Transition Planning Case Study

This case study, set in the winter of 2012/2013, is based on an actual farming operation in Manitoba. To ensure the privacy of the owners' operations, the names of the owners are replaced with Rob and Faye Sample. They have a married son and a daughter in university.

Background

Rob and Faye Sample have been farming for 33 years. Both are in their mid-50s. The couple bought 800 acres of land for $200,000 from Rob's father in 1979 and paid it off in 1994. They bought an adjoining half section in 1980 for $128,000 and paid it off in 2000.

In 2008, a neighbour wanted to sell 1,440 acres and some outbuildings to the Samples for $1.4 million. The Samples had been renting the land and even though they thought that the asking price was steep, they didn't think they had any option but to make the purchase. So they went ahead with it, feeling that if they didn't make the purchase, someone else would. In 2010, they added a grain handling system to replace/upgrade the older granaries bought from Rob's father. The loan is due in 2015. They also borrowed $50,000 in 2011 to renovate the house and buy a recreational vehicle. The loan is due in 2016. Both Rob and Faye think the nearly 4,200 cultivated acres they are now farming is enough. "We have what we want," says Rob. "We work hard and don't seem to have a lot of time away from the business, even though we have some excellent help."

The Samples have one full time employee and some seasonal workers during the summer and fall. The couple find it's always a struggle to hire good employees or any employees at all. When they first began farming, Rob and Faye thought they only needed help during seeding and harvest and only looked for help at those times, but finding qualified, reliable, motivated people was a challenge. They decided to hire a full time employee and only bring in seasonal workers during really busy times. The challenge of having a full time worker was how to keep him busy during the winter months.

Having a full time person worked well until he decided to leave without much notice, just before harvest in 2012, the Samples haven't replaced him. Fortunately, 2012 was an open fall and their son, John Sample, came back home to help his parents with harvest.

Business Structure

Rob and Faye farm together in a corporate business structure. They each own 50 per cent of the common shares. The first two pieces of land they bought are in both their names and are held personally, outside the family company. There is no rental arrangement between the business and the Samples, as personal owners, to farm this land.

The Samples discussed the best way to buy the most recent piece of land ($1.4 million) and decided the best approach was to have it bought and owned by the corporation, rather than owning it personally.

Business Challenges

The Samples' farming operations went pretty well until 2009 and 2010, when there were challenges with wet weather. The markets remained strong in 2011 and 2012 , but by the winter of 2012/13, Rob and Faye had some decisions to make. They had lost their full time employee just before harvest. And even with their son's help, it was a challenge to get the crops in with added stress and longer hours for the whole family. The couple wanted to make sure they didn't face the same kind of challenge again.

One of the things they wanted to look at was how to reduce some of their business costs.

For example, their custom farm work costs, because every year, the timing of getting the custom work done became more of a problem. Waiting for custom work can delay farming operations and that can affect yields and quantity. The Samples run one combine and one seeding unit, both of which are run at full capacity during the season.

Because Rob's equipment is older and slower, they needed to hire custom workers to help finish the work on time. They decided it was more efficient to hire custom workers than to invest capital in new equipment. Their reasoning was that they didn't want to take on more debt.

Rob says that their lenders do not appear to be overly concerned. Their financial situation was worse a couple of years ago. But in the year of this case study – 2012/2013 – even after the Samples had a couple of better years financially, their lenders are still cautious about extending more financing.

In spite of the challenges, the Samples say that farming has given them a good life. At this point in their lives, the couple want to enjoy more of the benefits of their hard work and persistence over 33 years. They say the farm should be comfortably paying its way, now.

Current Financial Status

The Samples have accumulated just over $1.7 million owner's equity (or about $3.6 million in equity – net worth). This is calculated using market value for their assets and without the outstanding shareholder loans. They have three term loans, an operating loan and some accounts payable. The operating loan has not revolved in the past two or three years. This chart shows the Samples' existing term loans.

Original Date	Original Amount	Principal and Interest Annualized	Principal Outstanding December 2012	Principal Due 2013
2008	*$1,400,000*	*$127,058*	*$1,244,561*	*$49,885*
2010	*$ 350,000*	*$70,000* *((equal principal)*	*$210,000*	*$70,000*
2011	*$50,000*	*$11,548*	*$40,962*	*$9,495*

The large loan in 2008 to buy more land was a risk. It was financed over 20 years and matures in 2028. Because their other land was already paid off, they used it as security for the 2008 loan and didn't need a down payment to get the $1.4 million loan. However, the loan did equal about 60 per cent of the farm's total land value.

