Is the Money Really Lost?

JAN 23, 2012

Think of your dairy's risk management plan as a way to minimize volatility, not gain or lose money.

By Robert Matlick, Frazer LLP

As I review 2011 financial statements and have conversations with clients about those statements, it appears there is an underlying theme being shared. Many producers, who entered into some type of risk management for their milk in late 2010, after the 2009 meltdown, are complaining about the trades they made in 2011, and therefore the so-called losses they incurred. My response, “You never had the money, so how could it be lost?” This statement on my behalf does not always bring smiles to my clients’ faces.

The point I am trying to make is that at some moment in time, i.e. when the risk management plan was executed, they were satisfied with the price to be received. However, as 2011 progressed and prices moved up, they suddenly looked at the situation as lost income. I rarely hear that argument when a producer locks in a grain price and it moves lower.

Risk management, on the milk side, must be viewed as a marketing plan for the product and be a part of the overall business plan or projected cash flows. Dairy Farmers of America (DFA) has an excellent chart of how producers who have participated in risk management fare against those who have not used risk management. The overall outcome of this chart, over numerous years, is basically a break-even -- meaning no money was made or lost using risk management.

The important message is that the line for those who used risk management is somewhat static with minimal volatility. The line for those who did not use risk management has wide fluctuations. Therefore, the question is, “How long can you stay in the game when the market drops below your break-even expenses?” If you have a tremendous amount of equity, the answer is most likely a long time, and if you have minimal equity (less than 40%), the answer may be not very long at all. After the financial disaster of 2009, I would venture to guess the higher percentage of operations fall into the minimal category.

Producers have a different risk profile based on their own balance sheet, management style, banking relationship and overall personality. Therefore, it is important to develop a business and marketing plan that projects your individual operation for 12-24 months. The plan should include anticipated milk production, any herd increase or decrease, seasonality of milk production, anticipated feed costs (including physical hedges-inventory and forward contracts), capital improvements and debt structure.

The first time developing such a plan can be a bit painful and time-consuming; however, it is well worth the exercise. There are several available resources (consultants and software) that can make the task easier. Then, after developing a plan, there should be a written policy created so the month-to-month risk management is better defined and more easily executed. The decision to market milk on a forward pricing or option strategy then becomes “acceptance” on a producer’s behalf and not money lost. I also believe with implementing such a plan in regards to risk management (both milk and feed), lending institutions will be better accepting of working with an operation because much of the volatility has been mitigated.

*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.*