Module 7
Benchmarks and Best Management Practices: Your Scorecard to Success

Module Outline

Introduction

How does my business stack up to my neighbors?

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The Final Analysis

Learning Objectives

The learning objectives for this module are for participants to:

- Gain knowledge and increase their understanding of key formulas and ratios that can be utilized to analyze the financial performance of a business.
- Learn about benchmarks and guidelines that can be used for comparing their business to their peers.
- Increase their knowledge and be able to use strategies that can improve the performance of their business.
- Understand how other factors may impact the risk exposure and management of a business.

Introduction

In the last module, you were introduced to the Five "C's" of Credit which included a brief overview of key financial components of your creditworthiness. In this module, we will ask you to roll up your sleeves and dig deeper into the numbers and other components of your business from a strategic risk management point of view.

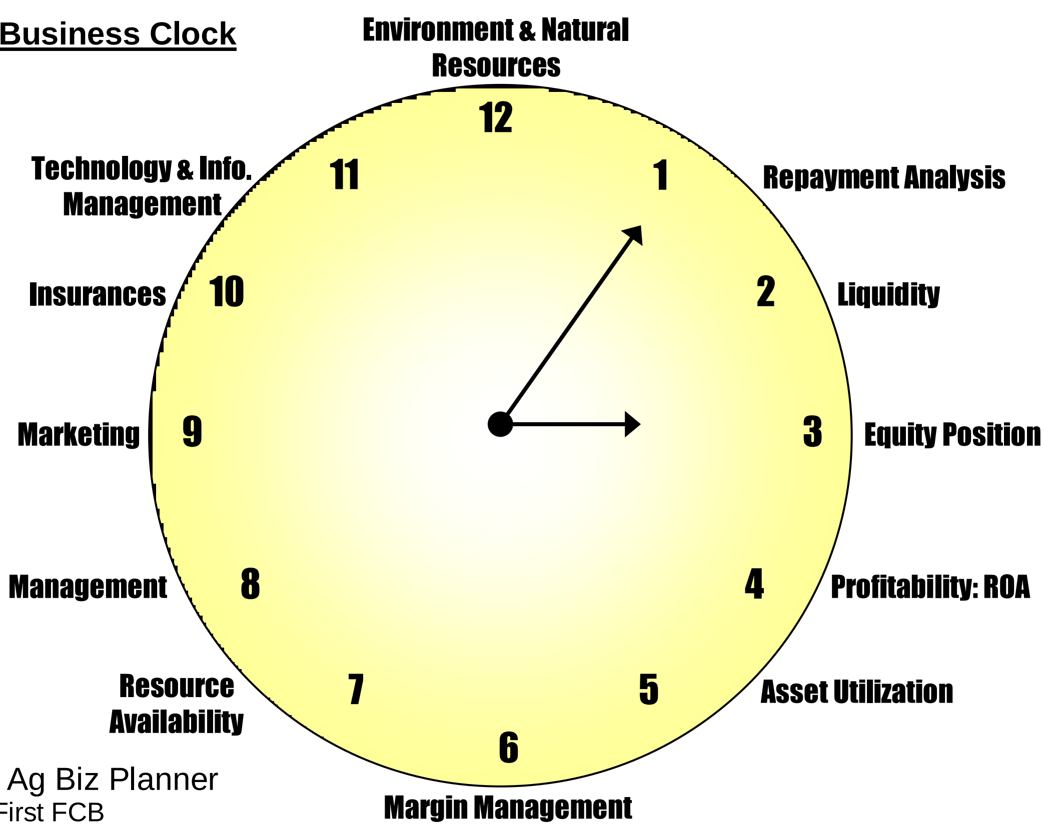
Let's buckle up our seat belts and get ready for the longest stretch in the road. Completing this module will be analogous to a cross country trip driving through the Great Plains. It will be divided into two sections with a workbook application pit stop in the middle. You will be introduced to the management clock. From one o'clock to six o'clock you will assess objective financial data, building upon information and analysis from previous modules. After your middle of the road pit stop, you will finish up the journey by completing points seven o'clock through twelve o'clock. These aspects are more subjective but are very critical to long run sustainability of the financial performance of the business. Get your mental engines fueled up for our long trek through this module.

How does my business stack up to my neighbors?

This question is becoming more common as the agricultural industry progresses into the 21st century. While the exciting opportunities arising in agriculture are not without challenges, these challenges will separate the leaders from the followers. Technology, global market competitiveness, government policy, consumer preferences, and other factors discussed in the Megatrends module, will place greater importance on decision making in a total strategic risk management context.

Strategic Management Check-Up: A Self-Assessment

<u>**The Business Clock**</u>



This Strategic Management Check-Up will allow you to “rock around the business clock” to analyze 12 critical areas in your business as they pertain to short term and long term risk management and sustainability of your business. From the one to six o’clock positions, you will be able to benchmark your business on repayment ability, liquidity, equity, profitability, efficiency (asset utilization), and margin management of the business.

At the seven and eight o’clock positions, you will analyze your resource base such as land, water, labor, market accessibility, and conduct a critical examination of the experience, skills, and capabilities of your management staff. At nine o’clock, critical in any risk management assessment will be a critique of your marketing program whether it is commodity, value-added, or contract production.

At the ten o’clock position, protection through insurance to mitigate risk in daily activities and long term health and estate planning will be explored. Finally, you will analyze your business concerning technology and natural resource management as an increasing and more challenging risk to the business.