The Samples took out a $350,000 loan in early in 2010 to provide more operating capital and financed it over five years (due in 2015). Their operating cash was low in 2009 as they were struggling with the wet weather. When things started to turn around in 2011, the couple took out a $50,000 loan to pay for some much needed home renovations and buy a recreational trailer (fifth wheel) so they could take vacation time away from the farm. This was also a five-year term (due in 2016).

In the past, Rob bought smaller capital items using operating cash, rather than taking a loan and setting a repayment schedule. He says cash flow feels tight at times.

Business Management

The management structure of Sample Farms is similar to the vast majority of mid-sized farms in Manitoba. Faye does the bookkeeping and helps with the office functions, such as payroll and GST reporting. Rob's passion is farming and while he assumes responsibility for all other management functions, he'd rather be outside working. He knows some changes are needed, but thought things were working fine until their hired man left, now reality is setting in. Who is going to do the work? How is Rob going to be able to manage?

The Family Options

Rob and Faye are in their mid-50s. Son John is 29 and married to Rebecca. Daughter Carol is 27 and finishing a degree at university.

John has an agriculture business degree and works for the provincial government and makes about $55,000 annually. John likes his job but is also very interested in expanding his horizons. He likes helping his family with harvest in the fall, but it wasn't necessary until the hired man left last fall. Rebecca is a trained health professional and has a lot of job options in any urban centre, but few if they move to the Sample farm. They have no children but do want to start a family.

The young couple have discussed moving to the farm and having John work with his father or take it over completely from his parents. If they do that, Rebecca thinks that would be a good time to start a family, since her career options will be limited.

Carol is in a long term relationship with an apprentice carpenter and living in another province. Their plans hinge on what kind of job Carol can get when she finishes her degree. Carol did help on the farm when she was younger, but has not talked about any interest in farming a career.

Rob and Faye take a fixed management salary of $60,000 plus an allowance for their daughter's university costs. Every month, Rob takes money from the farm account and transfers it to a separate account for family living expenses. Faye thinks they should be emphasizing savings and security now, for their retirement. Both Rob and Faye think the equity they have built in the farm will provide protection for their family and for their retirement.

Faye's parents ran a successful business. She and Rob may inherit from them in the distant future. Rob's parents have both passed away. Rob and Faye's term loans are life insured. Rob has no disability insurance. There are no other life insurance policies.

Rob is under constant stress and this causes Faye some concern. She has a hard time getting him to talk about their situation. Compounding the situation is the possibility that John and Rebecca may want to move to the farm but there hasn't been any real discussion about it.

The Future

The loss of the hired man was pivotal to the couple's future plans. They don't want to do another harvest without a full time person to help. They are asking themselves a lot of important questions:

- How do they avoid hiring someone who may leave at any time?
- Should they talk to John and Rebecca about taking over the farm? Will that put too much pressure on the younger couple?
- What would happen if John and Rebecca came to farm? How would the business be set up?
- If John and Rebecca take over the farm, what does that mean for Carol and her partner?
- Can Rob and Faye continue to manage with just seasonal help?

All these questions and more are integral to transition planning for this family.

