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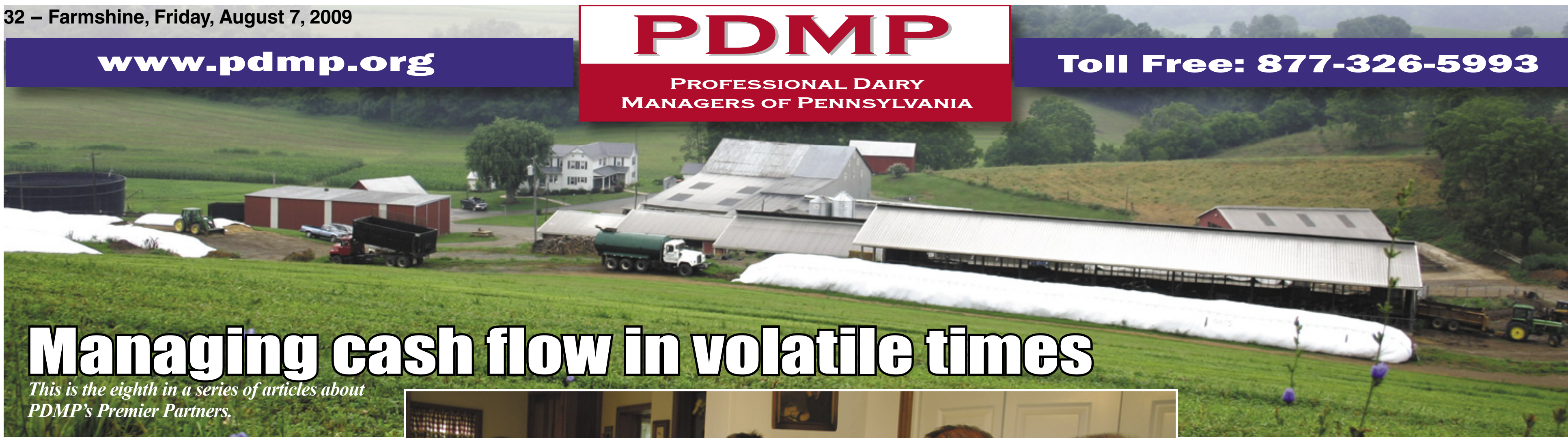

Managing cash flow in volatile times

This is the eighth in a series of articles about PDMP's Premier Partners.

By SHERRY BUNTING
Special for Farmshine

WARFORDSBURG, Pa.—Few, if any, dairy farms have a Chief Financial Officer—whose job it is to think strategically using analytical skills and tactical management to guide a business through thick and thin.

But more often today, what dairies are doing is hiring a business consultant to help them do the kind of tactical planning a Chief Financial Officer would do for a company. A business consultant helps the farm family look at their numbers, process them, and use them to make business plans and day-to-day cash flow decisions.

"A business consultant is a planner and strategic thinker and at the same time a cheerleader and coach," says Mike Hosterman, ag business consultant with the business management division of AgChoice Farm Credit.

2009 has been a year like no other on dairy farms. The economic recession, coupled with low milk prices and relatively high input costs, has produced tremendous stress on dairies, and there are so many missiles firing at farms these days that it can feel like it's time to head for the bunker and let the shots fall where they may.

Instead, business consultants, like Hosterman, roll up their sleeves and help dairies get to the frontlines to defend their positions. Using analytical skills, knowledge of the industry, networking resources, facilitation skills and unbiased positive attitudes, they provide tools to help read the situation and formulate a plan.

The most important tool? "Know your numbers," says AgChoice Farm Credit Chief Executive Officer Allyn Lamb. "Make sure you have good records and check them often. Daily is not too often in a business like dairy."

Lamb also encourages customers to manage for cash and reduce their cash breakeven points. He notes that a major restructuring is going on in agriculture. "Not only is this a great opportunity to get to a lower breakeven point, it is imperative," he says about "taking control" in an out-of-control market.

