

The Future of Dairy Financing

By Chris Garnier

Over the past couple months, my firm and I have been presented with numerous questions as to the future of the dairy industry, particularly the future of dairy financing. As we set out to speak with bankers and industry leaders, one specific phrase caught my attention – “Dairy Island.”

Historically dairies have had “special treatment” when it came to the ease and ability to receive financing. The loose requirements of lending to the dairies segregated them as if they inhabited their own island while the rest of the commercial industry was required to provide, budgets, projections and a business plan to be considered for a loan. The banking perception for the dairy industry was that dairies were low risk and safe with minimal, if any, losses. There have been very few business failures that resulted in losses to the bank. Additionally, the competitiveness of banks and the volume of low cost money due to low interest rates added fuel to the fire and freed up cash for dairies who to expanded and improved operations.

As we know, the long, drawn out period of low milk prices and reduced values of cows and real estate maimed and destroyed a life time of equity for dairy businesses. So now what? How does a dairy get financing and continue operations after the loss of equity over the past year and a half?

In order to be approved and receive financing, every business in every industry (except dairy) is expected to provide a lending officer with a business plan, a budget and a cash flow projection of future operations. The bank would review these documents that had been prepared by the CPA or internal staff and make their assessment.

No such requirement existed for dairies. The vast majority of dairies did not prepare a formal business plan. Budgets are for the most part non-existent. And current and future cash flow projections are only prepared at the request of the bank because of their concern about the on-going viability of the dairy business.

Throughout our many meetings and conversations with ag lenders across the country, we noticed they all share some overwhelming similarities. These similarities will be vital for the dairyman to understand and begin to implement in their operations.

Communication

Communication is one key to a good relationship. This also translates into a good relationship with the bank. It has become very difficult for some dairies to make decisions necessary to facilitate good operations because they feel they have to operate within parameters provided by the bank. The bank, however, is not in the business of operating a dairy. Nor do they have the knowhow and skill to manage a successful dairy operation.

For example, we have seen time and again the scenario of “bank cows.” These are cows required to be on the borrowing base/monthly collateral report because the dairyman has to have a specific number of cows to be in compliance with loan covenants. The dairyman knows low producing cows eat just as much as high producing cows but cost the same to feed. Do you sell these cows or keep milking them?

Each party, both bank and dairyman, needs to be educated about the issues and openly communicate and understand the options at hand. I urge the both to utilize the skills and knowledge of the CPA, who has many clients with similar issues and provides analysis to help solve these problems. The CPA and others can be used as a liaison between the bank and the dairyman and potentially bridge any gap. Everyone wins when education and communication is at the forefront of problem solving. When each party is honest about their plans for the dairy, fear of uncertainty begins to subside and progress continues forward.

Budgets, Cash Flow Projections

With a knowledgeable and experienced dairyman, it is fairly easy for a dairy to be profitable when milk price is \$20 cwt and higher. The industry was devastated when prices dipped to \$10 cwt and the inputs/expenses did not follow suit. The question that inevitably resurfaces is “what is the dairy’s breakeven milk price?” How can anyone know this figure if there is not a budget or a CPA reviewed financial statement.

It makes good business sense to have a goal and aspire to reach it. A budget and cash flow projection will help keep the blinders on so the dairy can follow a predestined path to profit. Not only does this make good business sense, but it will become mandatory by many banks as part of the requirement for financing and loan renewals. Dairies will unavoidably have to follow suit with all other industries that already prepare projections and budgets.

Risk management

Banks have become very uneasy with the fluctuating milk and commodity markets. Furthermore, dairies have been given the colossal task of managing cash flow when they face uncertainty in the amount of their milk check and the current spot prices of corn and other commodities.

With a properly designed risk management plan, dairies can mitigate their losses in a downturn. These plans are widely used in cattle, hog, poultry, farming, and oil industries in order to operate within a budget and to hopefully generate a profit with more certainty. This definitely takes the fun out of hitting the home run when milk prices go to \$20 and the breakeven price for the dairy is \$14. Some see this as leaving a lot of money on the table. However, the other side of the story is that the dairy may avoid a large loss if prices go the other direction.

Some banks mentioned to us that this may be a suggested tool if the dairy needs a higher advance rate on cows, feed or real estate. By eliminating as much uncertainty as possible, the dairy will be able to focus on meeting goals set in place.

By implementing open communication with your bank, preparing projections and budgets and then abiding by them, by minimizing risk using the knowledge of your dairy CPA and others, the dairy industry will once again be profitable for all parties involved.

Chris Garnier, CPA in Ontario, Calif., with ***Genske, Mulder & Co., LLP***, a certified public accounting firm representing clients who produce 12% of the nation’s milk in 29 states. Chris can be reached at 909-483-2100 or e-mail him at chris@genskemulder.com