Investing Extra Cash Flows: Be Sure to Look at All Alternatives

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Strong projected yields through much of Illinois and higher than average commodity prices may result in higher levels of cash flow and income for many producers. A common question is how to allocate any excess profits and cash flows across potential alternatives.

The answer depends substantially on each individual’s situation, goals and the stage in the life cycle of the operation. However, some fundamental principles can be applied by all individuals.

Taking a closer check of your financial health should help guide the decision. Cash needs are likely to be higher in 2008. Schnitkey and Lattz project costs to increase substantially over historical averages from 2001-2005. For example, the largest increases in corn come from fertilizer ($27 per acre), seed ($11), crop insurance ($5), fuel and oil ($5), and interest ($5). Cash rent levels are also likely to increase. Additional cash flows will be needed to fund these projected increases. So how much is adequate? A good rule of thumb is to subtract your current liabilities (debt and liabilities due within the next 12 months) from current assets (cash, savings, inventories, etc). This is defined as working capital. Divide this measure by gross revenue. A measure greater than 30% is considered strong. Excess cash flows could be used to build this level if needed.

Next consider your overall debt position. A general rule of thumb is to have your debt level less than one-half of your total asset values. Another metric is to express your interest expense relative to gross revenue. An adequate measure is to have the interest expense to gross revenue less than 15%. A third measure is to express your actual or projected cash income before you account for interest and depreciation relative to total debt. This measure should be greater than 25%. If you pass these important financial health benchmarks, it may not be necessary to prioritize debt repayment as an alternative. Responsible use of debt gives you flexibility to grow and invest in productive assets. For additional details on financial benchmarks and decision tools for investing in farm assets see [www.farmdoc.uiuc.edu](http://www.farmdoc.uiuc.edu).

Another area that warrants a financial check would be your level of retirement assets. Many income tax deferred alternatives are available to farmers. Funding these accounts early in your career allows the time value of money to work in your favor. For example, an investment that returns a modest 6% annually will double in approximately 12 years and will increase 8 fold in 36 years.

As you evaluate your other investment choices, be careful to assess their relative risks and rewards. Farmland has continued to increase in value, but does not generate
substantial cash flows. If debt is used to finance farmland, additional cash flows from other sources will be needed to support the debt payments. When investing in depreciable assets consider how these investments enhance your overall farm profitability and growth potential.

In summary, take a look at your financial health prior to making substantial farm investments. Take advantage of trusted advisors like Farm Business Farm Management field staff, lenders, accountants, lawyers, and other consultants to assist you in your decisions.