Dairy Issue Briefs

DIBS

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Plummeting prices in the dairy industry are creating critical cash-flow and long-term survivability issues on Ohio's 3,328 dairy farms. Cost-cutting decisions must be made with full awareness of both short and long-term production and economic consequences. OSU Extension's Dairy Working Group, a collaboration of OSU Extension Educators and Specialists discuss:

Reducing costs to improve short term cash flow

How should I take on additional debt?

Carefully, very, very carefully. Protecting your equity and the long-term potential profitability of your business is critical as you refine your war plan for managing through this down cycle in the dairy business. The market will recover when enough cows leave production and demand increases. When it does, there will again be profitable times in the dairy business. The question is: how long can you afford to wait for them? How much equity will you have left when they come?

Current 2009 mailbox prices are not covering variable costs. On average, every 100 cows milked came up $10,500 short in January. Ouch! 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 a line of credit. Typically, a line of credit is used to cover short term cash shortfalls and is usually repaid within a year.

If milk futures reflect what is likely to happen this year, farms will lose money every month, perhaps not as much in the last half of the year. 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 1-3 years to repay this debt.

Protect equity

The farm's net worth (total assets less total debts) is in a state of flux. The current decline in asset values is why we must be conservative when valuing cattle and land on balance sheets. 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, money to survive tight cash flows.

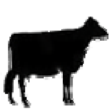
Monitor Debt
Now is the time to crunch some numbers. Current ratio or working capital, scheduled debt payment per cow, debt to asset ratio, and debt per cow are very good measures for monitoring debt for the dairy business. See the **15 Measures of Dairy Farm Competitiveness** at http://dairy.osu.edu for details about calculating and using these measures.

Control Debt
Right now, I would focus on the debt to asset ratio to monitor the overall farm business, and debt per cow to monitor repayment capacity as you consider 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 at current milk prices, 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 $500 or less per cow is reasonable. 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 loan with a set repayment schedule), and you don't anticipate being able to pay those dollars back within a year, you need to plan for repayment. Estimate how long you think it will take to repay the debt. Then estimate an annual principal and interest payment to include in your scheduled annual debt payment per cow calculation.

To date, controlling costs has been the front-line attack for dealing with pitiful milk prices. While this must be done, it will not make up the current 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 seriously consider if they should even try to borrow additional money or exit the dairy industry and preserve their equity.



Bottom Line: Additional debt should only be taken on if **you** know and have projected that your business can generate the additional dollars to repay that debt. Keep total debt, debt per cow, and debt repayment per cow in line to protect future profitability.

Author: Dianne Shoemaker, Extension Dairy Specialist, Wooster.
Contact at shoemaker.3@osu.edu, 330-257-3377.
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