Agribusiness

Managing risk key to future

The current damaging period of low dairy incomes requires careful management, says **Mark Hiddleston**

Few industries generate as much discussion or concern in New Zealand as dairy farming. Currently, there is much discussion about the high levels of dairy debt.

Those with long memories will know this is nothing new; there have been peaks in each of the past five decades driven by trade barriers, high interest rates, oil shocks and the "great recession".

This time, the causes are different and significant — more efficient production among New Zealand's competitors and reduced demand in China, the major driver of dairy growth in the past decade.

Each previous cycle has required a different response. While the long run demand outlook for dairy products is strong, the current prolonged and damaging period of low dairy incomes requires careful management appropriate to the situation.

New Zealand is more heavily reliant than any other producer on export to emerging Asian markets which large, and newly efficient, European and United States competitors, also supply. As a consequence, volatility of incomes has increased and looks set to remain a feature. A dairy commodity price recovery may still precede another dip.

Operating costs are higher and increased farm scale hasn't led to increased operating efficiency. Farm operating cost per kg milksolids (kg MS) of production increased from $2.66 in 2005-2006 to reach $4.33, in the 2013-14 year.

It is predicted to come in over $3.80 kg MS average in the May 2016 year, meaning the rate of adaption of costs to lower incomes has been slow.

Many famers understand they must reduce operating costs below that of newly efficient competitors and some are making substantial progress. The May 2016 NZ Dairy Farmers Forum featured farmers with cost structures below $3 per kg MS, and most farmers have plans to make progress in costs.

But farms are larger and farmers find it more difficult to "hunker down" as previous generations did. They employ more staff and often owners work "on" rather than "in" their business.

Debt levels are much higher. Farm debt levels increased massively since 2000, (from $12 billion in January 2000 to $59b at the end of April 2016) largely due to expansion and development of dairy farms, with a consequent increase in dairy production but also higher input costs.

In the past 10 years the average farm has increased production by 47 per cent, but at the same time average debt has risen 222 per cent from $1.53 million to $3.41m (and from $13.99 per kg MS in 2005-6 to $ 21.66 per kg MS by the end of 2015).

Even after any recovery in dairy commodity prices, debt may continue to increase per unit of production as accrued losses have been funded by increased debt.

But the main thing farmers have in their favour is that interest rates are lower than in any previous cycle, with many farmers paying less than 5 per cent for their money.

Interest and rent costs per kg have only increased from $1.08 per kg MS to $1.36 per kg MS over the past 10 years. The dairy industry itself plays a role in slowing the economy, and depressing interest and exchange rates, but economic activity is now more broadly based, meaning dairy is less protected by its previous ability to slow the New Zealand economy.

Dairy farmers have tended to rely on their underlying asset values and an expectation that cycles will turn in their favour over time, as a risk management strategy. As a result they place heavy reliance on bank support through extended periods of low prices. However, those who have responded most effectively to current commodity prices tell us they plan for profit every year and are willing to make significant changes to achieve it. They tend to take firm action to ensure costs reflect incomes.

To attract quality investors, dairy operations need to be well presented says Mark Hiddleston (below).

They are also more willing to control the things that can be controlled to create certainty, and therefore protect future earnings. For example, they take measures to improve pasture management to reduce feed costs, and take options to reduce volatility and protect profit by locking in interest rates. This more dynamic approach to risk management needs to become more consistent in the dairy industry.

New entrants will require a stronger balance sheet than they might have done, but the more highly geared farms have little choice but a long, steady effort to restore their position, with less likelihood that increases in land values will do some of the work. They can less afford market fluctuations and in addition to improving operating efficiency, need to take firm action to manage risk, and protect future earnings when they can. There are some options. Dairy companies offer fixed price milk contracts and milk price futures are an option to larger, more sophisticated business.

A number of farmers locked in a milk price in 2014-15 to significant advantage, but the key concept is that it isn't about inspired decisions, but a consistent policy to assess and manage risk, and defer the possible impact of market changes, giving time to plan and respond.

A similar approach is required with interest rates. Expectations of continuing interest rate increases in 2007 and 2008 led many farmers to fix interest rates on a majority of debt, and as a result they deferred the benefit of GFC-influenced interest rate falls.

However, this lesson has probably been too well learnt and few farmers are on fixed rates now, meaning they are fully exposed to interest rate increases immediately they take effect.

A return of interest rates to historic averages isn't predicted, but even a moderate increase could be disastrous for highly geared farmers.

A 2 per cent increase in interest rates would cost the average farmer over 40c per kg MS, and increase debt servicing 35 per cent and cost the most heavily indebted, vulnerable farmers much more than this.

A balanced interest rate risk management strategy with a mixture of short, medium and long term fixed rates will help to reduce the impact of market movements, particularly as wholesale funding costs are even more uncertain now that Britain has voted to leave the European Union.

Farmers should also be open to injections of new capital to invest in productivity improvements — where good incremental returns can be made — diversifying revenue streams, and improving debt/equity balance to accommodate lower payout expectations.

There is plenty of domestic and offshore investor appetite to achieve these structural moves, but to attract quality investors dairy operations need to be well presented.

It's vital a credible strategic plan is in place, with actionable deliverables and detailed financial reporting to accommodate savvy investor expectations.

The depth and length of this low commodity price cycle, inevitably leads to a reassessment of risk and returns, appropriate structures and management responses. Now is the time to take action.

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