

The Earnings Illusion and Playing the Long Game



The long-term health of your business requires paying close attention in your greenhouse and on your balance sheet.

BY BARRY STURDIVANT

As a greenhouse grower, your managerial accountabilities are a multiple of what they are for almost any other industry. You have to focus on growing, scheduling, purchasing, selling, customer relations, human resources, greenhouse maintenance and expansion and a lot of other things that require daily attention. It makes it hard to look ahead toward the horizon, or even to take a good look back at where you've been.

We like to think that taking care of the daily details helps ensure the long-term success of your business. That's not always the case. When it comes to the long-term financial health, it's easy to miss the subtleties that can impact your

business over time. You often depend on some direction from your financial advisor or your banker. Unfortunately, they, too, tend to play the short game and don't direct you to the things you need to consider for your company's long-term health. This short-sighted approach to long-term financial needs has left the average greenhouse in a precarious position.

MEDIAN GREENHOUSE USA

Median Greenhouse USA is a mythical operation based on real data compiled from dozens of greenhouse operations over the past six years from all over the country. The mean numbers are calculated for each financial measurement. It has sales of \$23,662,000 and has always been profitable.

You heard right — always profitable! Pretty good, considering the analyzed period includes one of our country's deepest recessions. While each year some part of the country has had detrimental weather-related or other issues, nationwide the average greenhouse has posted net earnings.

However, its balance sheet shows it is chronically short of working capital and, therefore, not paying all of its bills on

a timely basis. Further, bank debt has steadily increased and the owners own a little less of their business today than they did six years ago. Why does a profitable company have a slowly deteriorating balance sheet?

Median Greenhouse USA slouched into this position over a number of years. It's profitable, just not profitable enough. The result is a very small margin for error going forward. It can ill afford a bad year that comes with a

wet spring or a crop failure. Median Greenhouse is now only one or two loss years away from a serious cash shortage. That could result in a rapid deterioration in its relationship with its banker and other creditors. That's a stressful

way for the owners to live. Even if it doesn't experience a serious loss but continues its historic level of earnings, it is still heading for future problems — just more slowly. How did the owners, their financial advisors and their banker allow this situation to slip up on them?

We haven't communicated well. We tend to communicate by focusing on misunderstood, meaningless or misleading financial indicators. Performance markers, such as earnings, cash flow and liquidity are usually expressed in terms of percentages and ratios that provide little context to their relevance or usefulness. Everyone understands cash. Why don't we talk about our business in those terms?

When we talk about cash flow in terms of dollars, it is usually expressed as EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). EBITDA can be a valuable measurement, but it doesn't come close to accounting for your true cash flow. Median Greenhouse USA has reliably generated net profits and EBITDA, but it still finds itself unable to pay its supplier and banker bills on a timely basis. Let's find out how this happened over time.

First, on the surface the performance doesn't look all that bad over the past six years.

Six-year Average Net Income:
\$463,000, 1.96 percent of Sales
Six-Year Average EBITDA
\$1,257,000, 5.32 percent of Sales

But, that's just on the surface. It's an illusion. For many growers and their lenders, the analysis stops here. The owner has seen unscientific surveys or heard other growers talk about their earnings and cash flow levels and concludes he's right in the middle and, therefore, doing OK.

Bankers, financial advisors and accountants can also be hasty in their analysis. They take a quick look at the EBITDA number to see if it covers the term debt payments. That's called a debt coverage ratio

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which, in this case, is 1.74x (EBITDA of \$1,257,000/\$722,000 Principal and Interest). They consider this a very good ratio and call it a day. The line of credit is renewed, and probably increased, and they move on. We all should have looked more closely.

