5 tips to consider when restructuring debt during down times

Pete Jones for *Progressive Dairyman*

AT A GLANCE

Restructuring debt can usually result in improved cash flow, but don't make a hasty decision.

The ups and downs in the dairy industry can take a financial toll on your business. When times get lean, it's good to look at every aspect of your business and consider all of your resources to free up cash flow. It can be tempting to focus on the little expenses, and sometimes it's a combination of little things that can add up to big savings, but one often overlooked area to improve cash flow in a big way is the debt structure of your operation.

Restructuring debt is never easy; nearly everyone wants to have everything paid for someday, and usually a debt restructure event will include some payments being stretched out or equity being tapped. Assuming any cash out is put back into your operation, this isn't necessarily a bad thing. Depreciation on a dairy is real, and technological advances make debt restructures that include some capital improvements, great ways to improve cash flow and maximize the profitability of your operation.

With Class III futures prices sticking between $15 and $16 per hundredweight at the time of writing, and many cash-basis breakevens in the same range, it might appear daunting to even approach your bank about a restructure, even though this could be an opportune time to do so. If you're considering some type of restructure during low milk prices, here are five tips to consider.

1 *Don't panic.* Cash flow might be tight today; it might even be negative. However, lenders who deal with the dairy industry will recognize the market fluctuations are part of daily dairy life, and they've been through this before. Although the old adage about the best time to borrow money is when you don't need it is mostly true, ag lenders will look beyond the short-term low milk prices for a one-, three- or five-year projection based on historical information to make their lending decision.

Also evaluate the changes coming with the proposed restructure. In today's environment, there are a lot of mid-life old loans that look appealing to refinance – until you calculate the prepayment penalty or realize the existing interest rate is 1 or 2 percent lower than today's market interest rates. Making a hasty decision to free up cash flow when the cost of the money makes the business unsustainable could spell trouble. This isn't always a reason to stop a restructure, but it should be considered and approached in a well-thought-out manner.

2 *Be proactive.* Talk openly and honestly to your accountant and your banker. Look at pro forma information – pro forma information is historical information with a few changes to reflect a proposed transaction, such as a debt restructure. What would the operating results and cash flows have looked like with the proposed restructure? Review ratios such as debt to equity and debt service coverage. Also look at current loan covenants as a guide for what loan covenants may look like on a restructure and whether your proposed restructure would meet those covenants.

This can be tricky if some large capital expenditures are part of the restructure, but prospective information in the form of budgets or forecasts can be prepared and dropped into pro forma financial information in much the same way the new debt service is dropped in.

3 *Examine underperforming assets or business segments.* Sometimes borrowing money isn't the only answer. Selling a farm far away from the home place or which has appreciated drastically is a good way to tap equity. Sale/leaseback transactions can be used, where a dairy finds a buyer for land or other assets and leases the assets back, sometimes with a purchase option included if the dairy eventually wants the farm back. Many of these look very similar to loans, but they are structured in such a way to give the buyer/lender a little more assurance of repayment.

Sale/leaseback transactions or simply selling underperforming assets are great ways to tap 100 percent of the equity in assets, while a traditional lender will typically only loan 60 to 70 percent of the asset's value. However, be careful of the tax implications. Selling a fully depreciated or highly appreciated asset in such a way could have an adverse tax impact and needs to be considered with your tax preparer prior to consummating the transaction.

4 *Have a plan.* Borrowing money purely to cover operating losses probably won't work and, even if the bank loans it to you, it may not correct the underlying problems. Sit down with your CPA and banker and acknowledge the areas for improvement, and quantify these areas as far as cost and opportunities. If you can cut 50 cents per hundredweight off your cost of production by remodeling the barn, make this the centerpiece of your restructure. If cash flow is the issue, and you can reduce monthly expenditures by 35 cents per hundredweight simply by re-amortizing (starting the loan over and stretching out the payments) existing debt, ensure this is pointed out in the loan application package. Maybe it makes sense to move your cows to an interest-only note or at least request interest-only payments for a period of time. Not all lenders will do this, but sometimes it makes sense and is necessary to make short-term projections work.

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5 *Focus on the positives.* Your banker's job is to take your loan application to a committee and convince them that, if the bank loans money to this business, it will repay it according to the terms of the loan. If you're focusing on the negatives, such as low milk prices or other adverse market conditions, it's going to make that job a lot harder and make the restructure less likely to be approved. Don't ignore the negative aspects – as mentioned above, these could be opportunities for improving your business – but make sure to point out the strong points. Your feed efficiency might not look great, and you should look at that with the vet and nutritionist, but maybe your pregnancy rate is the best in your geographic area. Zero in on the positive aspects the restructure will have on your business. You want that to be the take-away your banker has.

Tougher economic times in the dairy industry has everyone scrambling for cash flow and operating profits. Restructuring debt can usually result in improved cash flow and a strengthened balance sheet, but there are many things to consider when evaluating options. Remember, don't make hasty decisions, be proactive, and be sure to use all of your resources to come up with the best plan for you and your business.

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