UW Growing Beginning Farmers & Ranchers

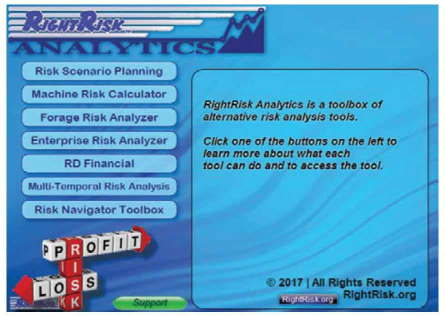
Getting Started in Ag:

Thriving in a High-Interest Rate Environment

The Landscape Has Shifted Significantly

Interest rates strongly influence the business of farming and ranching, and current interest rates are near 20-year highs. The Federal Reserve continues to hold rates higher in an attempt to reduce the risk of inflation; currently the federal funds rate is over 5 percent. Simply put, this increases costs in production agriculture. If you are a young producer or new to agriculture, chances are this may be your first experience operating in a higher interest rate environment.

Most farm and ranch operators borrow funds to cover expenses over the production year. For most, it is a necessary part of doing business, whether in the form of operating lines of credit, input financing, or purchasing machinery or land. An increase of 5 to 8 percentage points in interest rates results in a big difference in operating costs for most operations.



Unfortunately, this high interest rate environment will most likely continue for the foreseeable future. This has both negative and positive implications for agriculture. While borrowing costs will likely remain high, relative to the last 20 years, you may also find new investment opportunities, such as bonds or other securities offering meaningful returns.

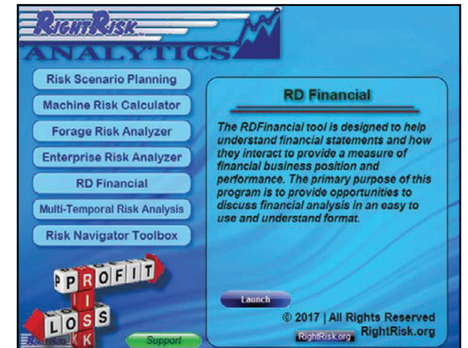
Continued high interest rates will also require managers to be more careful about how they spend money and how they budget for production, especially if they are just getting started in production agriculture.

The Importance of Record-Keeping

First and foremost, it is necessary to get financial and risk management plans in order. This means keeping accurate records, developing and maintaining up-to-date financial statements, and drafting strategic and long-term plans for your business. It is much easier to work out how your business will be affected by higher interest rates if you are aware of your financial position. Understanding your financial position can also allow you to be more nimble when considering opportunities or making a change. The more accurate and up-to-date your financial information is, the better your decision-making will be.

Opportunity Cost and Financial Planning

If you are a new or beginning producer, you may not be familiar with the concept of opportunity costs in business planning and budgeting. Opportunity cost is generally defined as the return foregone by choosing to use limited resources for a specific purpose or opportunity. Stated another way, opportunity cost is a non-cash expense valued by the next best alternative investment and is most often expressed as a rate of return. When used in budgeting, this often includes owner labor or capital.



—RD Financial from RightRisk Analytics allows users to:
—Enter data and build financial statements
—Analyze statements and ratios
—View credit scoring from a lender perspective

Frequently in agriculture, opportunity cost is the interest rate or rate of return you could receive for funds if they were not reinvested into the business, such as in a savings account or by purchasing a U.S. Treasury bond. Considering opportunity cost when budgeting can help develop a more complete and accurate financial picture of the alternatives available, including realistic expectations for future returns on investment. This is particularly important when considering asset purchases or exchanges.

For example, suppose you are considering paying cash—without borrowing it—to purchase a piece of equipment. You should include an opportunity cost in your budget (most likely the current interest rate), just like depreciation and other non-cash expenses, even if you are not borrowing money for the purchase. This helps provide a more realistic forecast for the return on your investment.

It is important to include an accurate opportunity cost when budgeting, especially when partial budgeting. This is especially important when considering any change in operations or management decisions. Including opportunity cost shows how a decision may compare with a level of return you could receive when putting your capital to use in some other investment.

When borrowing money in a high interest rate environment, it pays to find the best financing deal. Often, input suppliers offer short-term financing that is lower than current rates. If you are financing through an operating line of credit, be sure the inputs and other items you are purchasing are providing the best bang for the buck in terms of return on investment. It will likely cost much more to carry the purchase of those inputs on a line of credit with higher rates than it might using supplier financing.

Positive Effects of High Interest Rates

While increased interest rates pose challenges, they also offer some benefits. In a high interest rate environment, there are more places to earn a low-risk return with extra capital or profits, should you choose not to reinvest them directly into the business.

When interest rates were at or near zero for most low-risk investments like certificates of deposit (CD), treasury bonds, money market accounts and others, many managers probably reinvested into the business with little thought. In today's environment, it becomes more important to consider these alternatives for investment of business profits, even if only for a short time.

—The Multi-temporal risk analyzer (MTRA) was developed to examine a potential partial budgeting decision in a long-range framework.

—The key feature of the MTRA tool is that it can generate probability analysis accounting for the variables entered in the budgeting situation.

—MTRA can be used to measure the effects of variability for multiple variables for up to 20 years.

For most farms and ranches, there are plenty of options for reinvestment of business profits, whether that means machinery replacement or upgrades, deferred maintenance, or other improvements. However, it is important to account for risk and uncertainty when considering these alternatives. Before making a decision, compare the return on those investments to lower-risk options, such as a CD.

Thoughtful budgeting and accounting for risk and variability are essential when considering the reinvestment of business earnings into the farm or ranch, especially when comparing those to a relatively risk-free alternative. By keeping accurate financial records, understanding opportunity costs and carefully evaluating investment options, you can ensure your operation continues to thrive, even in a high interest rate environment.

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FOR MORE INFORMATION

Higher interest rates lead directly to higher borrowing costs. In addition to being on top of your financial situation, implementing a comprehensive risk management plan can help you prepare for challenges and opportunities that may arise in the current higher rate environment. To learn more about risk management planning, check out the RightRisk Analytics Toolbox at RightRisk.org. The toolbox offers various budgeting tools designed to help new and beginning producers.

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