GET FARM FINANCIALLY FIT

Dairy expansion comes with clear financial health warnings

Dairy farmers borrowing for expansion need to be aware of the potential pitfalls of higher interest rates and volatile milk prices

Thia Hennessy and Brian Moran

CONDITIONS were ripe for investment on dairy farms in 2014. The milk price was good, interest rates were low and the milk quota was about to be removed.

Accordingly, net new investment increased by 17pc on dairy farms in 2014 with dairy farmers accounting for almost two-thirds of all the new investment undertaken in the sector.

The benefits to this investment and dairy expansion in general have been well aired at this stage, in terms of employment, export and foreign earnings growth. But is it all a good news story?

A recent study produced by Teagasc showed that farmers would need to invest between €1.5 and €2bn in order to produce 50pc more milk. The question is whether the risk is worth taking for the individual farmer and what tools farmers can use to protect their income and investment?

Volatility

While dairy farm incomes have been on an upward path in recent years, so too have debt levels.

In 2014 the closing loans value on the average dairy farm was €65,346, an almost doubling of the debt level recorded 10 years earlier in 2004. Running parallel with this, milk price volatility is causing serious fluctuations in income. Average dairy farm income was just over €23,500 in 2009 and had increased to €68,500 just two years later in 2011.

Milk prices are currently running at rates 25pc lower than they were this time last year. Such volatility makes it very difficult for farmers to plan, borrow and invest.

Although investment on dairy farms has been on the increase in recent years, it is still low by international standards.

Farms in Ireland have one of the lowest debt to asset ratios in the EU at just 5pc compared to an EU average of 15pc or compared to Denmark where the position is strikingly different at an average of 60pc.

The considerable investment that would be required to expand milk production would alter these financial ratios significantly and expose Irish farmers to a range of new financial risks.

Debts to be repaid to banks could be double in four or five years — a lesson 10,000 farmers learned the hard way in the 1970s

Lessons

Although the milk quota regime was in operation across the EU since 1984, some Member States adopted a very liberal position on the trade of milk quota rights and as a result the dairy farm sectors in these states consolidated rapidly.

In Denmark for example, dairy farm numbers fell from about 33,000 in 1984 to about 3,500 today and average herd size increased from about 40 cows to 150 cows. This expansion was accompanied by a considerable increase in debt levels.

The average Danish dairy farmer now has a debt level of almost €1.8m or €12,000 per cow compared to less than €1,000 per cow in Ireland.

The Danish Knowledge Centre for Agriculture recently reported that the slump in milk prices in the autumn of 2014 and early 2015 has left 20pc of dairy farmers in financial difficulty and 15pc teetering on the edge of bankruptcy.

Clearly there are lessons to be learnt from the Danish situation.

1970s debt crisis

Many will remember that a similar "debt crisis" occurred in Irish farming shortly after our accession to the EU in 1973. Rising product prices instilled great optimism and enthusiasm in the farm sector and investment increased substantially throughout the late 1970s.

The interest rate hikes in the 1980s brought interest rates to over 20pc.

As Tom Clinton, a former IFA President, noted in a recent address "if not serviced, debts to be repaid to banks could double in four or five years; a lesson which 10,000 farmers learned the hard way.

Some 5,000 of them learned the dreaded new words in Irish farming, "restructuring" and "write-off".

It is crucial that dairy farmers do not fall foul of a similar situation, should interest rates start to rise again or milk prices drop suddenly.

Financially fit

Dairy farmers should avail of Teagasc's "Get Financially Fit Campaign" and the wide range of financial management tools available to assist in making sound investment decisions

In terms of coping with milk price volatility dairy processing companies are striving to bring greater certainty to farm businesses by offering fixed price contracts.

This year Glanbia will run its fifth Index-Linked Fixed Milk Price Scheme, while Kerry Group offers suppliers a fixed-price contract for up to 20pc of their supply.

Entering a fixed price contract offers farmers some certainty by eliminating the downside risk but also forgoing the opportunity to avail of any upside price movements.

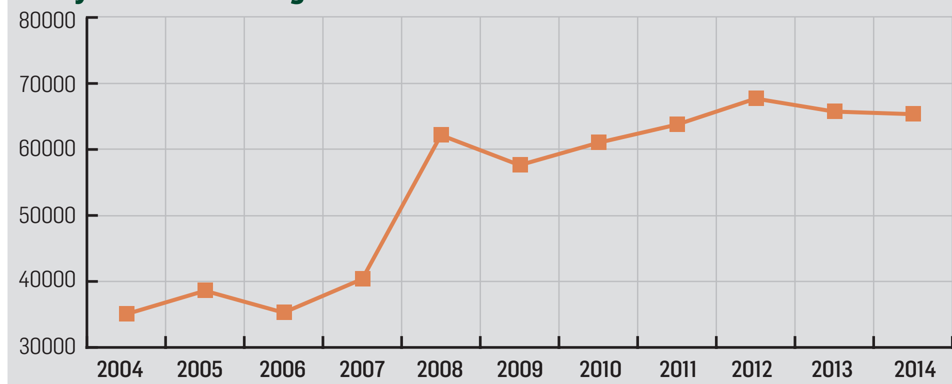
In terms of business planning Teagasc's e Profit Monitor and Cashflow planner can assist farmers in knowing their costs of production and what they can afford to repay on loans.

These figures should also be stress-tested at lower milk prices and higher interest rates to ensure farmers are not over exposed.

Thia Hennessy and Brian Moran are economists with Teagasc

VOLUMES: Net new investment on Irish dairy farms increased by 17pc last year

Dairy Farm Borrowings since 2004



Gap between dairy and beef incomes has started to narrow

Thia Hennessy and Brian Moran

THE DIFFERENCE in the average income earned by dairy farms versus cattle finishing farms attracted the most attention in the annual Teagasc National Farm Survey.

The average income on specialist dairy farms reached the unprecedented level of €68,877 while the average on cattle finishing farms was €13,834.

With the removal of the milk quota many are asking, if dairy farming is so much more profitable than beef then will we see all our cattle farms convert to dairy?

It is true that on average dairy farms are more profitable than cattle but there are significant differences between the two sectors that need to be considered.

Labour intensive

There are approximately 16,000 specialist dairy farms and over 40,000 cattle farms in the survey.

For the most part the dairy farms are a homogenous group made up of larger, full-time farms with almost 85pc of them farming 30ha or more. Almost 40pc of cattle finishing farmers operate a holding of 30ha or less.

Dairying is more labour intensive, rewarding around one and a half family labour units, compared to just one person on the average cattle farm. Around 37pc of cattle farmers have an off farm job, something almost unheard of on a dairy farm. Debt is also lower at around €10,500 on cattle finishing farms.

The income gap narrows somewhat when labour, farm size and capital requirements are taken into account.

Prices

Farming is a volatile business. 2014 was a good year for dairy farms and a bad one for cattle. Although milk prices were falling, they were coming from a very high point and production was ramping up for quota removal. For cattle farms the average annual finished price was down 12pc on the previous year.

This widened the gap between the sectors but we are likely to see a reversal of fortunes this year and probably a narrowing of the gap again. Cattle prices are more than 10pc ahead of where they were this time last year and milk prices are more than 25pc behind.

Conversion

Conversion from cattle to dairy is unlikely to happen on a grand scale, at least in the short term. A survey showed just 1pc was interested in converting to dairy farming over the next two years.

For many cattle farmers the scale of their farm business, their stage of life and the considerable investment required to start up a dairy operation are all inhibiting factors.

Farm partnership arrangements and/or long-term leasing agreements are the more likely channels through which land that is currently used for cattle production is likely to move into dairying.