This self assessment should be candid. It can be done in private or you may include the assistance other business stakeholders, like your spouse, adult children, or business partners. Your mentor or advisor (for example, an accountant, lawyer, financial planner, farm management advisor, or in some cases a peer) may also help to provide some insight during this process.

During your “rock around the business clock,” you will evaluate your business in these twelve critical areas using a scale which will quantify the assessment. Later, I’ll talk more about scoring the items in each specific category. You may have to modify the scoring to fit your specific situation. But, in each case a score of 0 to 4 will signal a red light, which may indicate the immediate need for altering your strategies and action plans for business improvement. A score of 5 to 8 is a yellow light, suggesting caution and the possibility of tweaking or modification some of your existing strategies. Finally, a score of 9 to 10 is a green light, indicating strength and to continue your business strategies which have been assessed as excellent! Remember, a weakness in one area may be overcome by strengths in other areas.

Realize that some of the categories on the clock will be measured at a specific point in time. However, other aspects in the financials may require a three to five year average because of inconsistencies due to such things as weather, production and operating cycles, tax strategies, management, and/or other kinds of uncertainties.

The objective of the check-up is to get you in the ballpark, but not necessarily to hit a home run. It should challenge your thought process and your planning abilities. The benchmarks represented are based on industry data and also over a quarter century of my exposure to many different agricultural operations. There may be variation in these benchmarks across industries, geographic locations, or due to tenure in the business.

The overall goals of this exercise are to assist you in your decision making by establishing for your business **strategic priorities**, **goals,** and **a business plan**. The ratios calculated and suggested guidelines we present can help in identifying symptoms of underlying problems within a business. Once you identify the underlying problems you will be able to develop strategies to correct, minimize, or overcome those problems. This may require you to use outside assistance or services in addressing main issues. This assessment should move you toward a more objective decision making process rather than making decisions on an emotional or intuitive basis.

Financial Factors

Starting with the financial factors, let's rock around the clock.

Repayment Analysis

Let's start off at the one o'clock position and analyze your ability to repay financial obligations. Repayment capacity addresses the ability of your business to support your family living expense, meet all business expenses and debt payments, replace depreciating capital assets, build business liquidity, and prepare for the future through business investments and retirement plans.

Term Debt and Lease Coverage Ratio

Repayment analysis compares your earnings available to pay your debt obligations to your total annual debt payments and capital investments. A common benchmark used to examine repayment ability is what's called the Term Debt and Lease Coverage Ratio. Chart 1 shows the data that are needed and the procedure used to calculate the ratio. I'll talk more about how changes in the various items listed in Chart 1 would affect a business in a moment.

Overall experience indicates that the greater the net earnings to cover debt payments, the easier an operation can handle unforeseen circumstances and expenses. That is, strong repayment ability lowers the risk to your operation. Thus, a ratio greater than 200 percent is a green light (score 9 to10) and would be an ideal low risk target. A ratio between 120 percent and 200 percent is acceptable, but riskier, and is rated as a yellow light (score 5 to 8). A ratio less than 120 percent indicates high risk and a red light (score 0 to 4). A business with a ratio in the red zone or showing a declining trend over time should take immediate measures to remedy the situation.

150 Percent or Greater for Expanding Businesses

To protect against adversity, or to provide for unexpected opportunities, an operation needs a cash margin to cover its debt payments. The relative level required will change depending on the needs of the business. A business that is expanding or making major capital adjustments should have a minimum coverage ratio of 150 percent (score 7 or greater). This will help the business handle cost overruns or unforeseen problems in production or marketing. On the other hand, a smaller repayment margin is acceptable for an operation whose loans are structured with fixed rates or operations that have stable non-farm income, living expenses, and income tax payments. However, the lower the coverage ratio, the more important risk management tools become, such as crop, hail, and property insurances, liquidity, hedging, options, contracted production, etc.

Chart 1: Repayment Analysis			
1	Net Farm Income From Operations*	$	43,750
2	Plus: Non-Farm Earnings	+	36,500
3	Subtotal	=	80,250
4	Plus: Depreciation Expense & Interest Paid on Term Debt and Capital Leases	+	59,000
5	Earnings available for Family Living, Income Taxes, Interest & Principal, Payments and New Investments	=	139,250
6	Minus: Family Living Withdrawals and Income Taxes	-	58,000
7	Capacity Available for Interest, Principal Payments and New Investments	=	81,250
8	Scheduled Interest and Principal Payments on Term Debt and Capital Leases	$	60,700
9	Term Debt and Lease Coverage Ratio (Line 7 / Line 8)	=	134%
10	Capital Replacement and Term Debt Repayment Margin (Line 7 - Line 8)	=	20,550

*NFIFO= Total Revenue – Expenses (NOT including income and social security taxes)

Coverage Ratio	
0	< 100%
1	100-104%
2	105-109%
3	110-114%
4	115-120%
5	121-129%
6	130-149%
7	150-174%
8	175-199%
9	200-249%
10	> 250%

Road Stop Test:

1. If non-farm earnings (Chart 1, Line 2) were not available, how would this impact the coverage ratio?

ANSWER: Coverage ratio would decrease to 74%, which means the business cannot cover its scheduled debt payments.

2. Holding all other numbers constant, how would a 20% increase in net income (Chart 1, Line 1) improve the coverage ratio?

