these questions. Each individual must make their decisions based on their own values and judgments.

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North Central Risk Management Education Center

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