

Should I Downsize/Exit? If So How?

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The combination of rising costs and lower prices has placed significant financial and economic pressure on many livestock as well as crop producers. Many are contemplating their future direction and seriously considering downsizing their business or exiting the industry. The decision to downsize or exit a business is a difficult one, requiring the resolution of numerous issues and answers to various questions. We pose some of these questions and provide some perspective on how to answer them.

Am I covering cash flow?

For those operations with significant debt loads as well as livestock producers who are buying the feeder animals, feed and other inputs including labor, the critical issue may be whether or not they are generating adequate cash income to meet cash demands. A highly leveraged livestock operation will be under significant cash flow pressures with high feed costs and low product prices. Even without any debt, operations that buy feeder animals and feed may encounter cash flow pressures. Grain farmers who pay cash for land rent as well as fertilizer, seed, chemicals, etc. may have similar cash flow problems. Those who decide to continue operations in spite of inadequate or negative cash flow margin will need to use working capital to cover those deficits, subsidize the cash losses from elsewhere in the farming business or from non-farm income.

How long will low margins/profits persist?

It's important to analyze the root cause of financial stress, and determine how long the current situation might persist before making irreversible decisions. Low or negative margins/profits can result fundamentally from low productivity, high input costs, or low product prices. Productivity problems (i.e. low yields, inefficient gains, high death loss, etc.) are generally less persistent over time and more controllable by implementing better management practices. Input and product prices are more difficult to manage and may remain unfavorable for longer periods of time.

One of the major concerns in the livestock industry is high feed costs; and a similar concern in the grain business is high fertilizer, seed, chemical and cash rent expenses. Because many crop inputs are energy dependent and the price of energy is expected to remain higher than earlier this decade, one might expect crop

production costs and prices to also remain higher than in the past. And higher crop prices suggest higher feed costs for livestock producers.

As to product prices, the persistence of low prices will depend heavily on the cause – if demand is weak because weak economic conditions globally have impacted consumer incomes and food (particularly animal protein) demand, the speed of price recovery will depend on how quickly the global economy recovers. Because of the high fixed cost structure of agriculture, producers are slow to adjust production (they will produce as long as they cover variable costs). A smaller supply typically does not occur quickly and low prices resulting from weak demand can persist for an extended period. If low prices are primarily a result of unusually favorable production conditions such as excellent weather or an unusually low death loss or feed efficiency in livestock production, output is more likely to adjust back to normal in subsequent production periods and prices are likely to recover more quickly.

What is my financial position?

The financial position of the business in terms of amount of debt relative to equity and the speed with which the equity is been “consumed” by losses is a major determinant of its “staying capacity”. A farming operation with little debt and a strong equity position that includes a substantial amount of liquid working capital can sustain operating losses for a longer period of time. If a business does not have much debt, but most of its equity capital is tied up in capital assets such as livestock facilities and land with very little of the equity capital in a liquid form, it will be unable to sustain operating losses for very long without having to sell some of those capital assets. Large equity capital and liquid financial reserves do nothing to stem the losses – they just mean they are more readily absorbed without forcing the firm to go out of business. A firm with a high debt load (60-70% debt to asset) would not be in a position to absorb operating losses for very long and should consider debt restructuring if repayment of the restructured debt is feasible, or an exit strategy.

Am I covering variable cost?

The cost structure of the business is important in making decisions concerning whether or not to shut that business down when losses are incurred. In the short run, the business will lose less money if it continues to operate as long as it is generating sufficient revenue to cover variable expenses, even though it may not cover total cost. Fixed expenses of depreciation, interest, property taxes and insurance will be incurred whether or not the business continues in operation – shutting down the business will eliminate these expenses only if the assets are sold. Variable expenses of feed and feeder animals, energy and repair bills, labor cost etc. could be eliminated if the operation is shut down. If revenues are adequate to cover variable costs and contribute something to the fixed expenses that will be incurred irrespective of whether the facility is or is not operated, the best decision is to continue operating the enterprise. Continuing to operate in this circumstance doesn't mean that the business will not lose money; it will just lose less than it would if the business was shut down.

Can I abandon the facilities; will there be any shutdown cost?