ANSWER: With increase in Net Income to $52,500, coverage ratio increases to 148%.

Capital Replacement and Term Debt Repayment Margin

Another measure derived during the repayment analysis process is the Capital Replacement and Term Debt Repayment Margin. This is the difference between your capacity to make your loan payments and your scheduled payments. In the example above in Chart 1, the margin is $20,550 (Line 7, $81,250, minus Line 8, $60,700). This margin is useful for analyzing several factors. For instance, the significance of non-farm income can be measured by comparing the level of non-farm revenue to the margin.

This margin can be used to purchase or replace capital assets, build liquidity reserves, repay debt and principal, prepay expenses, improve your insurance coverage, or invest in a retirement fund. Of course, a big mistake producers make is spending this margin on frivolous purchases or “killer toys,” particularly in the good years. Remember the old adage, “Use the good times to prepare for the bad times!”

Here is a list of the top ten “killer toys” I have seen. Compare this list with what is common in your area.

Killer Toy Watch List

1. Hunting Camps
2. Race Cars
3. Race Horses
4. Helicopters
5. Airplanes
6. Large Boats
7. Expensive Gambling Trip
8. Exotic Hunting Trip
9. Numerous ATV’s/4-Wheelers
10. Hummers

If the repayment analysis illustrates substandard performance, the following are strategies to improve repayment capacity.

- Increase net farm income through:
    - Improved quality, price, or amount of production
    - More effective marketing
- Reduce operating expenses, or increase efficiency in operating expenses
- Increase off-farm earnings
- Closely monitor family living withdrawals and reduce as possible
- Sale of capital assets (short-run strategy only)
- Infusion of outside capital
- Restructure debt by lender

<u>You, Inc.</u> – In the module Workbook, please take time to complete a Repayment Analysis for your business using your balance sheet and income statement. Note your Coverage Ratio score for this section:

Coverage Ratio: ____________

Score: _____________
Red/Yellow/Green Light: ____________

Liquidity Analysis

Liquidity is defined as the availability of cash and near-cash assets to cover short-term obligations without disrupting normal business operations. Liquidity is measured by creating a ratio of net working capital to total revenue. The current ratio (current assets divided by current liabilities) is also used to measure liquidity, but the working capital to revenue ratio paints a clearer picture of the liquidity position.

Net Working Capital / Total Revenue

Working capital is the **emergency backup** of a business in the 21st Century. Working capital to revenue is a common financial liquidity measure.

To determine your working capital position, first you will need your balance sheet. Add up all your current assets, usually those with a life of less than one year. Examples are such things as cash, crops growing in the field, inventories and receivables, and prepaid expenses. Subtract your current liabilities, which can include accounts payable, accrued interest, principal payments and notes due within twelve months. This will give you your **net working capital**. Then, from your income statement find your total revenue. Divide your total revenue into your net working capital to get your ratio.

(Current Assets – Current Liabilities) / Total Revenue

Variations in this ratio will occur by enterprise– there is not one working capital percentage that is perfect for every situation. However, generally speaking, as working capital increases so does your flexibility in marketing, acquiring capital assets, ability to take discounts and negotiating price increases. In a defensive mode, when cash flow is disrupted because of price, weather, supply/demand imbalances, or management decision-making, working capital represents a **fallback position** to meet short-term financial obligations.

The appropriate level of working capital will vary with the level of cash, quality of inventories and receivables, and production and market volatility. As volatility increases, working capital, particularly cash, should increase to offset the risk.

A benchmark to strive for is to have a working capital to total revenue ratio of greater than 33 percent.

When purchasing and financing land or when a business is in expansion mode, a minimum of 33 percent should be established before embarking on your plans. In the strategic analysis, it may be a good idea to keep higher levels of working capital if there is limited use of crop insurance, multi-peril insurance, no contract or market plan, variable interest rates on debt, or changes in business plans or business cycle.

Realize that if you fall below 33 percent, it denotes caution depending upon equity & earnings stability. Less than 10 percent, while it may not necessarily put you out of business, could represent significant financial stress if there were a disruption of cash flows, unexpected downturn of business, or a negative financial turn of events. A consultation with your account officer and an in-depth enterprise and budget variance analysis may be needed to ascertain your ability to handle shocks to your working capital position.

Chart 2: Working Capital/Revenue			
1	Current Assets	$	150,000
2	Current Liabilities	-	75,000
3	Working Capital	=	75,000
4	Total Revenue	=	280,000
5	Working Capital / Revenue Ratio (Line 3 / Line 4)	=	27%

Working Capital/ Revenue	
0	Negative
1	1 – 3%
2	4 – 6%
3	7 – 10%
4	11 – 15%
5	16 – 20%
6	21 – 25%
7	26 – 30%
8	30 – 34%
9	35 – 50%
10	50% +

<u>You, Inc.</u> – In the module Workbook, please take time to calculate your working capital /revenue ratio for your business using your balance sheet and income statement. Note that you calculated the amount of working capital in the previous module.

Working Capital / Revenue: _____________
Score: ______________
Red/Yellow/Green Light: _____________

Equity Position

Your equity position, or **percent equity**, reflects the relationship between your assets and your financial obligations, including any respective investment levels of both owners and creditors. Roughly speaking, your percent equity measures the business assets owned.

