

FIND YOUR 'PLAN A' BUSINESS

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Summary

Milk price fluctuations in recent years have put significant pressure on farmers and farming businesses. The recent lows in milk price have yielded negative cash flows and an increase in farm debt levels.

Farmers have made initial short term changes and now it is time to implement a strong 'Plan A' business going forward.

A 'Plan A' business is not time consuming or difficult to set up, it takes discipline to monitor and maintain. The benefits of this type of business is resilience and greater profitability over the long term. It enables the owner to drive the business, rather than being driven by the business, to achieve the long term goals.

To achieve a 'Plan A' business requires:

- Clear short and long term goals.
- Setting the business up to allow time to manage.
- A strong cash flow that is a living document monitored monthly at a minimum and revised quarterly.
- Setting KPI's for inputs and outputs, e.g., targets for pasture management, production, operating profit, etc.
- Keeping break even milk price low < \$4.90/kg MS (DairyNZ Economic Survey 2015-2016), and operating profit per hectare high to provide resilience during a low milk price cycle.
- Monitoring the debt: asset ratio to meet your desired level of risk.
- Keeping it simple.

Notes:

Introduction

Over the last three years, low dairy prices have put pressure on farm systems, farm businesses and farmers themselves. This has led many farmers to assess how strong their farming business is and with the pressure expected to remain for some time, looking at how they can build a stronger business to weather these fluctuations.

The response to date has been fairly reactionary with farmers focussing on reducing farm cost structures; ‘tightening their belts’ to combat the low milk price environment. This is an appropriate short-term reaction, but we are now into a secondary phase of restructuring business and farm systems to be economically sustainable at the long term average milk price. The question is ‘How do you plan to operate going forward in a market that could well stay at this level indefinitely?’

What is a resilient or sustainable farming business? One definition of a sustainable farming business is one that has the strength to withstand financial and climatic stressors while meeting environmental and animal welfare compliance, and come out in a productive position with a balance sheet in good shape. A strong balance sheet and operational profit are key to thriving in the industry.

The current situation

Table 1. Key Financial Benchmarks (source DairyNZ Economic Survey 2015/2016)

	2012-2013	2013-2014	2014-2015	2015-2016
Operating Expenses \$/kgMS	5.03	5.17	4.94	4.45
Operating Profit \$/ha	1830	3295	1537	-9
Term liabilities \$/kgMS	20.82	20.14	21.26	22.49
Debt:Asset %	43.7	41.9	45.8	50.3
Equity Growth %	13.0	9.7	-3.5	-9.3
Break Even Milk Price \$/kgMS	5.98	6.35	5.77	4.93

Over the last couple of seasons, with a reduction in milk price, operating profit per hectare has declined while term liabilities and debt to asset have increased. A large percentage of farmers have run at a cash loss and transferred this loss into term debt.

From the 2013-2014 season to 2015-2016 season the percentage of farmers with greater than 60% debt to asset ratio has increased by 15%. Debt to Asset ratio at the end of the 2015-2016 is illustrated in Figure 1.

The higher the debt to asset ratio the less resilient a business is – due to the commitment to pay interest on debt. Businesses with higher debt to asset (shown on right of Figure 1) are

more vulnerable at a lower milk price due to the cost of the interest overhead. The cost of this debt is out of the farmers' control.

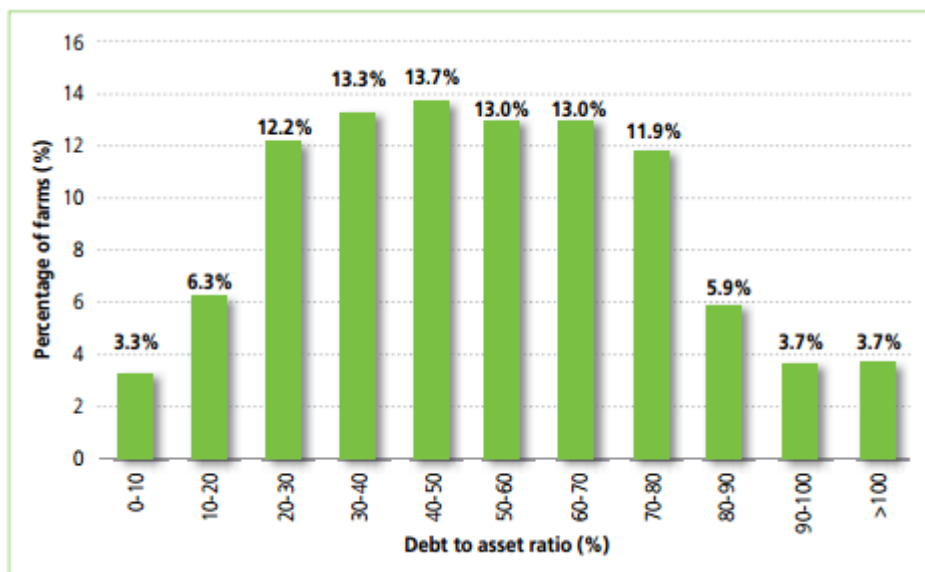


Figure 1. Debt to Asset Ratio 2015-2016 (Source: DairyNZ Economic Survey 2015-2016)

Over the last four seasons equity growth has also declined. This decline is due to a reduction in profit, increase in liabilities and minimal or negative change in capital value held in land and stock, hence a negative change in equity.