For livestock operations in particular, a critical issue in downsizing or exiting the industry is whether or not there will be cost involved in this activity. In many cases, buildings and facilities that do not use modern technology

and have not been well maintained can be shut down or not used, but there still may be costs such as property taxes that will be incurred unless the facility is torn down or destroyed. A more serious cost and concern are any lagoons or livestock waste containment structures and facilities associated with the production unit. Generally, these lagoons and containment facilities cannot be abandoned without clean up costs. The facility must be emptied and generally protected from unexpected spills or leakages even when not in use. In some cases these clean-up/shut-down costs may be significant, and/or the liability of an environmental accident or contamination may continue to present financial vulnerability even after the facility is shut-down. In cropping operations, the key issue in abandoning or shutting down a particular site is the disposal and clean-up of any fertilizer, chemical or fuel storage facilities – and it may not just be the tanks and/or buildings themselves; if there has been any leakage or chemical spills, it may be necessary to remove and dispose of some of the soil contaminated by these spills.

What are the efficiency characteristics of the facilities or operation?

A business that has modern and up-to-date facilities and a well trained workforce should have higher efficiency and be incurring smaller losses than one with outdated and low productivity facilities and a less skilled workforce. It is critical to benchmark your cost and productivity performance to determine whether your losses due to high feed costs and low livestock prices are being compounded by productivity problems such as low feed efficiency, high repair and maintenance costs, high death losses, etc. Benchmarking data could be obtained from the [Illinois Farm Business Farm Management Association](http://fbfm.ace.uiuc.edu/public.htm) (<http://fbfm.ace.uiuc.edu/public.htm>), the [Kentucky Farm Business Analysis Program](http://www.uky.edu/Ag/KFBM/pubs.php) (<http://www.uky.edu/Ag/KFBM/pubs.php>), the [Center for Dairy Profitability](http://cdp.wisc.edu/Financial%20Benchmarks.htm) (<http://cdp.wisc.edu/Financial%20Benchmarks.htm>), and other similar publicly available sources. Also, some livestock producer associations and feed suppliers have developed production standards useful for benchmarking. If productivity/efficiency problems exist, lower feed prices or higher product prices may only stem the size of the loss, not return the operation to profitability. If productivity problems exist, now may be the time to depopulate and make the necessary improvements to increase productivity and restart the business or sell it to someone else when economic conditions improve.

What are the tax consequences of liquidating or selling out?

One of the most painful experiences of selling a business after suffering significant loss is the requirement to pay income taxes when a decision is made to liquidate that business. But in fact that is a common occurrence in farming because of the unique cash accounting rules farmers can use in reporting their taxable income. In essence, if a farmer reports his taxable income under Schedule F cash accounting rules (which is quite common for most farmers), raised grain and livestock inventories (including raised breeding stock) have a tax basis equal to zero. Consequently, if such inventories are liquidated and offsetting expenses are not incurred which is typically the case when an operation is shut down, the entire proceeds from these product sales is taxed as ordinary income. So even at these low prices, a sizeable taxable income can be created because of the liquidation, resulting in a significant tax bill. Part of this tax bill can be mitigated if operating losses in earlier years are carried forward. Sale of fully depreciated capital assets will likely result in depreciation recapture and possibly a capital gain tax burden as well. Good tax counsel is essential to reduce the tax consequences of liquidation.

What about contracting my grain or livestock production?

One way to reduce the vulnerability of a farming business to the product price volatility that has occurred recently is to produce under contract – to feed hogs on a cost plus or price premium contract, or to forward contract crop production on a price per bushel or even revenue per acre basis. Contract production has been very common in the livestock industry, and new contracting arrangements are currently available in the pork sector (see the [National Pork Producers Guide to Contracting](http://www.porkgateway.org/web/producer/home) (<http://www.porkgateway.org/web/producer/home>) and other articles on contract production available from the Pork Information Gateway on the Internet for some additional information on contracting arrangements). But many pricing contracts link the sales price to market prices and do not adjust for changes in cost, so provide little protection from the cost increases that occurred during the past year. Cost plus contracts provide protection from those feed and other cost increases, but they are not readily available in most locales. In the grain markets, forward contracting became more difficult during the summer months of high grain prices because buyers were concerned about their own financial commitments with margin calls to maintain their hedged positions on contracted grain. Revenue per acre contracts are typically not available for commodity corn and soybeans, but are often used in seed corn, popcorn and some of the specialty crops. Generally, buyers of products are more hesitant to offer attractive contracting arrangements during periods of price volatility and increased financial stress; contracts to protect margins are not readily available today. Also make sure the contractor has the financial health and capability to fulfill his/her contract commitments.

Could I convert the facilities to other uses?