To obtain your equity position you will need your **business balance sheet**. Your equity position is calculated by dividing your total equity by total assets. This can quickly be used to measure an owner's investment level in their business.

A ratio greater than 70 percent indicates lower risk from a producer and lender perspective. While equity does not repay loans unless you sell assets, it does represent an opportunity for a refinancing strategy if markets or weather adversely impact production and revenue. However, if you use equity to refinance every 2 to 3 years, then there may be earnings, spending, or operational problems.

Equity can be pledged to expand operations if growth strategy is desired. Be sure and examine the condition of **your equity position**. Is it because of growth through earnings, age of business or managers, inflation, inheritance, land appreciation, or location?

A 40 to 70 percent ratio would indicate a caution sign. Farm and ranch businesses and agribusinesses such as feedlots, dairies, nurseries, vegetable growers, leased operations, contracted poultry growers, and new and beginning operations may be in this range and have acceptable risk from a business and lender standpoint. Grain farmers and livestock ranchers with beef cow/calf operations, on the other hand, might find these debt levels risky because of the slow turnover of capital. Look at the trend in this ratio over time. As you normally pay down your loans, this ratio should increase over time. However, a decreasing ratio is a sign that you are facing more financial risk over time. Possible causes of a decreasing ratio are low profitability, inefficient use of assets, or excessive family living expenses.

An equity ratio under 40%, while acceptable in some cases, particularly with young or beginning farmers, reduces a manager's flexibility and puts pressure on earnings available to service debt. Also, the chance of insolvency (liabilities exceeding assets) is greater, particularly in an extended economic down cycle.

Yellow and Red Ranges

Producers in the yellow and red range must strategically implement five basic strategies. First, you must be in the top 25 percent of production efficiency managers holding cost under control. Second, have a strong marketing plan and contracts, with appropriate risk mitigation strategies such as insurances, options/hedging or other appropriate tools. Third, be very cognizant of cost efficiencies. Fourth, keep living costs modest compared to peers, and finally, be a proactive planner with execution and follow through.

Equity Growth

Some of you may want to benchmark equity growth. Peak performing managers attempt to average a business earned net worth growth rate of 5 to 7 percent annually or more (excluding inflated / deflated assets) over a five-year period as a strategic objective. This usually will equate to doubling your equity through earnings every decade. To accomplish this, some will make additional payments when prudent, avoid unnecessary business and capital expenditures, control living withdrawals, and improve operating profit through a combination of price, quality, volume, value-added, or cost control. For some of you and your lenders, you may use debt to asset and debt to equity ratio. Each of these ratios measures financial solvency.

Chart 3: Percent Equity			
1	Total Equity	$	300,000
2	Total Assets	=	976,225
3	Percent Equity (Line 1 / Line 2)	=	31%

Percent Equity	
0	Negative
1	1-10%
2	11-20%
3	21-30%
4	31-40%
5	41-50%
6	51-60%
7	61-70%
8	71-80%
9	81-90%
10	90-100%

<u>You, Inc.</u> – In the module Workbook, please take time to calculate percent equity for your business using your balance sheet.

Percent Equity: ______________
Score: _______________
Red/Yellow/Green Light: ______________

Profitability - Return on Assets (ROA)

Profits are essential for the long-term viability of a business. Profitability evaluates how productively a business uses such resources as land, people, capital, and technology by comparing business revenues against all economic costs. While a business can operate in the short-run on breakeven or negative returns, profits are necessary in the long-run to support family living withdrawals, build equity, service debt and ultimately sustain and grow the business. Inadequate profits can result in problems in repayment ability, liquidity, or cash flow, as well as a decline in equity.

The following example (Chart 4) is an annual snapshot of a business's profitability. Realize that in order to get an accurate picture, accrual income information should be utilized to analyze trends over a three to five year period.

First, you will need the net income from the business' income statement and any interest paid; living withdrawal or management fee. Take net income and add interest paid (from the income statement). Deduct living withdrawals or a management fee of 5 to 7 percent of revenue (This is a standard, acceptable method of estimating the management fee). Divide the resulting number by total assets.

You will need your balance sheet to obtain total assets. If market value is used, your returns will likely be lower than cost-based statements because of the appreciation / depreciation implications. This gives you your rate of return on assets, or ROA.

Chart 4: Return on Assets			
1	Net Income	$	43,750
2	Interest Paid	+	31,000
3	Subtotal	=	74,750
4	Living Withdrawal or management fee	-	26,500
5	Subtotal	=	48,250
6	Total Assets	=	976,225
7	Return on Assets (Line 5 / Line 6)	=	5%

	ROA Owned	ROA Leased
0	Negative	Negative
1	Zero	1%
2	1%	2-3%
3	2%	4%
4	3%	5%
5	4%	6%
6	5%	7%
7	6%	8-9%
8	7%	10-11%
9	8%	12-14%
10	9-10%	15% +

The benchmarks for this ratio are different for operations that own a majority of their assets versus operations that lease a majority of their assets. The benchmarks we provide are for either extreme. If your operation is 50/50 owned and leased, then split the difference evenly.

If your ROA is above 7 percent (for owned assets) and above 10 percent (for rented or leased assets), congratulations, you are in the top 25 percent of producers! This is a green light concerning profitability.

If your ROA is between 4 and 7 percent (owned) and between 6 and 11 percent (leased), you are in the yellow light range. You should consider some of the suggested measures for improvement.