Financial Performance

Ratio Analysis

		2008	2009	2010	2011	2012
Liquidity						
Current ratio	current assets / current liabilities	**2.3**	**1.4**	**1.4**	**2.1**	**2.7**
		$1 743 077	$1 346 126	$902 137	$2 106 650	$2 591 404
		$756 705	$980 005	$631 263	$1 004 929	$965 588
Working capital percentage of total operating expenses	current assets - current liabilities / cash operating expenses	**74.1%**	**29.9%**	**23.0%**	**78.5%**	**120.1%**
		$986 372	$366 121	$270 874	$1 101 721	$1 625 816
		$1 330 637	$1 226 399	$1 176 975	$1 403 805	$1 353 326
Debt structure ratio	current liabilities / total liabilities	**35.7%**	**42.5%**	**28.7%**	**40.2%**	**41.4%**
		$756 705	$980 005	$631 263	$1 004 929	$965 588
		$2 120 646	$2 305 543	$2 195 902	$2 496 962	$2 331 731
Solvency						
Equity ratio	total equity / total assets	**54.8%**	**48.3%**	**47.4%**	**54.0%**	**60.8%**
		$2 574 515	$2 155 864	$1 982 625	$2 926 306	$3 609 359
		$4 695 161	$4 461 407	$4 178 527	$5 423 268	$5 941 090
Debt to equity ratio	total liabilities / total equity	**0.82**	**1.07**	**1.11**	**0.85**	**0.65**
		$2 120 646	$2 305 543	$2 195 902	$2 496 962	$2 331 731
		$2 574 515	$2 155 864	$1 982 625	$2 926 306	$3 609 359
Debt servicing ratio	debt servicing capacity / principal and interest	**2.06**	**-1.92**	**-0.44**	**4.55**	**3.27**
Debt servicing capacity	net income (before tax) *plus* interest on term debt *plus* amortization *minus* owner withdrawals *minus* income tax paid	$365 683	-$372 111	-$96 660	$1 020 651	$756 689
Net income		$175 430	-$546 751	-$301 339	$815 581	$554 953
Amortization		$99 037	$91 976	$107 625	$106 816	$99 652
Interest		$91 216	$82 664	$97 054	$98 254	$102 084
Principal		$86 059	$110 899	$122 606	$125 890	$129 380
Interest		$91 216	$82 664	$97 054	$98 254	$102 084
Payments		$177 275	$193 563	$219 660	$224 144	$231 464
Financial Efficiency						
Gross margin ratio	gross margin / gross revenue	**48.3%**	**22.6%**	**4.7%**	**62.7%**	**63.0%**
		$639 963	$171 527	$31 319	$1 256 449	$1 166 975
		$1 324 340	$759 509	$670 053	$2 004 093	$1 851 116
Contribution margin ratio	contribution margin / gross revenue	**28.4%**	**-13.8%**	**-18.8%**	**48.9%**	**45.9%**
		$375 813	($105 164)	($125 862)	$979 471	$849 964
		$1 324 340	$759 509	$670 053	$2 004 093	$1 851 116
Net operating profit margin ratio	net operating profit margin / gross revenue	**-8.0%**	**-73.6%**	**-91.7%**	**24.6%**	**21.5%**
		($105 334)	($558 866)	($614 547)	$493 472	$398 138
		$1 324 340	$759 509	$670 053	$2 004 093	$1 851 116
Interest expense ratio	total interest / gross revenue	**8.1%**	**13.5%**	**18.8%**	**6.0%**	**6.3%**
		$107 893	$102 551	$125 986	$120 808	$116 722
		$1 324 340	$759 509	$670 053	$2 004 093	$1 851 116
Amortization expense ratio	amortization / gross revenue	**7.5%**	**12.1%**	**16.1%**	**5.3%**	**5.4%**
		$99 037	$91 976	$107 625	$106 816	$99 652
		$1 324 340	$759 509	$670 053	$2 004 093	$1 851 116
Profitability						
Return on equity ratio	net income / total equity	**6.8%**	**-25.4%**	**-15.2%**	**27.9%**	**15.4%**
		$175 430	-$546 751	-$301 339	$815 581	$554 953
		$2 574 515	$2 155 864	$1 982 625	$2 926 306	$3 609 359
Return on assets ratio	net income + long term debt interest / total assets	**5.7%**	**-10.4%**	**-4.9%**	**16.9%**	**11.1%**
		$266 646	-$464 087	-$204 285	$913 835	$657 037
		$4 695 161	$4 461 407	$4 178 527	$5 423 268	$5 941 090
Asset turnover ratio	gross revenue / total assets	**28.2%**	**17.0%**	**16.0%**	**37.0%**	**31.2%**
		$1 324 340	$759 509	$670 053	$2 004 093	$1 851 116
		$4 695 161	$4 461 407	$4 178 527	$5 423 268	$5 941 090

