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INTELLIGENT FARMER™

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Farm wealth advisors helping your family make important decisions.

TO BUILD OR NOT TO BUILD?

FEATURE ON PAGE 3

HELP REDUCE YOUR RISK, BOOST YOUR BUSINESS, AND IMPROVE YOUR RATES WITH THIS STRATEGY

As a farmer and business owner, sometimes it can feel like your banker speaks another language. Whether you're applying for a loan, buying the farm next door or upgrading your equipment fleet, focusing on these key aspects can help you improve your business and your lending rates.

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Management skills and financial health are two vital aspects of any successful business. We touched on both topics in volume #3 of Intelligent Farmer, and delved deeper into managing risk in volume #4. In this issue, we focus on something that many business owners dread: record keeping.

Keeping useful records

If you've ever attended any business seminar or training, you've probably heard the Peter Drucker quote: "You can't manage what you don't measure." The reason this gets repeated often by business gurus and public speakers is simply because it is so significant. It is easy to let record keeping slide as you work in the day-to-day responsibilities of your business and sometimes forget to take the time to work on the "housekeeping" of your business. Without the ability to track performance, you won't know if you are truly achieving success. The old assumption, "Well, we are lower on the operating line this year, so we must have made some money" just doesn't cut it anymore. Frankly, without being matched with inventory and accounts receivable & payable, the operating loan balance won't tell the full story.

In the age of technology, it is getting easier and easier to keep good records. Whether it is a program to manage agronomy and production costs down to the acre, or bookkeeping software that automatically imports transactions, the main reason to keep proper records is to leverage them to make decisions that lead to a successful and sustainable business. Harnessing your records to make management decisions is crucial to maintaining or growing a business that provides for your family and your employees. However, information management is something that the bank often takes into consideration when assessing your abilities as a manager.

What does the bank look for in regards to information management on your farm?

The bank wants to know that you keep good records that are organized, accessible and accurate, but also that you review them regularly to help make informed decisions. This not only shows that you aren't making decisions on a whim, but makes it much easier when it's time to ask for money from the bank. The ability to produce year-to-date financial statements or return-on-investment information upon request can improve turnaround times and speaks to your overall management skill. Good financial and production information can help get you to "yes" sooner, and may even help achieve a better lending rate.

4 key recording keeping questions to ask yourself

1 Would I be confident printing out a monthly or quarterly income statement and making accrual adjustments for inventory, accounts payable and accounts receivable?

2 Are my records thorough enough to allow me to confidently understand the impact my production decisions? For example, can I determine whether that extra pass of fungicide paid for itself by evaluating the improvements to average daily gains in the feedlot vs. feed costs?

3 Could I narrow down my cost of production to the acre / animal for each commodity I produce, using my historical records? When was the last time I did this? E.g. Do I know my costs per piglet weaned, or per pound of gain for each turn through the barn

4 At any given point in the year, do I know if I am on track to net more or less than the previous year? What changes drive these results?

There are all sorts of programs available to help you manage your records, and every farm will have different preferences help you what works for their operation. Whether they are in a journal, an Excel spreadsheet or a fancy software program, accurate records, are critical to making good business decisions — it also takes a conscious effort to review these results on a regular basis in order to succeed. Not only will keeping better records help you to make better decisions, but your banker will thank you, as well!

TO BUILD OR NOT TO BUILD?

Build with relationships anchored in trust

"TO BUILD OR NOT TO BUILD?" THAT'S THE QUESTION SO MANY ARE ASKING AS THEY WEIGH PROS AND CONS.

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For many farmers, fall is an ideal time for a building project. You close your eyes and imagine a new, state-of-the-art dairy barn, an indoor arena, some new equine stables, or perhaps a larger garage / storage facility. With interest rates at historic lows, the thought of upgrading your operation is tantalizing.

But this year has no shortage of uncertainty. These last 18 months have been unprecedented. Who knows what the next few months might hold, much less what awaits us in 2022?

"To build or not to build?" That's the question many farmers are asking themselves as they weigh the pros and cons.

For what it's worth, it's understandable to be on the "construction fence," so to speak. There are valid reasons for caution right now.

Volatility in the cost of building materials

Thanks to work stoppages and supply-chain disruptions during the early stages of the pandemic, lumber prices skyrocketed in 2021. One viral meme featured the caption, "The next time your wife asks you to take her someplace expensive" along with a picture of a well-dressed couple eating a fancy dinner in the lumber department of a big home improvements warehouse!