Less than 3 percent (owned) or 5 percent (leased) is a red light. It does not necessarily mean a business failure. However, if not corrected and business profits are a goal of your business, long term success may be in jeopardy, because your rate of return is under the long term rate of inflation of 4 percent.

Roadside Chat 1: What strategies can I use to increase profitability?

1. First, you or your team of advisors (lender, farm management advisor, and accountant) must aggressively monitor expenses and revenues to increase efficiencies.
2. Create an analysis of each specific enterprise to determine your “profit centers”.
3. Dispense of unproductive assets, both capital and human, and focus on productive assets.
4. Reduce costs (especially the five largest expenses).
5. Improve revenue through increased value-added or quality of production.
6. Better manage interest rate risk and examine various loan products with your lender.
7. Cut back on management withdrawals and/or living expenses.
8. Maintain working capital to take advantage of discounts and negotiate better deals.
9. Resign yourself to the fact that you may have to depend on off-farm revenue as a cash flow generator.
10. Make a resource assessment, quality and quantity of land, labor, capital, etc.

You, Inc. – In the module Workbook, determine the Return on Assets for your business using your balance sheet and income statement.

ROA: ____________
Score: _____________
Red/Yellow/Green Light: ____________

Asset Utilization

Asset utilization or financial efficiency of both capital and human assets is a key to business success, particularly for commercial farm businesses. The capital turnover ratio is a financial measure used to determine financial efficiency. To calculate the ratio, total revenue is divided by total assets. In the illustration in Chart 5, assets were $976,225 and revenue was $280,000. This leads to a capital turnover ratio of 29 percent. If you divide this percentage into 1 (or 100%) you can see that the business is turning over its capital every 3.5 years. Business enterprises such as nursery, dairy, feedlots, hog, poultry, and rented assets will generally have a higher turnover ratio.

Cow-calf, and grain farms and ranches with more owned assets will experience slower degrees of asset turnover.

While there is variance by industry, if one exceeds 40 percent, congratulations, you are a green light. At the other end of the spectrum, below 20 percent may be indicative of your particular industry, or a need to improve asset utilization.

The main cause of poor asset utilization is too many high valued assets on the balance sheet, which are not generating revenue. The solution is first to do a complete inventory audit of asset items. Next, for crop farms conduct a machinery and equipment budget per unit focusing in on fixed costs. Compare these budgets to peer benchmarks provided by farm record systems. If numbers are out of line, sell unproductive assets or undercapitalized assets. In some instances, you may sell fixed assets and lease back or control the assets rather than own them.

Chart 5: Capital Turnover			
1	Gross Revenue	$	280,000
2	Total Assets	=	976,225
3	Capital Turnover Ratio (Line 1 / Line 2)	=	29%
	# years to turn capital (1/ Line 3)		3.5 years

Capital Turnover	
0	Negative
1	1-4%
2	5-9%
3	10-14%
4	15-19%
5	20-24%
6	25-29%
7	30-34%
8	35-40%
9	41-50%
10	50% +

<u>You, Inc.</u> – In the module Workbook, calculate capital turnover for your business using your balance sheet and income statement.

Capital Turnover: _____________
Score: ______________
Red/Yellow/Green Light: _____________

Margin Management

"It's all about the margin" is a business adage applied to successful and sustainable business models. The margin ratio can be used to size-up the efficiency of an operation regarding net income and gross revenue. To calculate a profit margin, take the net income, and add back any interest paid. Then, subtract family withdrawals or management fees. Divide this subtotal by gross revenue to get your profit margin percentage. In the example, net profits of $43,750 plus interest paid of $31,000 gives a subtotal of $74,750. The management fee of $26,500 is deducted to give a subtotal of

$48,250, which is divided by $280,000 of gross revenue for a profit margin of 17 percent.

As with capital turnover, there will be variance among industries. Usually an 8 percent margin or lower is a sign corrective action is needed. Generally a profit margin higher than 15 percent is indicative of superior margin management regardless of the industry.

To improve profit margin, keep good farm records to know cost of production by enterprise and what are fixed versus variable costs. A sound business plan with a three-point risk management program concentrating on revenues, input costs, and interest rate strategy is highly suggested.

Chart 6: Profit Margin			
1	Net Income	$	43,750
2	Interest Paid	+	31,000
3	Subtotal	=	74,750
4	Living Withdrawal or management fee	-	26,500
5	Subtotal	=	48,250
6	Gross Revenue	=	280,000
7	Profit Margin (Line 5 / Line 6)	=	17%

Profit Margin	
0	Negative
1	1-2%
2	3-4%
3	5-6%
4	7-8%
5	9-10%
6	11-12%
7	13-14%
8	15-16%
9	17-19%
10	19% +

<u>You, Inc.</u> – In the module Workbook, please take time to determine the profit margin for your business using your income statement.

Profit Margin: _____________
Score: ______________
Red/Yellow/Green Light: _____________

The bottom line to improve the profitability of a business is all about "earns and turns;" either improve the profit margin or better utilize the assets. If you multiply turnover percentage by the profit margin percentage, you will obtain ROA. (29% x 17% = 5%)

As an example of this relationship, let's reduce assets by $100,000, down to $876,225, and increase the profit margin by 2 percent, up to 19%, and holding everything else constant.

Answer: $280,000 (gross revenue) / $876,225 (assets) = 32% turnover ratio x 19% profit margin = 6.1% ROA

This shows that a modest improvement in turnover and margin can positively impact profitability.

