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What happened to your breakeven?

Rising interest rates will have an impact on cost of production and breakeven and may require additional communication with lenders, advisers and vendors, as well as right-sizing risk management tools and operations.

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Your cost structure has changed.

The Federal Reserve raised interest rates seven times in 2022. The most recent hike, a 50 basis point increase in December 2022, pushed the Federal Funds Rate to approximately 4.5% or 4.25% higher than December 2021. While this rate is certainly not unprecedented – we have seen higher rates than that in the past – it does significantly alter the economics we've been operating within for the last 15 years. With all the talk around interest rates, inflation and feed prices, I'd like to take some time to work through how they will impact your farm and the dairy industry as a whole in 2023.

2023 cost of production and breakeven price projections

Twice a year, our company produces a **Dairy Farm Operating Trends report** (https://frazerllp.com/resources/dairy-farm-operating-trends/) which shows the financial health and performance of dairies within our clientele during the previous six months.

One of the key metrics tracked in the report is Herd Line Debt Per Cow, which is the approximate amount of operating debt that can be assigned to each cow. In 2021, the average dairy in California's San Joaquin Valley had $818 of operating debt per cow. In most cases, operating debt on a dairy will be on a variable interest rate structure and thus will fluctuate as mar-

ket conditions change. Assuming the average San Joaquin dairy in the study has 2,500 milking cows, the 2022 interest rate increases would increase that dairy's interest costs by $87,000 compared to the previous year (2,500 cows x $818 x 4.25%). With average milk production per cow of 84 pounds per day, this increase would equate to an additional 11 cents per hundredweight (cwt) to the average dairy's cost of production. For producers with variable rates on their real estate debt, the impacts can be much larger. In 2021, the average San Joaquin dairy in the cost study made 57 cents per cwt – meaning, all else being equal, the increase in interest rate on the operating line alone would have reduced net income by nearly 20%.

Of course, not all else is equal.

Inflation rates have also increased rapidly in the last two years. According to the U.S. Bureau Of Labor Statistics, from January 2013 to December 2021, the average annual inflation rate in the U.S. was approximately 2.1% – very near the stated target of 2% the Federal Reserve has viewed as an indicator of a healthy economy. From January 2022 through December 2022, the rate jumped up to an average of 6.2%. While not every line item will be affected in lockstep, we can assume certain expense line items are impacted and will reflect a similar increase. Some of these expenses include hauling, breeding, supplies, repairs and maintenance, and utilities. In 2021, these five line items together averaged $2.40 per cwt in the San Joaquin Valley. Using the 6.2% inflation factor above, we can expect to spend another 15 cents per cwt (approximately $115,000 on a 2,500-cow dairy) this year, eating up approximately 26% of the average 2021 net income on the dairy.

The impacts of inflation and interest rate increases, unfortunately, pale in comparison to the impacts we are seeing from increased feed prices. In 2021, the average feed cost per milking cow in our cost study for the San Joaquin Valley was $7.22 per day ($8.60 per cwt) – approximately 13 cents per pound of dry matter. Today's rations – and our projections for 2023 – are now closer to 20 cents per pound of dry matter, adding another $3.40 or so on milk cow rations alone. Over the course of a year, that $3.40 a day is approximately $3.1 million of additional expense without any additional revenue added for a 2,500-cow dairy, putting red brackets on the bottom line for most producers.

With the three items listed above, the average cost of production for a 2,500-cow dairy in the San Joaquin Valley will be approximately $22 to $23 per cwt in 2023. Much of the progress and equity built up by strong margins in 2022 will be at risk. While I hope my estimates are inflated – that I've overestimated the impacts somewhere or the market changes quickly – I firmly believe we need to be realistic about the position we find ourselves in as we begin 2023 so we can make the best decisions for our businesses and be better positioned to han-

dle what this year brings. While I don't believe there's a silver bullet that will work for every operation, I do believe there are some key steps producers ought to be taking: communication, right-sizing of operations and risk management.

Communication

Communication is going to be key in the coming year, especially with lenders, advisers and vendors. I recommend discussing your position regularly with your banker. As part of these conversations, I would put extra emphasis on understanding the amount of availability you have on your loans as well as the loan covenants you currently have in place on your existing notes. With an increase in interest rates, for example, loan covenants such as debt service coverage ratios will change quite a bit, and we want to avoid any unforeseen defaults. Make sure you understand how those covenants are calculated and – if the covenant will be difficult to perform to – discuss with your lender how best to navigate it. Lenders hate surprises, so keeping your banker up-to-date on current market expectations and operational performance is key to keeping the relationship strong. With the interest rate changes, the cost of capital is significantly higher than prior years. As such, we want to make sure to weigh all options before taking on any more debt.

Likewise, it is important to communicate the challenges you're facing with your advisers clearly. In order to bring value to your operation, your advisers – whether veterinarians, nutritionists, risk managers, etc. – need to understand your position. While these conversations can be tricky and even uncomfortable, they are very important, as it can drastically change the strategy you take. Communication does not cost anything but can bring big benefits.

Right-sizing of operations

With cost increases and carrying costs higher than the previous few years, dairy producers should consider whether their operations are right-sized. In particular, I often like to look at heifer and feed inventories. Ensuring there is adequate feed or replacements available is vitally important in today's market, but carrying significantly more than you will use is a sneaky cost generator that often does not get the attention it deserves. While excess feed inventories are a hedge against future feed price increases and feed scarcity issues, they often also require significant leverage to procure and hold. With higher interest rates, this cost to carry these large feed inventories is often substantial and can add several more dollars to the cost of the silage over the course of a year – turning $95 corn silage into $100-plus corn silage quickly. Each operation should assess their feed price and scarcity risk and develop clear feed management plans to limit their exposure to a difficult market while also reducing the carrying costs required.

Risk management

Lastly, continue evaluating and actively looking for opportunities to utilize risk management tools. Risk management should not be viewed as a profit center but rather a way to limit your operation's exposure to obstacles outside of your control. Today's market is full of unknown risks and volatility. Every producer I work with has worked hard to get their operations running smoothly and efficiently, and risk management allows a producer to protect that hard work from being derailed by off-farm challenges.