"That has been a big plus in working with Mike (Hosterman) as our business consultant. It makes us sit down and look at the numbers. We've done a lot of cash flow planning," says fourth generation dairyman Lonnie Palmer, who operates Pigeon Cove Farm, LLC, Warfordsburg, Fulton County, with his wife Deb and son Brad. They milk 260 cows, shipping 24,490 pounds of milk per cow per year.

"We look at the numbers at the dairy benchmark meetings and in our dairy profit team meetings," Deb explains.

The Palmers are members of PDMP and Lonnie and Deb have been attending the Dairy Summit for three years. Their son Brad is a partner in the LLC. His wife Linette takes care of the calves and son Logan, 15, helps mix feed and haul manure. Another grandson, Alex, 9, also likes helping at the farm. When the younger boys talk about the farm, their grandparents see the future in a sixth generation. This makes the things they are doing now—to plan strategically for the future—all the more important.

For example, the Farm Credit Dairy Benchmarking program allows farms, like Pigeon Cove, to compare themselves to the top 20 in their peer group. AgChoice also has a Biz-360 tool, which is a questionnaire for risk assessment. This tool promotes the strategic thinking that is needed on dairy farms today.

The Palmers say benchmarking has really helped them "be in the mode of continually evaluating cash flow from one year to the next and to identify their weaknesses."

Mike Hosterman (second from right) is an ag business consultant in the business management services division of AgChoice Farm Credit. He does business consulting for Pigeon Cove Farm, Warfordsburg. The 260-cow dairy is owned and operated by Lonnie (right) and Deb (left) Palmer and their son Brad (second from left). Photos by Sherry Bunting

Among other things, Hosterman explains, "Benchmarking helps the producer look at the whole business and how he can control costs."

The Palmers give the example of how benchmarking helped them determine their corn yields were not as good as they should be, and they took a hard look at that this year.

"Benchmarking also helped us figure a breakeven for forward planning," says Lonnie. "When you have a history, it makes it easier to do those projections for cash flow."

"Last year we also made changes in labor," the Palmers report. "And the benefits of that are showing up this year."

The benchmarking program is great for getting a strategic perspective—beyond financial management—to areas such as production, cropping, culling and reproduction.

But dairies are in an unprecedented time of change. How do they do strategic business planning in the face of the unknown?

"Facing what we are now with the milk price, we are looking at ways to handle the fact that the cash flow is not there," Lonnie relates.

"As lenders, we have had to adjust the ratios we used to rely on," adds Lamb. "The pace of change has accelerated."

Through benchmarking, having a profit team, and working with Hosterman as their business consultant, the Palmers are learning how to better allocate their dollars during profitable milk cycles and through tough times.

"We have learned that what we really need to do during good times to position ourselves better for the bad times, is to build our cash reserves," Lonnie reflects. "When this cycle is over, it will take time to catch up to do that."

Building cash reserves requires a very deliberate action plan. And even though it will take time to catch up when the milk price eventually turns around, now is the time to devise that action plan to prepare for the next downturn.

Hosterman encourages producers to develop and manage liquidity for times when margins are negative by building cash reserves of $500 to $1000 per cow when margins are positive. "We used to talk about cash reserves of $200 to $300 per cow, but that's not enough anymore to get through these straight-up, straight-down milk cycles," he says. "It's increasingly important to establish cash reserves before purchasing a capital investment with available cash."

Building cash reserves can be savings liquidity, but it can also be in the form of paying down lines of revolving credit so this money is available again when the cycle turns. When profits are available, producers may want to also pay down long-term, structured debt.

That's okay, says Hosterman, as long as the producer knows he is working with a lender who understands agriculture and will re-lend.

"If the term debt is structured appropriately for the business, then paying that down should come after first paying short-term debt, building up cash reserves, and having a capital investment plan," Hosterman advises.

Paying down debt before the milk price collapse was one thing the Palmers did focus on. "We were pretty aggressive on paying back our loans," Lonnie reflects. "My goal was to have debt caught up by retirement. We were down to six or seven years, now we're out nine or 10 years (with this year's losses)."

"Their ace in the hole was their short-term debt repayment," observes Lamb, "which is another way of managing the cash reserve."