ROADSIDE CHAT #2: Dr. Kohl, I've heard you say numerous times to focus on efficiency first before growth. Why is this?
When businesses get into financial difficulty or low profit, there is a tendency for business managers to attempt to grow their way to profits by increasing sales or revenue. However, if the business is not efficient in the first place, the result is digging the business in a deeper hole. If a business becomes more efficient, first, through expense management and, and adding to sales or revenue second, the result will be an improved bottom line. It is difficult to grow your way to profits if you are not operating efficiently.

<u>Pit Stop:</u>
We're halfway around the clock and have covered all the quantitative, objective financial factors. Take a break and, using your workbook, apply these first six factors to your own business. Then continue on with the remaining six non-financial factors that are more qualitative and subjective. Keep in mind that these remaining six factors, while not quantitative, will impact success in the first six factors over the long term.

Non-Financial Factors

Resource Availability

There is an old saying about taking an excellent manager and placing him or her on poor or average resources. They become average in profitability very quickly with wide variances in income over the business cycle.

Let's shift gears away from the financials. Examine your resource base including land, water, infrastructure, labor, political stability, and market accessibility. Look at your resources as an "outsider" would – in other words, look at your farm as you would if you were considering buying it. This helps to make your evaluation more objective.

To conduct a strategic analysis of your business's resources: consult soil maps; evaluate water supply and quality; assess the quality and quantity of the local workforce; measure political, public and financial institutions' support for agriculture; analyze the local infrastructure (roads, agribusinesses, schools and community); and finally, examine market access and location.

If you have good quality resources (land, water, labor), developed infrastructure, political and financial support for agriculture, are strategically located relative to markets, and have good access them, you have the foundation for long-term success and a green light.

Weakness in one or two of these critical areas puts your business at lower chance for strategic success. If you have weakness in three or four of the major areas, while not impossible to overcome with superior management, is a decided threat to overall business success, particularly from the one to six o'clock position, in the financial analysis.

Chart 7: Resource Availability		
1	Land, water, labor	______
2	Infrastructure, roads, agribusinesses	______
3	Financial stability	______
4	Political stability	______
5	Access to markets	

Resource Availability	
0-4	Strong in 1-2 areas
5-8	Strong in 3-4 areas
9-10	Strong in all 5 areas

Roadside Chat 3: Well Doc, we did the resource analysis and we are lacking on some attributes. What can we do?

If you have below average land base or insufficient water, then some insurances (i.e. crop and multi-peril) become imperative, not an option. Second, lack of infrastructure or market accessibility may require the formation of strategic alliances or groups facilitated by an agribusiness professional. The aggressiveness of your management plan and technology use may have to be modified to match your resources and infrastructure. You will have to be an excellent production and marketing manager to overcome these weaknesses.

You, Inc. – In the module Workbook, score your resource availability.

Score: ______________
Red/Yellow/Green Light: _____________

Management / Experience

Now let's move our analysis to the micro level. It's time to examine yourself and the rest of the management staff. When you talk with farm managers who excel, it soon becomes apparent that they share many traits – a total of seven. You'll find these traits listed below. How do you compare?

The first attribute is **objectivity** – that is, they can examine strengths, weaknesses, opportunities and threats to the business, and adapt and take appropriate actions.

Secondly, farm managers who excel are calculated-**risk takers**: they seek input or counsel and analyze the best- and worst-case scenarios.

Third, they **think in terms of systems** rather than components. Although they, like everyone, compartmentalize tasks, they also evaluate impact of change as it affects the business as a whole through an effective monitoring and measuring system.

Fourth, they are **effective time managers**, focusing on what is important versus what is urgent.

Fifth, they are good **human relationship managers** who share input and decision-making with employees, family and outside suppliers. Human relationship managers attempt to develop the next generation of managers, frequently sending them away for education and exposure to "other schools of thought."

Their sixth attribute is being a **good communicator and networker**, not only in the business, but also throughout the industry and their community.

Seventh, and most importantly, they possess **a passion for the industry**, seek positive influences, and take time to exercise their mind, body and spirit.

In your analysis, if you find that you have all seven of the habits then grade yourself with a green light. If you have strengths in three to six of the areas then you would be a yellow light. If you score in the red light range, courses or mentorship in this area may prove to be valuable for improvement.

Chart 8: Management Ability		
1	Objective bias for action	
2	Calculated risk taker	
3	Thinks in systems rather than components	
4	Strong human relationship manager	
5	Develop next generation of management	
6	Good communication skills	
7	Passion for the industry	

Management Ability (2 points for each area, max of 10)	
0-4	Strong in 1-2 areas
5-8	Strong in 3-6 areas
9-10	Strong in all 7 areas

<u>Road Stop 4:</u> "Dr. Kohl, I need assistance with the management component. Do you have any suggestions?"

Methods to improve in any of these areas include bank-, lender-, or Extension-sponsored seminars with specific information and training in many of these subject matter areas. Second, a family business or one with outside partners should encourage education and cooperative educational experiences away from the business. Your account officer could be a resource to find excellent learning opportunities under top-flight management.

<u>You, Inc.</u> – In the module Workbook, score your management ability.