Sample Farms Ltd. Balance Sheet

		2008	2009	2010	2011	2012
Assets						
	Current					
	Accounts Receivable	$55 885	$207 624	$170 384	$169 881	$274 665
	Inventory	$1 591 159	$1 043 327	$656 833	$1 800 868	$2 195 199
	Prepaid Expenses	$96 033	$95 175	$74 920	$135 901	$121 540
	Total	$1 743 077	$1 346 126	$902 137	$2 106 650	$2 591 404
	Long Term					
	Patronage Dividends	$17 667	$18 931	$21 551	$23 101	$26 983
	Land	$1 728 000	$1 728 000	$1 728 000	$1 728 000	$1 728 000
	Property and Equipment	$630 417	$664 350	$694 839	$605 517	$506 703
	Total	$2 376 084	$2 411 281	$2 444 390	$2 356 618	$2 261 686
	Total Assets	$4 119 161	$3 757 407	$3 346 527	$4 463 268	$4 853 090
Liabilities						
	Current					
	Bank Indebtedness	$429 577	$507 972	$491 199	$631 620	$611 606
	Accounts Payable	$241 069	$361 134	$17 458	$247 419	$224 602
	Current Portion Term Debt	$86 059	$110 899	$122 606	$125 890	$129 380
	Total	$756 705	$980 005	$631 263	$1 004 929	$965 588
	Long Term Debt	$1 363 941	$1 325 538	$1 564 639	$1 492 033	$1 366 143
	Shareholder Loan	$805 190	$805 190	$805 190	$805 190	$805 190
	Total Liabilities	$2 925 836	$3 110 733	$3 001 092	$3 302 152	$3 136 921
Retained Earnings						
	Share Capital	$100	$100	$100	$100	$100
	Net Earnings (Loss) Current Year	$175 430	-$546 751	-$301 339	$815 581	$554 953
	Retained Earnings Prior Year	$1 017 795	$1 193 325	$646 674	$345 435	$1 161 116
	Retained Earnings	$1 193 325	$646 674	$345 435	$1 161 116	$1 716 169
Liabilities and Retained Earnings		$4 119 161	$3 757 407	$3 346 527	$4 463 268	$4 853 090
Normalizing Adjustments						
Balance Sheet						
Market Value Adjustment to Land						
	Acres	2 560	2 560	2 560	2 560	2 560
	Market value	$900	$950	$1 000	$1 050	$1 100
		$2 304 000	$2 432 000	$2 560 000	$2 688 000	$2 816 000
	Original cost	$1 728 000	$1 728 000	$1 728 000	$1 728 000	$1 728 000
	Net worth adjustment	$576 000	$704 000	$832 000	$960 000	$1 088 000
	(note: no adjustment to market value for equipment)					
Shareholder Loan Adjustment		$805 190	$805 190	$805 190	$805 190	$805 190
Total Adjusted Assets		$4 695 161	$4 461 407	$4 178 527	$5 423 268	$5 941 090
Total Adjusted Net Worth		$2 574 515	$2 155 864	$1 982 625	$2 926 306	$3 609 359

Sample Farms Ltd. Income Statement

	2008	2009	2010	2011	2012
INCOME					
Crop Sales	$1 265 882	$1 307 341	$1 056 547	$860 058	$1 456 785
Inventory Change	$58 458	($547 832)	($386 494)	$1 144 035	$394 331
GROSS REVENUE	$1 324 340	$759 509	$670 053	$2 004 093	$1 851 116
DIRECT EXPENSES					
Fertilizer	$291 717	$241 624	$279 728	$381 991	$240 996
Chemical	$147 110	$150 966	$154 134	$223 288	$240 577
Seed/grain purchases	$226 939	$179 022	$204 872	$114 958	$164 351
Crop Insurance	$18 611	$16 370	$0	$27 407	$38 217
Total	$684 377	$587 982	$638 734	$747 644	$684 141
GROSS MARGIN	$639 963	$171 527	$31 319	$1 256 449	$1 166 975
VARIABLE EXPENSES					
Custom Work	$67 355	$76 637	$17 990	$82 229	$84 101
Fuel and oil	$42 186	$54 447	$44 441	$72 140	$65 821
Wages (direct)	$63 106	$59 670	$61 212	$73 374	$97 864
Repairs & Maintenance - Machinery	$91 503	$85 937	$33 538	$49 235	$69 225
Total Operating Expenses	$264 150	$276 691	$157 181	$276 978	$317 011
CONTRIBUTION MARGIN	$375 813	($105 164)	($125 862)	$979 471	$849 964
FIXED EXPENSES					
Utilities	$13 273	$11 431	$14 953	$12 143	$14 898
Rent	$64 659	$56 969	$61 201	$60 304	$66 652
Repairs & Maintenance - Building	$26 333	$20 286	$11 473	$28 179	$8 230
Insurance	$34 731	$39 195	$39 532	$30 876	$30 646
Interest & Bank charges	$16 677	$19 887	$28 932	$22 554	$14 638
Interest on Long Term Debt	$91 216	$82 664	$97 054	$98 254	$102 084
Office	$34 020	$24 577	$25 530	$31 860	$20 529
Professional Fees	$10 468	$7 134	$7 475	$9 050	$8 240
Property Taxes	$23 521	$26 284	$22 743	$11 687	$12 998
Salaries & Benefits	$67 212	$73 299	$72 167	$74 276	$73 259
Amortization	$99 037	$91 976	$107 625	$106 816	$99 652
Total Overhead & Administration Expenses	$481 147	$453 702	$488 685	$485 999	$451 826
NET OPERATING PROFIT	($105 334)	($558 866)	($614 547)	$493 472	$398 138
OTHER REVENUE (EXPENSE)					
Programs (Government)	$231 382	$18 988	$290 477	$291 058	$117 295
Rebates	$17 667	$16 384	$25 226	$17 194	$22 437
Custom work	$18 326	$3 255	$11 903	$13 857	$17 083
Gain / (Loss) on capital assets	$13 389	($26 512)	($14 398)	$0	$0
Total Other	$280 764	$12 115	$313 208	$322 109	$156 815
NET INCOME	$175 430	($546 751)	($301 339)	$815 581	$554 953