

WATER STREET SMARTS

The Difference Between Working Capital and Net Worth

Ken Rahjes interviews Darren Frye, President and CEO of Water Street Solutions

Q: Tell us the differences between working capital and actual net worth.

A: Working capital is different from net worth because it deals more with the cash side of the business. Working capital includes your current assets minus your current liabilities. That's how much money you are really making. As you make a profit in a business, or as you are out here farming, producing crops and raising livestock, the cash you make builds your working capital.

Net worth is different. It is the part of the balance sheet that really is the part that you own as a producer. If you look at a balance sheet, you have assets at the top of the sheet, and those assets are divided into two classes: The parts you own, which is your equity, and the parts the bank owns, which is the liability. And those equities plus liabilities always equal your assets. Your net worth is simply the equity that you have in this operation.

If you had a million dollars worth of assets and half a million dollars of equity, that means you would own half of your asset base; the bank would own the other half. Your net worth would be at a 50% ratio, your equity-to-asset ratio. That would be your net worth- the part that you own.

Q: Why is it important to have working capital?

A: Working capital is important for a lot of different reasons. If you are in an operation where you are trying to expand or go a different direction, maybe with another enterprise, you need cash to do that. When you go to the bank to work with a banker to go along with that business plan or expansion plan, they're going to want to take a look and see what the most recent trends are in your business, and if you're making money or not. If you're making money, your working capital is solid and it's been growing, and that means that you're driving profit to your bottom line. The bankers want to see that working capital because they know that you are a viable business, making money. Your business plan is working and you're managing things properly.

And if you don't have that working capital, they want to know what the trend has been- if that has been going *down*, that means you've had some type of a problem, like production, or marketing, or maybe not insuring for the correct perils, like hail or wind or something like that which has caught you off-guard. They want to know why you're not making money and what you are doing to change that. Whether you make money or not is a direct correlation between the ability to manage situations or not manage situations.

Q: How much working capital should you have?

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A: Everybody has a different way of figuring that, but the way we do it at Water Street Solutions is to look at the gross revenue your farm is taking in. Then we simply take the working capital, once again that's current assets minus current liabilities, and divide it *into* that gross revenue, and *that* is the ratio that we're looking for.

When we do that, we're looking for 20 to 40 percent. Forty percent is ideal in these volatile times we've been in. Twenty percent is a very good number, but we like to see more. How much you need will depend on whether your farm is in expansion mode or not, because expanding does take capital. But 20-40% of working capital as a percentage of gross revenue is the number that we're looking for.

Q: What if you don't have enough working capital?

A: There are a couple of things you can do. One is you have to take a look first and foremost at why you don't have working capital. Is it a production or insurance or marketing problem? Is it a spending problem? Are you just not able to make a profit? First you have to diagnose what to fix because you have to get that working capital moving in the other direction. But if you have to put working capital into the balance sheet, how does one do that?

You have to take assets that are paid for and restructure some term debt into those so that you can put working capital on the balance sheet. And that is just a restructuring process. Banks will do this, but they are reluctant to do it if you're not fixing the management problems that are causing the lack of profitability and the lack of working capital growth. You can always go to a bank and take asset base like land, and say, "I want to borrow money against this on a 10- or 20-year term structure," and put that capital on your balance sheet, but you better make sure you've fixed your managerial issues so that you can be assured of making money going forward.