The meme is humorous. But the reality? Not so much. In March 2020, a 12' length of 2x4 SPF cost $4.32. By the end of May 2021, that same stick of wood was selling for $15.96!

This shocking rise in the cost of wood (and other construction materials) left everyone wondering how much higher prices will go. As builders, we figured most farmers would "pull the plug" on their 2021 building plans. To be sure, some did. And yet, our phone has continued to ring off the hook.

With so much uncertainty in the cost of materials, construction companies started asking a similar question: To bid or not to bid?

Uncertainty in the bidding process

Due to the extreme volatility in the prices of construction materials, bidding on projects has become more nerve-wracking than ever. Here's one example: in late May, we were preparing a bid for a sizable project. In setting up the tender bid, we did what we always do—we consulted current pricing.

Then the bidding deadline got extended. A week later, while doing our final bid audit, our local supplier provided us with updated numbers: a 17.7% increase in lumber prices, in only two weeks!

This project wasn't scheduled to begin framing for six months. The contract still had to be awarded, the permit attained, and the foundation completed. If prices could rise almost 18% in only two weeks, what would they be in six months? Would the market continue to go up? Surely, it couldn't go much higher. But, then again, we had been saying that for the previous four months! With the tender deadline imminent, we faced a haunting question: Do we bid or not?

Suddenly our whole approach to bidding was flipped upside down. Instead of being able to focus primarily on providing value for our clients through efficient bidding, we had to focus on avoiding "the winning bidder's curse."

I know: How could winning a major construction project be a curse for a builder? By submitting a bid too low to account for the rising costs of building materials. In that scenario, a construction firm could lose money on a project before the project even began. In such an uncertain business climate, it's hard to know what to do after winning a bid. Do you celebrate, or assume the crash position?

Flexibility in the client / builder relationship

This year has demonstrated to us the importance of business relationships rooted in trust and good faith. Clients have had to wrestle with the question, "Do I sign a construction contract that contains a variable clause?" For years, we urged, "No! Don't ever do that!" That's because we've heard of too many instances in which farmers received final invoices loaded with price overruns to the budget presented earlier. And we have always prided ourselves in staying on-budget, avoiding project overruns and not sending out invoices filled with unpleasant surprises.

At the same time, what builder can afford to ink a contract with a client who is unaware of, or indifferent to the reality of surging prices? When a customer insists that a builder honour an outdated quote—despite obvious volatility in the market—it doesn't exactly make for a great client / builder partnership. I can assure you that most builders aren't looking to get rich on one job. But neither are we looking to go broke on one project!

So the question becomes How can clients and builders structure fair contracts that allow for flexibility during a period of wild market fluctuations?

This is why good faith collaboration between farmers and builders is so necessary. So far in 2021, we've found that constant reviews are necessary throughout the bidding, contract, and building process. We've had to ask ourselves, "Are the prices we used in the original bid still current, as the client is set to ink the contract?" And we've had to quote some projects a second time. Months later, when a building permit was finally issued, we've had to hold our breath. Have there been price increases in these intervening months? If so, another adjustment was made.

It's easy to see why the question "To build or not to build?" can be so perplexing. How is a client supposed to budget when prices are subject to such wild swings? How can they avoid surprises when the invoices start arriving? And how can builders make plans, deliver great value, take care of clients and still earn enough to keep their companies afloat?

All in all, it's been an interesting and exciting year. We've had to adapt and alter our contracts. We had to return some project deposits. We even learned to rejoice over lost projects! While it's true that some of our early contracts sustained additional charges, other more recent contracts—when material prices started falling—reaped applied credits.

Through it all, we've learned to appreciate clients who share our values. It's been a joy to serve fair-minded clients, anchored in relationships of trust.

When there's trust—when it's obvious that a client and builder are allies, not adversaries—market fluctuations can be taken in stride. Contract amendments that allow for fairer pricing are allowed. In these kinds of collaborative partnerships, builders aren't given a blank cheque. But they also aren't expected to fully absorb the "curse" of surging prices. Written contracts allow enough flexibility to make sure the final build price is fair for all parties, and that the final invoice doesn't contain an unwelcome surprise.

