

## **Managing Debt to Preserve Future Profitability**

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Dairy farms are doing their part to stimulate the economy. Cash is flowing out at a rapid rate. As all dairies are painfully aware, cash is not flowing in as fast as it is flowing out.

How to deal with the shortfall? Lists of strategies abound. Controlling feed costs, the largest single expense is critical. Controlling death loss, reproduction and replacement mortality can mean the difference between a 100-cow herd having to raise 61 heifers or 78 heifers a year. At an average cost of \$2,150 per head, that is a substantial savings.

Additional dollars might also be found by reviewing and shopping around farm insurance, loan interest rates, Worker's Compensation group rating programs, etc. However, as much belt-tightening as any farm can -and should- do, today's milk prices will not cover total costs of production.

Once existing cash reserves are used up, alternative sources of cash must be found if the dairy is going to stay in business. Short term, we usually look at procuring or increasing an existing line of credit. Typically, a line of credit is used to cover short term cash shortfalls and is usually repaid within a year.

If today's milk futures reflect what is likely to happen this year, farms will lose money every month. Just maybe not as much in the last half. So realistically, debt taken on to manage cash flow this year is not going to be repaid this year. When markets turn around, the farms left standing will likely need several years to repay this debt.

### **Protect equity**

The farm's net worth (total assets less total debts) is in a state of flux. Along with milk prices, the value of cows and heifers is also in decline. Land prices are currently holding but may also show some softening. This is exactly why we have to be conservative when valuing cattle and land on balance sheets. If conservative values were used on the farm's balance sheet, they are probably still in line with today's markets. If higher values were used when cattle prices were strong, and dollars were borrowed against that value, the farm's debt position will deteriorate with declining asset values.

Total debt should be less than 40% of the value of the farm's assets. As asset values drop, the farm's percentage of debt increases. Farms at 40% debt or higher will not be able to borrow much, if any more money to weather tight cash flows.

## **Monitor Debt**

Now is the time to push some numbers. Current ratio (current assets divided by current liabilities), scheduled debt payment per cow, debt to asset ratio, and debt per cow are very good measures for monitoring debt for the dairy business. See the 15 Measures of Dairy Farm Competitiveness at <http://dairy.osu.edu> for details about calculating and using these measures.

## **Control Debt**

Start with the debt to asset ratio to monitor the overall farm business, then debt per cow to monitor repayment capacity if you are considering taking on additional debt. If these are less than 40% and \$2,500 per cow respectively, then calculate scheduled annual debt payment per cow with a goal of keeping it at \$500 per cow or less.

While the cows are not going to be able to pay back additional debt this year if current conditions continue, you have to protect their ability to repay debt when the market returns. In most cases, a total debt of \$2,500 per cow with annual repayment of principal and interest totaling less than \$500 per cow is doable. However, each farm has to push these numbers for themselves. A few can handle higher levels; others will not be able to handle these levels.

If you are borrowing additional operating dollars (rather than a collateralized term loan) “schedule” them for your per cow figure over the time period you think it will take to repay the note if it is greater than one year.

Controlling costs has been the front-line attack for dealing with pitiful milk prices. While it absolutely should be done, it is not enough to make up the cash flow shortfall. As cash reserves are depleted, it is critical that borrowing be done carefully so that the farm’s equity and future profitability are not endangered. Some farms are facing very challenging situations and will have to consider if they even should try to borrow additional money or exit the dairy industry and preserve their equity.

The FINPACK farm financial analysis and projection software is an excellent tool to help generate the information to help make these decisions. Thirty Extension Educators and FBPA Instructors around Ohio are trained to use the FINPACK program. Contact your County Extension Office for assistance.