Dairy basics - Management
Written by Bob Matlick
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Do you have a business plan, a marketing plan or a liquidation plan? In general, agriculture has always been a price taker (in both inputs and outputs), and dairy is no exception, perhaps even the leader.

When milk price volatility brings negative margins, the typical producer seems to focus on cost cutting, as opposed to revenue generation. The cost cutting is then usually done without a plan and is more of a knee-jerk reaction.

Many times, this type of reaction, along with the lack of a business plan, can lead to the dreaded liquidation plan.

A typical 2,500-cow dairy operation in the western U.S. will generate approximately $11,000,000 in gross revenue per year and, while there are no clear definitions, I would categorize this as a medium-size business. We know that large businesses (i.e. WalMart or Chevron), have a great number of staff devoted to the process of business and marketing plans.

I would venture to guess most mid-size companies (manufacturing, machinery, widgets, etc.) would also have a written business plan that extends over a three-year to five-year period with staff dedicated to the process.

Commonly, dairy operations are lacking in the area of business planning since they are risk takers by definition, influenced by climate and “manufacturing machines” that have to be cared for daily, can contract disease and can die daily. With wide variations in these areas, many operators feel they cannot plan for the future.

Why, then, do dairymen loaded with risk (as described in the previous paragraph) also add the additional burden of risk associated with areas they may be able to control, such as inputs and outputs?

As a general rule, they feel the most comfortable with the cows and in their fields, not behind a desk creating business plans or tracking and adjusting their objectives. It might also be because they do not know where to start or because the process is just another burden in their very busy schedule.

I would argue that business planning is one of the most important areas to be addressed in all dairy operations. The communication of the plan to key advisers and consultants would run a close second to the development of the plan, followed closely by the monitoring and updating of the plan.

A business plan for a dairy should contain the following elements:

1. Projected cash flow

2. Sensitivity analysis

3. Marketing plan

The projected cash flow should be for a minimum of 18 months and be developed from historical performance coupled with anticipated results of the future. It should be built in such a manner that herd inventories (including milking cow numbers) can be quickly updated. Feed costs and cropping programs should also be formatted in such a manner that they, too, can be quickly updated.

All debt payments, owners' draws and projected capital improvements should be included. This cash flow is not a profit and loss statement – it is a schedule of how an operator expects the dollars to flow in and out of their operation.

The cash flow should be a living, breathing document. For example, if a breeding problem rears its ugly head, the cash flow should be altered to reflect the longer days in milk, potential decreased production, etc.

Therefore, actual numbers should be inputted once the projection is completed, variances evaluated and the remaining cash flow altered if need be. The last step would be to add on one more remaining period.

After the cash flow is developed, sensitivity analysis should be applied to the cash flow. This can be accomplished in several different ways – one way is to compute the breakeven milk price, the breakeven milk production (lbs shipped from the dairy daily or monthly) and the breakeven feed expense on a daily or monthly basis.

These calculations should be completed on a monthly basis over the same time period as the cash flow projection. An alternative method is to build a pivot table to explore the various scenarios listed above.

After the cash flow and sensitivity analysis have been completed, a marketing plan will need to be developed. Using the cash flow, an operator should compute the margins he is willing to accept and create written policy as to how he will trade or hedge his various outputs (milk) and inputs (feed, fuel, interest).

When acceptable or better margins present themselves, the producer will then have the knowledge and confidence to execute the various trades.

I find many times that an operator will suddenly want to hedge his milk output when milk volatility rises, but have no clue of his projected breakevens or actual breakevens.

When a hedge is placed and the market moves against the producer, they then view the whole risk management experience as lost money – it is not lost money; it is a knee-jerk decision to market volatility. With a written policy in place, the producer agrees that he is willing to accept a specified margin. The same concepts would hold true in the area of inputs.

When a dairyman has committed his business plan to paper, he needs to share and communicate it to his key advisers – the nutritionist and veterinarian should be aware of their part of the projections, commodity brokers should be informed of your written policy and bankers should be aware of the plan so they can have forward knowledge of any anticipated borrowings.

It is a big job, but a very important one. Some dairymen elect to bring the function in-house; others prefer to employ financial counselors to help with the process. I have received pushback regarding the cost of bringing another employee on board or working with an outside party.

Bottom line, the salary of an employee capable of handling these tasks would most likely be in the range of $50,000-$70,000 per year. Going back to the example of the 2,500-cow dairy I used at the beginning of this article, that salary equates to approximately $.09 per hundredweight (cwt).

We must admit with milk price volatility, not to mention feed volatility, this is a small price to pay to avoid writing the liquidation plan. ***PD***

PHOTO
When milk price volatility brings negative margins, the typical producer seems to focus on cost cutting, as opposed to revenue generation. The cost cutting is then usually done without a plan and is more of a knee-jerk reaction. *Photo illustration by PD staff.*

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