Finally, an update on material costs in July, we began to see a reduction in lumber prices. Then August brought a new round of metal cladding price increases. Through it all, farm construction continues at a phenomenal pace. Maybe things will stabilize this fall, maybe not.

The bottomline? The question, "to build or not to build" is really a question of "to trust or not to trust?" Work with a reputable, dependable builder with a goal of mutual success and your experience is likely to be positive no matter how volatile the market is.

FOUR REASONS TO CONSIDER RENTING FARMLAND

The advantages of buying property are well known to most farmers. It is a great way to build equity in your business and usually grows in value over time. Owning farmland also offers more tax planning options down the road, can allow you to avoid rent increases, gives you more freedom in the way you use the land and helps protect you from losing access to the land, in the event your landlord decides to sell it or rent to someone else. However, in spite of all these advantages, there are also several reasons to consider renting farmland.

1 Cash flow

When you own farmland, whatever you are spending each month on principal and interest limits your ability to invest in other areas of your life and business. This money is not available for farm equipment, buildings, production quotas, overhead (like seed, fertilizer and chemicals) and living expenses. At the end of the day, you are in business to enjoy a comfortable lifestyle, and that requires cash flow—something typically more plentiful for farmland renters than buyers.

2 Long-term acquisition

Even if cash flow is not a major concern for your business, the availability of land may make renting a worthwhile consideration. If there is one particular property you would like to purchase, but the owner is not interested in selling, renting this land could be preferable to purchasing a piece of land that is geographically further away or less desirable. If you continue renting this property for several years and develop a relationship with the owner, you may be in a better position to buy that property when it is available for purchase. The owner may even give you an opportunity to purchase this land without placing it on the open market.

3 Flexibility

When you purchase a property, it is far more difficult to get rid of the property if the needs of your business change. Selling property involves hiring a real estate agent, finding a buyer and getting a lawyer to draw up the purchase and sale agreement, which can be a costly, challenging and time-consuming process. In contrast, ending a rental agreement is relatively straightforward and inexpensive. There are also cases where farm businesses need additional land on a short-term basis – like if you are growing a specialized crop that you are not able to grow on the land you already own. In that case, purchasing would be an overly expensive and complicated option. Renting gives you an opportunity to temporarily expand the acreage you are farming without making any long-term commitments.

4 Debt-to-equity ratio

When lenders evaluate your business to determine if they want to lend you money or continue an existing relationship, debt-to-equity ratio is usually one of the criteria they consider. This is the amount of debt you have in relation to the equity you have in the business. If you have $2 million of debt and $1 million of equity, that's a 2:1 ratio. The higher that debt number is versus the equity, the greater the risk that lenders will perceive in your business. When you buy a piece of property, your debt immediately goes up in relation to your equity, which could put you at risk with lenders and make it more difficult to be approved for financing to construct a building or buy a piece of equipment. However, if you rent property, there's no immediate effect on your balance sheet. This allows you to farm more land that could expand your operation, while keeping your debt-to-equity ratio in check.

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SOYBEANS, CORN & WHEAT UPDATE

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Volatility has been the name of the game for the grain and oilseed markets throughout the 2021 growing season. Near-record, tight, old crop stocks across the board have caused trade to keep an even-closer eye on growing conditions throughout the midwest this year. For most crops, the battle between east vs. west has added to the uncertainty of what this final yield picture may or may not look like.

For soybeans specifically, eastern growing regions and crop conditions have been favourable to crop development, and the early planting date is also typically supportive of increased yields. However, what has somewhat muddied the outlook are the reports of too much moisture stress in the eastern beans, along with inconsistency from field to field. In the western growing regions, it has been a much different story with drought conditions taking a toll on crops. This is prominent in the Dakotas, where good / ex conditions are quite low. August is the month that makes or breaks yield for soybeans, and after last year's big miss on yield guesses, it is likely that trade could take a more "wait-and-see" approach this year heading into harvest. On the demand side of the equation, things have quieted. After a very aggressive start to the new crop export program early in the crop year, China's presence has been relatively absent. The USDA is already pricing in an approximate 200-million bushel decline in exports year-over-year, but trade needs to see a return of exports if further upside is to be warranted. Additionally, crush pace has slowed into the end of the year. Whether this is due to a slow down in demand or a lack of supply, though, won't be known until final old-crop estimates are produced. The key going forward will be the final 2021 crop size, export demand and size of the new SA soybean crop, which many are already betting on being a record large.