This is the *minimum* of where the earnings and cash flow *needed* to be:

Needed Six-year Average Net Income-	\$808,000	3.41 percent of sales
Needed Six-Year Average EBITDA-	\$1,602,000	6.77 percent of sales

How did we arrive at these numbers? Because it was this level needed to meet these cash needs:

- Repaying the principal on long-term debt;
- Paying for non-financed fixed assets;
- Paying a dividend to the owner; and
- Supporting some portion of the growth of the trading assets (inventory and accounts receivable), which, in turn, support the increased sales growth.

The Median Greenhouse USA's earnings level was short by \$345,000 in the average year. It is calculated as follows:

= EBITDA	\$1,257,000
- Avg. Annual Inventory Increase	\$ (480,000)
- Avg. Annual A/R Increase	\$ (100,000)
+ Avg. Annual A/P Increase	\$ (-0-)
= Net Cash After Operations	\$ 677,000
- Interest Expense	\$ (200,000)
= Net Cash Income	\$ 477,000
- Term Debt Servicing	\$ (522,000)
- Dividends	\$ (100,000)
Cash After Debt Amortization	\$ (145,000)
- Avg. Annual Non-financed CAPEX	\$ (200,000)
Financing Requirement	\$ (345,000)

This is why you don't end your cash flow analysis at EBITDA.

THE CUMULATIVE EFFECT ON THE BALANCE SHEET

The annual average of \$345,000 in needed cash had to come from somewhere else. Most years, that meant their bank line of credit or the trade accounts payable. Your banker is fine with this — for a while. So are your suppliers. Sooner or later though, it will come to their attention bills aren't being paid as agreed and the line is over-advanced against the accounts receivable and inventory collateral.

Each year the line balance increased a little more, or the trade creditors were pushed a little harder. Now, the bank owns more of the company than it did six years ago. It's not yet a problem for the bank,

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but the increasing leverage position has become a topic of conversation at the loan committee. Once the line is no longer properly collateralized or recurring cash flow can't support more term debt, a line increase may become a problem. This would be compounded if the trade creditors decide to put the greenhouse on a COD basis.

For Median Greenhouse USA, the accumulation of years of inadequate cash flow has resulted in the following:

Working Capital Needed	\$3,614,000
Actual Working Capital	<u>\$2,230,000</u>
Working Capital Deficiency	\$1,384,000

DIGGING OUT

The cumulative effect of insufficient past earnings has upped the ante for future earnings. As their banker and friend, I would want to work with management to correct this deficiency over three to four years by replenishing cash through a higher level of retained earnings. Or, if it has the term debt borrowing capacity, I would want to correct it with a term loan now with the repayment coming over the same three- to four-year timeframe.

This would also increase the earnings requirement since the term debt would need to be repaid from cash earnings. Correcting the working capital deficiency of \$1,384,000 over four years would require Median Greenhouse to increase its cash flow by \$346,000 (\$1,384,000/4 years). Add this to the current \$345,000 earnings deficiency the company has been experiencing (see above) and Median Greenhouse needs to be earning about \$1,154,000 annually instead

of the \$463,000 it has averaged over the past six years. To recap:

	<u>Net Profit</u>	<u>Percent of Sales</u>
Six-Year Average	\$ 463,000	1.96 percent
Needed to Correct Avg. Deficiency	\$ 345,000	1.04 percent
Four-Year Plan to Replenish Working Capital	<u>\$ 346,000</u>	<u>1.46 percent</u>
	\$1,154,000	4.88 percent

There was a time when this level of earnings was not an issue for the industry. Now, attaining this level is a challenge. The best year for the mean in the past six was in 2009 when the net profit was 3.50 percent. Median Greenhouse remains in the good graces of its banker and its suppliers for the time being. There is time to turn this around. But make no mistake; there is an expiration date on how long this slide can continue.

Seek input from your banker and financial advisor on what they consider the important metrics on your financial statement and get on the same page. Know your working capital requirement and maintain it. Recognize the gradual toll insufficient earnings takes on your long-term financial viability.

And, always ... beware of the Earnings Illusion! *gpn*

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