Score: _____________
Red/Yellow/Green Light: ____________

Marketing

An essential aspect of a total risk management strategy is marketing. 21st Century agriculture finds that producers are generally oriented either toward commodity/contract marketing or value-added marketing. Your operation may be one or the other, or both. Use the following criteria to size up your own operation and your abilities as a marketer.

If you are a **commodity producer**, there are five specific attributes that market leaders tend to exhibit. First and foremost, they know the cost of production. Second, they have a plan, which may include commodity options, futures, and hedging. Third, they have a timetable and checkpoints for executing the plan. Fourth, they have a monitoring and measuring system. Finally, many have in place the necessary risk management tools ranging from insurance and contracts to irrigation, to protect the downside and still lock in a profit.

On the other end of the spectrum in **value-added marketing**, many of the already mentioned attributes for success apply here as well. Again, knowing the cost of production is critical to establish breakeven and pricing strategies. Second, is having a marketing plan that has alternatives and a possible exit route. Third, is establishing a system of client relationship management. Fourth, have a system of quality control concerning products and services. Finally, whether its contract or value-added, a plan is needed for the next product or service because product life cycles tend to be shorter as competition intensifies in the 21st century. Value-added producers need to know their market including customers and potential customers, market concentration, psychological and demographic trends that would impact buying habits, and attributes of customers who fit the company's philosophy.

Now, it's time to size up your business. Choose either commodity or value-added marketing, and for each of the attributes you display, award yourself 2 points. Give yourself a green light if you scored 9 or greater. If so, you rank within the top 25% of farm managers who consistently maximize pricing and profit-making opportunities. A score of 5 to 8 is a yellow light and would apply if you don't have such things as a written marketing plan, contract(s), or use the appropriate risk-mitigation tools. If you scored 4 or below, red light! You are weak in all key marketing areas and your business could be very much at risk!

Chart 9: Marketing: Commodity		
1	Know cost of production	______
2	Have marketing plan	______
3	Timetable and checkpoints	______
4	System monitoring	______
5	Tools for risk mitigation	

Marketing (2 points for each area)	
0-4	Strong in 1-2 areas
5-8	Strong in 3-4 areas
9-10	Strong in all 5 areas

Chart 9: Marketing: Value-Added		
1	Know cost of production	______
2	Have marketing plan with alternatives/systems	______
3	Target market fit and client relationship management system	______
4	System of quality control	______
5	Plan for next product development	

<u>Road Stop 5:</u> I need a tune up in the marketing area. Any suggestions?

A possible solution to improve your position would be to explore insurances and risk management products offered by lenders and agribusinesses. Second, seek educational opportunities for you and your staff or obtain a trusted advisor. Care should be taken to ensure their reputation and track record and ability to work specifically with your business. Finally, many of your lenders as part of the loan package are going to demand and expect a written marketing plan with documentation of any contractual arrangements. Thus, being proactive could place you in a better negotiating position in dealing with finances. It is imperative to be able to execute strategies, action plans and monitoring systems.

<u>You, Inc.</u> – In the module Workbook, score your marketing plan.

Score: ______________
Red/Yellow/Green Light: _____________

Insurances

The clock is about to stop at ten for an insurance checkup. Business managers have two choices concerning insurance: They can accept total risk, and the consequences, or pass that risk to other organizations at a cost. After the mining industry, agriculture ranks second in terms of risk. This is the result of dealing with livestock, chemicals (pesticides, herbicides), machinery, and weather. For example, according to *USA Today,* the typical non-farm citizen has less than a 30% chance of becoming disabled for more than 90 days in their lifetime. If you are involved in agriculture, this increases three times. Five insurances are critical for managers and their families. They are disability/life, liability, long-term health care (including nursing home or assisting living care), key person, and major medical where applicable.

In scoring yourself, if you have adequate coverage in all five areas or feel you are sufficiently self-insured, you score a green light. If three of the variables are missing or you are not adequately self-insured, you may be placing your family and business at risk. If you have little or no insurance and your equity is insufficient to cover your losses, you are red-flagged. Some would say there are insufficient profits in agriculture for insurance. Quite frankly, if you can't afford insurance, you probably should consider getting into a different business. Producers and spouses in this situation have resorted to off-farm revenue and benefit packages to alleviate risk.

Chart 10: Insurances		
1	Disability/Life insurance	______
2	Liability insurance	______
3	Long term health care	______
4	Key person	______
5	Major medical care or self-insured	

Insurances (2 points for each area)	
0-4	Strong in 1-2 areas
5-8	Strong in 3-4 areas
9-10	Strong in all 5 areas

<u>Road Stop 6:</u> Do you have any "Rules of the Road" for insurance?

As a general rule, producers should strive to have enough life insurance to cover all loans, or the equivalent of five to seven times net farm/non-farm earnings. Concerning insurance cost outside of crop, multi-peril, fire, etc., the annual cost should not exceed 5 percent of revenue in total. Liability insurance at a minimum should be $1 million, and sometimes up to $5 million, depending on the type of business.

Some lenders, agribusinesses, and insurance companies offer many insurance products such as life insurance, disability on loans, long-term health care, and key person insurance. Contact your account officer or agent for details.

<u>You, Inc.</u> – In the module Workbook, score your insurance coverage.

Score: ______________
Red/Yellow/Green Light: _____________

Technology and Information Management

Technology has two basic components, biotechnology and information technology. Whether you produce bio-altered or naturally-grown products, each requires a system of traceability and compliance. For example, an organic producer is required to meet certification standards including no commercial fertilizer and pesticides for certain time limits. On the other hand, agribusiness and government programs require livestock and crop information, all the way from the fields or feed yard to the plate.