Over the last couple of decades a significant proportion of growth in equity has come from asset appreciation, an increase in land and stock value.

Many of you will have a view on whether land values are going to continue to appreciate or not. That's a personal view and a personal situation. One thing that won't change is that the integrity and strength of your cash flow will be as critical to your business in twenty years' time as it is today.

A strong, resilient cash flow gives you the ability to withstand market shocks and pursue your goals. A weak cash flow takes away time, opportunities and choices.

All farmers need to revisit the plan for their business. Is it going ahead or are we standing still? How vulnerable is the business to milk price fluctuations and how dependant is our future on growth in capital value?

Notes:

The last few years have given farmers an opportunity to look at the cost of production and to make some short term and, in some cases, longer term changes. The initial dust has settled a little with the milk price coming up to the \$6 mark and this has provided some much needed 'breathing space'. This higher milk price may or may not last so now is the time to take a long hard look at your business. It is time to identify and establish your 'Plan A' business.

What is your 'Plan A' business and how do you get there?

What is not a 'Plan A' business?

- No short or long term goals.
- No set targets.
- Prepare a cash flow for the bank once a year and never look at it.
- Fully immerse yourself in the day to day running of the business and don't stop to look at the business.

Does this sound familiar to anyone?

Identifying your 'Plan A' business requires a full review of the whole farm system. The strengths, weaknesses, risks and opportunities across all components of the business need to be assessed including strategy, governance, finance, environment, people, animals, pasture, feed, reproduction and infrastructure. Is the whole package currently working?

Firstly the strategy is the overall driver of the business. This has to take into account both the business and personal motivations of the individual farmer.

The key questions to ask are:

- What is important to you?
- Where are we now? The current reality.
- Where do we want to be?
- How will we get there?

The answers to these questions formulate direction and goals for the business.

Are the current outcomes from the business going to meet the short and long term plans? If you have the dream of purchasing the land next door or perhaps retiring from day to day management in 10 years' time but your cash flow is currently in the red, this dream is unlikely to be a reality. If this is the case it is time for change. It is time to ask the tough questions.

What is important to you? Where do we want to be?

A clear strategy is critical to achieve the optimum result rather than the default result.

What does life look like in 5 years and 10 years' time? Set both personal and business goals. With the majority of dairy farms owner operator the personal goals often drive the business goals. Make these goals SMART, specific, measurable, realistic and achievable.

For example:

Goal: Move back from day to day management in five years' time.

Current Situation: No time or money available to do this. Break even milk price is \$5.75/kg MS and overdraft is still in the red from the last two seasons. Definitely no time for looking at the budget, no idea how the budget is tracking. Take very little time off at present as no one seems to get the pasture management right, the staff don't know what to do if you're not there.

Change required: Set targets for all financial KPI's and monitor these. Analyse the current cost structure and make changes where possible. Is the overall system efficient and is it the best system for this property? Put in place simple systems so all staff can complete daily tasks when needed? Take time to plan the workflow and delegate to staff appropriately? Have clear targets in place and explain to staff the purpose of these. Provide staff with training. Are the right staff employed?

Goal: Reduce debt: asset ratio from 70% to 60% over the next 5 years.

Current Situation: Break even milk price is \$5.90/kg milk solids and forecast milk price is \$6.00/kg milk solids. At this rate there is very little debt reduction if any. It only takes a large plant breakdown and any surplus is spent. A milk price of \$5/kg milk solids and the business is heading backwards.

Change required: At least \$1/kg milk solids of business profit available to repay term debt. Reduce breakeven milk price by 0.80c/kg milk solids. Benchmark key areas of the business to identify opportunities to achieve production efficiencies. Is the current system the most efficient for this property?

The plan may need updating along the way but the target remains the same!

Where are we now?

Navigational tools are needed to identify where the farm is now and guide all decisions.

These include:

- Benchmarking

Note:

- Cash flow budget
- Balance sheet/Accounts
- Pasture Management Plan, Feed budget
- Milk Production Information
- Herd reproductive performance.

Understanding the metrics of the business provides opportunities. How does your business compare to the top 25%? Allow time for benchmarking.

Key financial performance indicators include:

- Operating expenses (\$/kg MS)
- Operating profit/ha
- Return on Equity
- Break even milk price 2015-2016 New Zealand Average \$4.93/kg MS.

The break-even milk price is a business indicator of success and highlights the ability of your business to cope with milk price fluctuations. All systems can make changes to bring the break-even milk price down to a more secure level in relation to that individual business.

