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Debt on Heifers

Looking at bred cow sales, the values of bred females and pairs are at levels of historic nature. It seems like that has been a recurring theme for the past several years and demand continues to be strong. In looking for inspiration on what to write about this week, I came across an article from Eric A. DeVuyst, Professor and Rainbolt Chair of Agricultural Economics, Oklahoma State University from a couple years ago discussing the financial ramifications of debt on operations. He was referencing values on bred heifers, nearly $1,000 less than today, when cautioning about debt on female purchases. That is likely even more of a concern today. I'm not an economist, so I'm using the article as it was printed.

Record high prices make financing of replacements risky for many producers. First, let's consider financial position as measured by current ratio, debt-to-equity (D./E), and debt-to-assets (D/A). These measures help measure a farm's ability to withstand financial shocks. Current ratio is the ratio of current assets to current liabilities. When buying replacement heifers, the producer increases longer-term assets (more breeding stock) while decreasing current assets (cash) and increasing current and longer-term debt. The means the current ratio drops. The producer is less able to generate cash in a timely manner. So, unanticipated expenses (e.g., equipment breakdowns or higher feed bills) or decreased revenues (e.g., disease outbreaks or breeding failure) can put the business in increased financial risk.

The D/E ratio is relative proportion of debt financing to owner financing. The D/A ratio is the percent of the farm's assets "owned" by creditors. Both are important measures of credit reserve. Healthy D/E and D/A ratios (lower values are better) indicate the business can replace longer-term assets (equipment, building, breeding stock) as needed. And healthy ratios indicate the business has a buffer to withstand lower revenue and higher expenses as the firm can borrow against their asset base if necessary. What this means for cow-calf producers is that borrowing to buy replacement heifers increases D/E and D/A, reducing the firm's credit reserve. This reduces the firm's ability to replace other longer-term assets as needed and the firm's ability to withstand shocks.

Second, let's consider cash flow demands. Debt financing increases cash outflows for debt service. Current replacement heifer notes will not self-liquidate unless a large downpayment is applied, maybe as high 75% down depending on loan terms. So, most producers will need other sources of unencumbered cash inflows to make principal and interest payments. Before committing to buying high-priced replacements, those sources need to be identified.

What the current conditions mean for financially struggling producers is that waiting to rebuild herds may be the best financial option. If excess forage is available by delaying replacement purchases, the producer has options. Calves can be weaned onto grass to add pounds and revenue. Forage can be stockpiled to reduce feeding hay to cows in the fall and winter. Pastures can be leased to neighbors until needed. Hay can be baled and sold. Each of these options may result in healthier (i.e., less risky) financial positions and better cash flow balances.