This is all good information for planning and implementing when milk prices eventually recover. But how to get through the situation today is another story.

To get a snapshot of where the farm is in managing its cash flow day-by-day, Hosterman urges producers to monitor their accounts payable and compare them to the farm's budget. Budgets should be done at least annually, but monthly is even better, he says. Armed with these numbers, comparisons are made to the previous year's.

"Farms must have a budget if they are going to control cash flow. This allows the producer to compare to last year. They can track how their cost of production is changing," Hosterman notes. "I look at the income over feed cost margin to see what that's doing. I also look at the net cost of production today versus last year to make a hundred pounds of milk."

Hosterman uses the Dairy Profit Analyzer tool to evaluate these things on a 12-month rolling average. This quickly reveals trends used in the farm's business planning, profit teams, and cash flow planning.

"This shows the producer—sooner—if the farm is on track or not," Hosterman explains. "And when the cost of production is known, this helps with marketing and risk management. Our services are geared to help producers be profitable and think strategically."

A historical review, for example, could show that a dairy was profitable and successful. The five-year projections could show continued profitability and predict a small loss in 2009. But, when the severity of these losses in the market turns out to be deeper and longer than anyone could have predicted, the focus shifts to find ways to limit these losses. What is discovered and implemented will vary from farm to farm. But having the history and projections helps the producer know earlier where the dairy stands financially and what some options are for minimizing the losses.

In times such as these, proactive cash flow management is critical. Some examples of activities that contribute to cash flow management are: 1) having a dairy profit team and using strategic planning, 2) knowing the difference between needs and wants, 3) taking advantage of discounts wherever possible, 4) employing the farm's cash reserves to cover payables and keep them up-to-date, 5) using the budgets and tracking reports to make strategic decisions.

Above all, says Hosterman: "Have good communication with your key vendors and your lender." A good relationship with the lender is something that is cultivated over time, but there is no time like the present to start communicating and developing the kinds of plans and priorities that lenders like to see.

Dairy farms today also need to have some type of capital spending plan for improvements, he adds. This helps the family know what is needed and how to pencil it out to a cost per cow that can be managed over time.

"By figuring out (before) what will need to be upgraded (on a planned basis), some farms are still making upgrades this year for things that are necessary," Hosterman observes.

"Some things can be deferred and some cannot. The important thing is to have a plan," Lamb adds.

Having a business consultant has helped the Palmers look at such decisions, like buying new harvesting equipment. They have 260 cows, and they figured they would need to feed 1000 cows to justify the cost. Instead of adding cows, they added a custom harvesting operation as a separate enterprise. They are also currently preparing to put in a basic feedlot with headlocks to raise their heifers at home. And to control feed costs, the Palmers are buying commodities for the ration.

They've also structured their labor differently. Working with Scott Moseman at nearby Misty Mountain Dairy, they exchange services at cost. "We do their crop work, and Scott does our herd work two or three times a week."

In the benchmarking program, they saw their somatic cell count as a weakness. "It's never been terrible—averaging around 250,000—but we wanted to get it lower, and we saw that we had too much mastitis in the herd. We wanted to control our medication costs," Lonnie relates. "We had a consultant help us make changes to where we went from 26 treated cows to three."

"Milk quality was an area we noticed in the benchmarking," Hosterman confirmed. "They were giving up 10 to 20 cents per hundredweight just on the quality premium."

This is a good example of cost control as monitoring dollars in (premium opportunities) and dollars out (cost of mastitis medication).

The bottom line in these difficult times is cost "control," Hosterman stresses, adding that this is not the same thing as cost "cutting."

"Producers can use cost control measures to drive their income," he explains. "Cost control starts by having more awareness of the dollars that are coming in and going out of the farm."

When farms are so engrossed in survival, this type of strategic planning is often postponed, but there has never been a more important time for such planning than right now.

"The biggest thing about AgChoice, as a lender, has been the relationship," Lonnie states. "They know the agriculture business and can help us through these tough times. On the business management side, it's also nice to have someone helping us look at where we are and to think ahead so we make better decisions."