How to Project Your Dairy's Working Capital Needs

AUG 31, 2012

Forecasting your cash-flow requirements and ensuring you have access to adequate cash are essential because volatility is here to stay.

By Robert Matlick, Frazer LLP

Working capital. This two-word metric is rarely found in financial conversations regarding production dairy and dairy farmers. By its simplest definition, working capital is Current Assets less Current Liabilities.

Bottom line: Working capital is the amount of readily available cash a business has available to meet its operating needs and any unexpected volatility related to its own business cycle. In the past, a dairy producer has relied on bank lines of credit for his or her working capital needs.

With increasing volatility in the milk output and feed input side of the dairy business, a dairy owner should be keenly aware of his own personal working capital position. One of the most effective ways to accomplish this is to forecast business operations.

I have often written about the need for every dairy to have a working 12-month cash-flow projection that is measured to actual performance on a monthly basis. Each month, when the cash flow is updated with actual numbers, another month should be added to the end after reviewing the actual performance.

The cash flow should then be tested as to sensitivity. This may sound difficult, but it simply entails working through several "what ifs." For example, what if the milk price drops $4.00 per cwt.? What if the feed cost increases by $2.00 per head per day? What if production falls by 8 lb. per cow per day? Bottom line: Stress-test the main drivers of the cash flow. If the cash flow is set up in an Excel format, the what-ifs can be changed easily and the effect identified quickly.

After the sensitivity is accomplished (you will be amazed at the various scenarios you will become interested in), evaluate and identify negative cash flow positions and their timing that will occur within the 12-month time frame. The question then becomes: Does the operation have enough working capital to survive the negative projections?

Many producers have always relied on the bank to fund the losses should they occur. Others have depended on trade vendors. However, as volatility has increased and margins have decreased, many times these fallback positions are not reliable sources of working capital. The dairy business person needs to identify and monitor his cash needs going into the future and plan for deficit cash flow while making certain there is adequate cash (working capital) to meet those needs.

The sale of operating assets cannot be considered readily available working capital nor can the extending of trade credit. I have been part of many discussions in the past 12 months that will argue the use of operating bank debt may also not be considered available working capital, and only cash reserves or assets not associated with the day-to-day operation of the dairy that can be converted to cash in a very short time frame can be considered working capital.

In my mind, bank lines of credit could certainly be considered available working capital if openly discussed with the lender at the annual renewal and the assurance of the lender that valuation of the underlying collateral supporting the line will not change dramatically. If a producer is going to depend on the bank for working capital, there should open and honest communication when the loans are established and renewed. Otherwise, make sure the cash is around because volatility is here to stay.

Robert A. Matlick is a partner in the accounting firm of Frazer LLP. Based in Visalia, Calif., Matlick is a management advisory specialist and provides business consulting services to the agriculture industry, with an emphasis in the Western U.S. dairy industry. Contact him at bmatlick@frazerllp.com or 559-732-4135 Ext. 107.