Many of the same weather conditions plagued the U.S. corn crop as well this growing season, with conditions from east to west varying greatly. Favourable conditions in the east are hoped to offset drought-stress losses in the west. Yield data will ultimately be the key at harvest. BRZ second-crop corn also had a very tough year, with drought and frost knocking a substantial number of bushels out of production. The latest estimates are in the low-80 mmt for total BRZ corn crop. Many are looking for this to shift world / China demand to the U.S. and Ukraine. Like soybeans, USDA's balance sheet has a large 350-million bushel decrease in exports year-over-year. New crop corn exports were red hot at the start of the year but have also tailed off as of late. However, ethanol demand has remained strong, and barring a large-scale return to lockdowns, it should stay above levels from a year ago. Going forward, trade is waiting to see the final yield data and a return of export demand. Large increases are once again expected in BRZ crops next year, but until this can be realized, world feed grain stocks will be tight.

Winter wheat yields in the U.S. ended up being better than expected, despite some early growing drought and cold weather concerns. The most recent story, however, has been the very poor condition of the spring wheat crop. Drought has taken its toll, with the crop now rated the worst since 1988. The Canadian prairie crop is not much better off. The USDA has drastically cut spring wheat yield forecasts, but there could still be room for further production reductions due to crop abandonment. Russian yields have also been disappointing so far this year. World wheat trade has picked up, with prices looking like they have put in their seasonal low as harvest pressure starts to ease. U.S. wheat continues to be expensive in the world marketplace, but this is common as the U.S. is typically a price follower. In any case, ending stocks in the US and major-exporting nations continue to contract. This will be key to watch going forward and with the losses to U.S., Canadian and Russian wheat, will put even more importance on the this year's southern-hemisphere harvest.

THE DRAWBACKS OF DEFERRING TAXES

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Most businesses must pay taxes on all income, including accounts receivable and inventory in the year they are created. However, farm businesses are one of the few exceptions, as they are permitted to pay taxes on a cash basis.

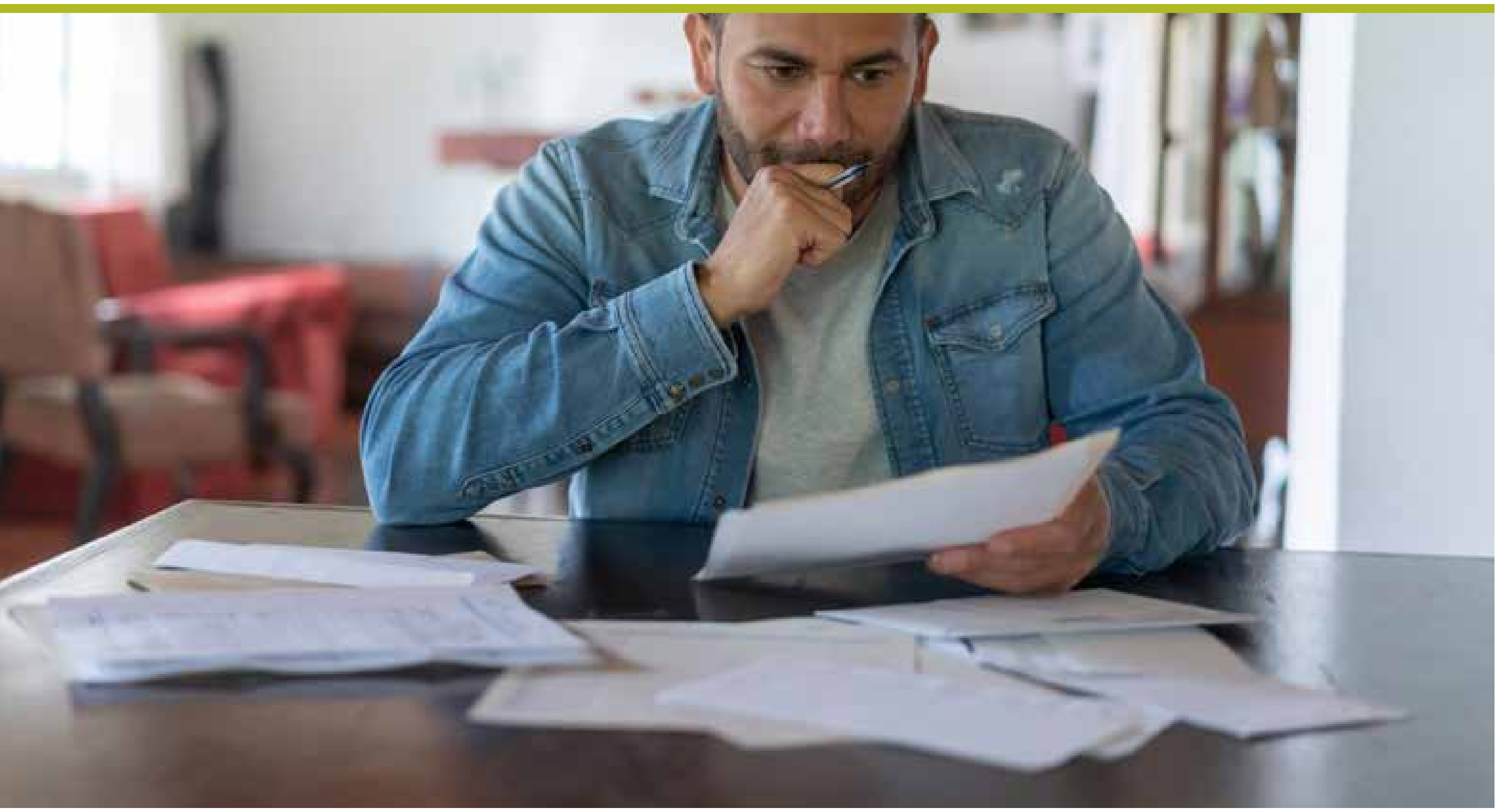
Farms have the unique ability to deduct prepaid expenses and push income into future years. Rather than pay tax on inventory, they can wait until this inventory has been sold. While most farmers prefer to take advantage of this deferral opportunity, this is not always the best option.