Concerning information technology, too much data can cause a manager to focus on what is urgent rather than important. A peak-performing manager should aspire for two to six hours of education per week to stay abreast of new breakthroughs in the information society. A plan for employee training and upgrading is critical as well. Schools, seminars, websites, and reading are all part of this plan.

As agriculture consolidates, risk increases. A food scare (real or fabricated), for example, can rapidly spread via the Internet and media, and potentially place a business in a precarious position. Thus, documentation, traceability and information systems, should be viewed not only as compliance (where required or put in place voluntarily) but also as adding value for the end consumer.

In scoring yourself on this measure, there are five related aspects. Each aspect can receive 2 points. First, examine your record system of traceability and documentation throughout the food chain. Second, examine your process for updating or staying current. Do managers get the two to six hours of training per week? What is your system of educating employees? Finally, is your ability (and past experiences) of adopting technology and new ideas effective?

If you score well in all areas, you are ahead of the curve. If you have deficiencies in one or two areas, then start embarking on a system or plan for improvement. If you score 4 or below, it's a red light! In this strategic component, you may be profitable and cash-flow well in the short run; however, the long run leaves your business and family wide open for a technology disaster or slowly falling behind in the educational or updating process. What is your system for keeping records? Is it organized, easily accessible, and can records be quickly analyzed? As many of you who have used computers know well, it is important to have a secure backup system for your records also.

There are a number of seminars and schools that are available and some are lender sponsored with the various components of technology whether it is organic, bio-altered, or informational. Various websites and publications can keep you abreast of the latest information.

Chart 11: Technology & Information Management		
1	System of traceability	________
2	Process for updating	________
3	2-6 hours of training each week	________
4	Success in adopting technology	________
5	System for backing up info. & technology	

Technology & Info. Management (2 points for each area)	
0-4	Strong in 1-2 areas
5-8	Strong in 3-4 areas
9-10	Strong in all 5 areas

<u>You, Inc.</u> – In the module Workbook, score your management of technology and information.

Score: ______________
Red/Yellow/Green Light: _____________

Environmental Compliance & Natural Resource Management

Environmental compliance and natural resource management will become increasingly important factors in strategic risk management. As agriculture consolidates and competition becomes more intense for water and land for development and recreational use, environmental plans will be essential. More lenders and public officials are demanding environmental assessments before they approve loans or expansion plans. Good public relations with neighbors and the community as a whole will not be an option, but a requirement.

Now let's complete the final assessment. There are five attributes. Score 2 points for each one if it describes what you are doing.

1. *Waste and nutrient management plan*
   Do you have a proactive **waste and nutrient management plan** that is tested and updated?
2. *Soil and livestock testing*
   Do you regularly **test your soils** to determine proper applications of fertilizer and pesticides?
3. *Records that document procedures for environmental & natural resource practices.*
   Do you have sufficient **records** to document and backup your procedures for fertilizer and crop applications and storage?
4. *Little pressure from development & recreational use*
   Is **smell** from your farm a possible air quality risk? What is your system for bio-security? Is the location of your farm or business prime for development? Could you turn this into a value-added strategy by changing commodities? Is risk increased because of population or recreational pressures in close proximity to livestock, machinery, or crops?
5. *Long term land arrangements, if leasing*
   Is the land you are leasing owned by elderly people, who if they die could disrupt your production plans?

If you have a solid plan for compliance that is backed with good records, and do not face increasing competing pressure for land and water use, give yourself a score of 9 or 10. That's a green light!

If you have deficiencies in some of the areas and threat by the community your risk increases into the yellow zone. If you are a manager who has done very little planning and your business is vulnerable to the threats listed above, then your score is 4 or below and that's a red light with considerable risk.

Chart 12: Environmental Compliance & Natural Resource Mgt.		
1	Waste & nutrient management plan	______
2	Soil & livestock testing	______
3	Records that document procedures for environmental & natural resource practices	______
4	Little pressure from development & recreational use	______
5	Long term land arrangements, if leasing	

Environmental Compliance & Natural Resource Mgt. (2 points for each area)	
0-4	Strong in 1-2 areas
5-8	Strong in 3-4 areas
9-10	Strong in all 5 areas

<u>You, Inc.</u> – In the module Workbook, score your environmental compliance and natural resource management ability.

Score: _______________
Red/Yellow/Green Light: ______________

The Final Analysis
Now that you have completed each section of the Strategic Management Check-Up, let's look at the assessment as a whole.

Scores under 5 in any category should demand priority and your immediate attention! At the other end of the spectrum, if you score 9 or above, continue to do what you are doing well!

If you fall in the middle, determine your progress and examine reasons for the trends. For example, it is difficult for a new business or young producer to have a strong equity position or a long-term transition or estate plan just due to their short tenure in the business.

Realize that the objective measures in the one to six o'clock realm of your business are very dependent upon the emphasis in management that occurs from seven to twelve o'clock.

Finally, strategic risk management is not doing one component of your business 100% better, but rather doing 100 little things 1% better. Young, beginning, small, and minority farmers and ranchers may have deficiencies because of less experience in the business lifecycle. This assessment can be a guide as you evolve your business and strategically think about identifying strategies for improvement.