Particularly in the case of flat storage facilities and pole barns or other non-specialized livestock facilities, it may be possible to convert them to other uses in the farming operation. In many cases these facilities will not be nearly as efficient or effective in their new use compared to the purpose for which they were designed and built, but this conversion strategy may be a way to capture some revenue compared to abandoning the facility. Specialized livestock facilities and machinery and equipment such as harvesting or planting equipment likely cannot be effectively used for other purposes, so sale or shut-down may be the only available alternatives.

Could I sell the facilities; or sell the entire company/enterprise?

A common way a business can capture value when downsizing or exiting is to sell the productive assets of that business. Depending upon the efficiency/productivity of those assets and the financial condition of prospective buyers as well as the business climate for the industry, these assets sales could be heavily discounted. And the discount may be higher if the sale must be completed relatively quickly without much opportunity to identify and market the assets to alternative buyers. In some cases a liquidation of the specific assets of the enterprise makes sense, particularly if those assets are flexible in their use and/or the sale must be accomplished quickly. In other cases, it may be desirable to sell “the business” as an on-going enterprise, and maybe even negotiate for the work force to be employed by the new owners of the business. It is frequently the case that sale of an “on-going” concern results in more value than the liquidation of individual assets, but such a sale typically requires a longer time and more work to complete successfully.

How would downsizing/exiting impact other enterprises?

Exiting or downsizing an enterprise might have significant impacts on other enterprises in the farming business. This is particularly the case for farms that have combined livestock and crop production in the same business. If livestock facilities are downsized in a grain-livestock operation, less manure will be available for the cropping operation and more commercial fertilizer will be required to maintain efficient crop yields. Clearly, more grain would be available for sale at market prices if less is fed to livestock – the key issue here is whether livestock profitability improves sufficiently so that more profits can be generated by feeding grain to livestock or through direct sales of the grain products. If the grain operation is downsized by for example renting less land, it may be necessary to purchase more feed for the livestock operation. And increasingly important is the prospects that less land is available to dispose of the manure from the livestock operation, which could result in the livestock facility not being in compliance with environmental and other rules for waste disposal. Clearly, downsizing one part of a multi-enterprise business also has implications for labor availability and utilization. And if assets are sold as part of the downsizing/exiting strategy, the proceeds of this sale would be available to reinvest in the remaining enterprises to modernize or update machinery and facilities, or be used elsewhere including being maintained as financial reserves.

Do I have an alternative use for my personnel and my own labor resources?

For many farmers the livestock operation is only part of a diversified farming business. In these circumstances the potential of using the labor resources elsewhere to generate income is an important consideration. Less competition between the livestock operation and the grain operation will allow timelier planting and harvesting. For some farms, this is an important factor to consider. Maybe labor and other resources released from shutting down a livestock facility can be used to rent or custom farm additional acreage. Or more hours might be available to work in the non-farm job. On the other hand, if the livestock operation includes a skilled and experienced work force that would be hard to replicate if the operation was shut down temporarily and then restarted, it may be the preferred option to continue operations so as to maintain efficiency and productivity when industry profitability is reestablished rather than incur a significant start up cost of re-staffing the business with a less skilled and experienced work force. For those who are near or at retirement age, the issue of what to do with your labor resource and time may be less of a challenge than for those who are mid career farmers.

How would exiting impact my reputation and self esteem?

For some livestock producers who are leaders in industry associations or trade groups as well as in their local community, exiting the livestock business may be an emotional as well as financial decision. For many of us, part of our self esteem is linked to our career and/or business success. Choosing to exit or quit that business has important emotional as well as financial implications. It is not simply a matter of cost and return computations, or “do I have a better use for my time and money than producing hogs or milking cows.” For many, it may be the emotional cost, the feeling of failure, the lost business relationships and associates, the loss of self esteem – all of the emotional and personal dimensions of exiting a business that may be the most difficult to cope with and to manage.

A Final Comment

The adjustments that may be required in periods of significant financial stress are not easy to consider and evaluate. One reason the task of making adjustments is difficult is that the source of the problem or weakness is likely not associated with a big deviation from normal for a single item or even a small group of items. The more likely situation is one with small deviations from normal for several items. To do a good job of monitoring the financial position of the business in a timely manner, it is important to develop projections and then compare actual performance with the projections. Planning tools make the development, monitoring, and revision of projections much easier. [Finpack](#), developed by the [Center of Farm Financial Management](#), is one example of such a planning tool. Using planning tools can aid in developing answers to some of the questions posed here. Having a well designed process for the timely monitoring of financial outcomes has the potential to decrease the need for more painful restructuring/downsizing/exit decisions.

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