The problem with deferrals

For most businesses, it seems silly to pay taxes when you don't have to, but for a farm business, a deferral only postpones your tax burden. In the short term, farmers who defer might feel like these taxes are being eliminated, but when the inventory is sold, the tax needs to be paid. Some farmers who operate as an unincorporated sole proprietorship or partnership mistakenly believe it's best to postpone paying tax whenever possible, but there are significant advantages to making these payments in smaller increments. For one, this allows you to pay tax in lower tax brackets. In general, I advise farm clients to consider paying taxes in the lower tax brackets every year. The rest of the tax can be deferred, but there's no reason to delay tax, as the taxable inventory accumulates and eventually pushes you into higher tax brackets. This can become a significant problem as your tax liability grows, and it could potentially reach an unmanageable level.

The future of capital gains tax

Since the government is currently running substantial deficits, there has been speculation among politicians and officials that the capital gains tax rate is likely to increase in the years ahead. As of right now, capital gains are only 50% taxable, which means the other half is tax-free. When the inclusion rate increases, it could go up to 75 or even 100%. If you can trigger a capital gain right now—by selling or transferring a piece of farm property into a corporation—



you can avoid being taxed on these gains at a potentially higher inclusion rate in the future. In addition, all farmers can currently access the capital gains exemption, which allows you to shelter $1 million of a capital gain if it's qualifying farm property. It might make sense to use that now, rather than saving it for later, as there could be changes in the future that make the exemption less attractive or eliminate it altogether.

When deferring is best

I regularly try to convince many clients with a large amount of inventory (which will one day be taxable) to pay low rates every year, rather than put it off and pay tax in higher brackets later. However, it is worth noting that there are some situations where deferring is preferable. If your succession plan is to transfer the farm to a family member and you don't plan on selling part of the operation, savings in the area of capital gains is not a concern. It's also worth considering income-tested benefits such as the Canada Child Benefit (CCB), which is based on your family income. If you set your income higher than it needs to be, you might not qualify for certain benefits. With these (and other) issues in mind, every family should consider the complexities of its own situation. This includes the possibility that deferring taxes might not be the most cost-effective option for your business.

FARM FACT

What rank is Canada in the world for agricultural exporting?

A) 1st

B) 10th

C) 25th

D) 5th

D. 5th

Question C/O Form & Food Care:
www.farmfoodcareon.org/resources/did-you-know-resources

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MEET THE TEAM

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