To hedge or not to hedge – that is the question

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As a CPA, I am often asked about dairy milk hedging strategies, particularly “to hedge or not to hedge.” There are many ways to answer this question, but the most common answer is: “It depends.” And hedging depends on many factors.

I can speak all day about the mathematics of hedging, show graphs proving historically cyclical outcomes of the milk/corn/soy markets or even provide a detailed strategy of hedging.

For the last 15 years, I have seen thousands of financial statements and operational results of dairy farms. And yes, there have been plenty of times when hedging milk or feed has proven to be a boon and minimize losses. As I’m sure you can predict, more often than not, I have seen losses pile up from poorly formulated hedging strategies. So which way is it, hedge or not hedge?

Fortunately, there are some factors already known that can lead us in the right direction to determine if hedging makes sense for your dairy. For example, it is common knowledge that milk price is volatile.

What is less commonly agreed upon is its cyclical nature. We used to believe in the magical three-year cycles of lows occurring in 2000, 2003, 2006 and 2009. (The average price for those years was $11 per hundredweight.) The year 2012 broke that cycle with Class III prices averaging near $17.50.

The year 2015 certainly makes it seem like the cycle is back with an average price of $15.80 (only in comparison to the year of 2014 with milk price of $22-plus hundredweight). The problem with this theory is the fact that “black swans” (global trade, political uncertainty and the ever-changing consumer mindset) throw a monkey wrench into this prediction.

Another factor to consider is the U.S. dairy herd size in terms of cow numbers. It makes sense that the more cows we have, the more milk is produced, and therefore the lower milk price that will soon follow. When cow numbers are down, prices seem to rise. This is simple supply and demand. So let’s all just get rid of a few cows or implement some sort of price control to limit growing herds.

Problem: Try telling a dairy farmer who has invested years into efficient operations and millions of dollars in land and facilities to reduce his or her herd size for the good of the industry. Good luck with that. In fact, the opposite usually occurs, which is to add more cows to get more milk in the tank and thereby reduce costs per cow and per hundredweight.

So what do you do? Many questions begin to formulate in your head, almost always gravitating around cash management. Can I pay this month’s bills? Do I have enough available line of credit to get me through the downturn? Will this downturn be prolonged? If I hedge, will I miss out on the windfall years of 2014?

What prices do I pull the trigger at in order to make a profit? This can make your head spin, all the while missing out on what should be the main focus, which is creating more efficient operations.

By now you are probably saying to yourself, “Please get to the point!” So here goes: The point of all of this is that hedging can make sense when your primary focus is keeping your costs of operations low and milk production high. How do you know you are efficient?

Do you have financial statements reviewed by quality CPAs who know your industry? Do you know how your surrounding region is performing and where you need to pay attention? Do you have the right banking relationship to get you out of a slumping milk market?

Once you determine that you have a handle on these items, then consider if hedging will work for you. It's obvious to me that our industry is heading down the path of a margin-based industry, much like hogs, poultry and beef. All the more reason to have a good handle on your financial standing and industry comparatives.

Now that it is clear a good foundation is an efficient operation, when should you consider hedging, if ever? The answer to this is: consistency. Know your breakeven milk price and implement a consistent hedging policy, or don't even bother trying.

By implementing a long-term strategy consistently, you can minimize volatility and be a more efficient cash manager. As an example, limiting downside risk while keeping the upside potential is very logical and encouraged.

This is essentially an insurance policy. I never hear dairy farmers talk about the low milk price they missed because of consistent put options or minimum price contracts they implemented.

I do certainly hear about the $4-per- hundredweight milk price left on the table when contracts are purchased that limit the upside. If you are able to implement the most cost-efficient operations possible with high milk production, capping your low price and leaving the upside open has proven to work for many dairies.

Here is my final opinion. The most successful dairy farms have in-depth knowledge of their costs and methods to minimize those costs. It may be investing in repairs/improvements that have a significant effect on efficiency, changing breeding strategies that reduce cost or getting more involved in raising your own forages.

Knowing your costs and complementing it with a consistent hedging program usually works out very well. However, hedging is only a complement to an efficient operation. Being an efficient low-cost producer should be the primary goal. You may just realize that hedging might not even be needed or worth your time when your cost of operations is lower than your peers.

- **Chris Garnier**
- *CPA, Partner*
- Genske Mulder and Company
- Email Chris Garnier