Debt : Asset ratio is also important. It is not a direct measure of performance but an indicator of risk. A farm with a debt : asset ratio of greater than 65% carries great risk. This risk level varies also depending on how strong the cash flow is. A lower break even milk price and a strong cash flow help reduce the risk of high debt.

Table 2. Dairy Farm Performance 2015-2016 (source Economic Survey 2015-2016 DairyNZ)

	Top 25%	Bottom 25%	Top 20% 2016/2017 Canterbury
Financial KPI's			
Farm Working Expenses	\$3.00/kg MS	\$4.27/kg MS	\$3.32/kg MS
Operating Expenses	\$3.74/kg MS	\$5.48/kg MS	\$3.49/kg MS
Operating Profit	\$1073/ha	-\$1097/ha	\$2550/ha
Return on Dairy Assets	1.7%	-2.4%	
Break Even Milk Price. NZ average 2015/2016 \$4.93/kg MS			

Profit and a strong cash flow provide time and choices. Financial planning and monitoring makes decision making easier.

Key physical performance indicators:

- Pasture eaten (tDM/ha)
- Cow efficiency (kgMS as % of liveweight) Target 80 -85%
- Total supplements used (kgDM/cow).

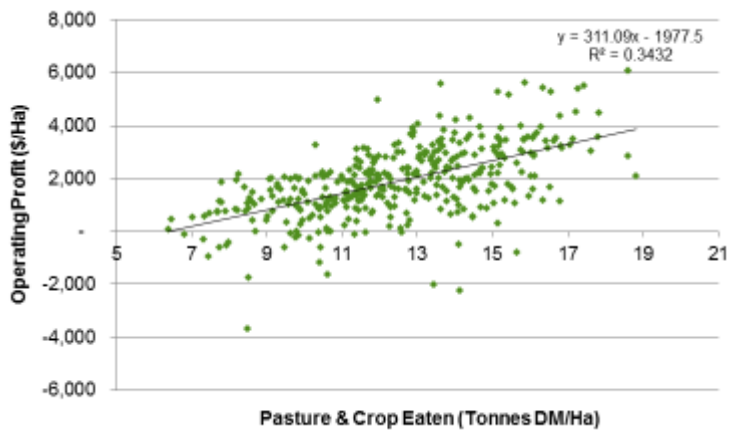


Figure 2. Pasture Eaten compared to Operating profit (source: DairyNZ)

Figure 2 illustrates that operating profit increases as pasture and crop eaten increases. Pasture is the cheapest form of feed on the farm. How many farmers carry out farm walks and measure this resource? Pasture eaten is a simple calculation. There are templates available on the DairyNZ website or your farm consultant can help with this.

How do we get there?

Set targets and follow up with a concise action plan to achieve these. The action plan is focussed on achieving the short and long term goals. The first step is simply making the most of what you have on farm and utilising management tools.

This is not a new concept but one we lose sight of when the milk price goes up and often one that is forgotten when the milk price goes down. The good news is the majority of changes needed often do not have a direct cash cost but do require an investment in time and commitment to ‘make it happen’.

Ensure all day to day decisions are consistent with your long term plan.

Set up a forecast budget and cash flow and monitor monthly and update quarterly. Every area of expenditure can be analysed in relation to the goals and direction of the business. There are no surprises.

If there is no pasture management plan in place, no targets and no farm walk are you making the most of the largest resource and how do you measure if purchased feed provides a return?

The greater the pasture production and feed eaten the greater the operating profit.

For example: (Based on a return of \$350/tDM/ha)

A 200ha farm growing 16tDM/ha and eating 12tDM/ha. 75% of pasture is utilised.

An increase of 5% generates an additional \$56,000 minimum

An increase of 10% generates an extra \$112,000 minimum. This is a significant financial gain.

Time taken to set targets, monitor the situation and form strong guidelines on purchasing decisions can yield a significant return.

For many farmers operating expenses have been high over the years of high milk price and many farms have systems that are not simple to manage. Greater capital structure requires greater profit per hectare to provide an equivalent return and is not easily 'detuned' during times of low milk price.

Low capital cost systems tend to have 'smoother' cash flows and lower operating overheads. These systems are more robust in times of lower milk price but also do not make as much at the higher milk price. They do tend to be sustainable long term. Adding cost is easy but removing it is difficult.

Try not to be tempted to chase marginal return unless it fits in with your business plan. Always ask the question is the added cost a fixed cost or a variable cost. Fixed cost is harder to remove. Layering in additional long term overhead to chase a short term marginal return is very high risk. Suddenly the marginal cost/ marginal return looks very different. Think about the long term consequences.

Marginal cost and marginal return are variable. Spending a dollar to make a \$1.50 depends on a price point, in this case milk price. If the milk price drops make sure the extra \$1.00 can be removed.

All decisions need to be based on the long term goal. Do not spend on additional resources unless you are making the most of what you currently have. This includes land, stock, staff, water, feed, machinery, etc.

For some the changes will be small, if at all, while for others this may be a big mind set shift.

All farms have the ability to set up a "Plan A" business model.

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References

DairyNZ Economic Survey 2015-2016.

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