

WELCOME:

So this is Christmas and another year over... one to forget for many in the UK dairy industry! In the December issue of Promar Matters we consider the Promar FBA results for the year ending March 2016 and take a look at the market indicators as we move into 2017.

Milk prices are now in full recovery mode, probably not as quick a recovery as we would like but a lag was to be expected. World dairy markets showed a notable uplift in November. The main driver has continued to be the very wet spring in much of Australia and New Zealand, although Chinese buyers have also shown increased activity having become concerned about securing supplies.

Looking closer to home, the UK has seen milk production volumes decrease by 10% over the last 12 months. With the increase in milk price there will be a hope from the trade that dairy farmers will be able to turn on the tap again – but will this be possible?

We suspect that with farmers looking to save whatever costs wherever they can over the last 12 months, a situation has developed that means making increasing volume an issue:

- 1 Autumn calvers were at grass longer than normal due to kind weather in October. Have these cows been on the best plane of nutrition? Probably not and as a result peak yields will not have been achieved and this milk will be difficult if not impossible to recover over the winter.
- 2 With the exception of maize perhaps, the quality of forage this year is not as good as we would like. This could be weather related but may also be, in part, due to the reduction in additive use this year due to cost cutting which has compromised fermentation and may lead to increased aerobic spoilage as clamps are fed. This will make efficient milk production more challenging.
- 3 The switch to beef semen over the last 18 months has been pronounced and prolonged due in part to the large numbers of heifers present in the UK two years ago, and in part to the lower cost associated with getting a cow in calf to beef as opposed to dairy. This will lead to lower replacement numbers in 2017. With the option of importing heifers now more costly due to the weakening of sterling following the Brexit vote, there may be pressure on herd size.
- 4 Fuel and feed prices are likely to be higher this winter leading to increased fertiliser prices and a reluctance to increase concentrate feed to compensate for lower forage quality.

Cows are not machines. They can't be switched off and back on as the market requires and we don't anticipate a surge in UK production as a result of these points. Each individual business must assess its own position and decide whether it is cost-effective to increase production. We are actively involved with many farmers, helping them determine the best course of action based on their particular circumstances.

I hope you enjoy reading this issue of Promar Matters and that you all have an enjoyable festive period.



James Dunn
Promar Managing Director

LESSONS FROM FBA



Andrew Suddes
Promar Regional
Manager

The Farm Business Accounts (FBA) results to March 2016, give a unique insight into how the dairy

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Results to 31st March 2016

In the year to March 2016, milk price was a particularly dominant factor and many farmers sought to reduce costs wherever possible. On average, scale of operation remained relatively constant with small increases in herd size and milk yield per cow being achieved alongside continued gains in technical efficiency with concentrate use per litre continuing to decrease.

But what does this mean for financial performance? Looking at a matched sample of FBA farms from 2014/15 and 2015/16 we can see the impact of milk prices and farmers' reaction to them (Table 1).

The most significant and dramatic changes have been made in reducing discretionary non-trading capital expenditure, with a 34% reduction in capital investment and a 10% cut in private drawings.

Investment in machinery and in buildings both fell on average by £11,500 while £10,000 less was spent on fixtures.

Table 1: Compared to last year? (same farms - matched farm sample)

2014-15 (all £ per year)	Average	%	2015-16 (all £ per year)	Average	%
Gross output	642,960	100	Gross output	598,509	100
- Variable costs	313,767	49	- Variable costs	295,070	49
= Gross Margin	329,193	51	= Gross Margin	303,439	51
- Direct overheads	186,718	29	- Direct overheads	174,449	29
=Operating Profit	142,475	22	=Operating Profit	128,990	22
- Depreciation	39,339	6	- Depreciation	42,756	7
- Rent + interest	37,489	6	- Rent + interest	39,208	7
=PROFIT	65,647	10	=PROFIT	47,026	8
Less subsidies	32,069	5	Less subsidies	29,832	5
=PROFIT no subs	33,578	5.2	=PROFIT no subs	17,194	2.8

- Output has decreased significantly leading to reduced profits. Farmers have responded by looking to make economies in all cost areas and identifying efficiencies to try and drive down expenditure.
- Continued to improve dairy herd performance and technical efficiency. By looking to improve efficiency, control costs and eliminate cause of losses like poor fertility, farmers have been successful in offsetting a sizeable proportion of the milk price fall so variable costs remain 49% of output.
- Overhead costs reduced by around £12,000 with the main area of economy being in power and machinery charges.
- Fewer reductions in depreciation and rent and interest. Many of these costs are set for several years and reflect decisions made before the last milk year. They have increased in both financial and percentage terms.
- The combined impact is that average profits have fallen from £65,647 in 2014/15 to £48,026 this year.

In the context of the expenditure in previous years and of the ongoing capital expenditure required on many dairy farms, these are very significant numbers, reflecting the steps farmers took in the year.

Despite these considerable economies and responses, the average farm in the sample remains cash negative. The funds generated from trading are inadequate to cover total financial commitments, resulting in an increase in overall farm borrowings.

It is also worth noting that this debt is increasingly being structured over a longer term rather than an increase in overdraft. The average level of new loans taken on by the farms in the sample in 2015/16 was £96,000. Clearly all farms in this average group need to address this cash shortfall by assessing and then driving the performance within their business.

Future prospects

While the current milk price increases should be welcomed, they will not, on their own, lead to an immediate rebuilding of farm finances. Although milk prices are rising now, they are only in effect making up for lost ground compared to previous years. For the first six months of the current financial year, we have seen milk prices below the prices received in 2015/16. It is probably only in the last six months of the milk year that prices will show a real year on year increase.

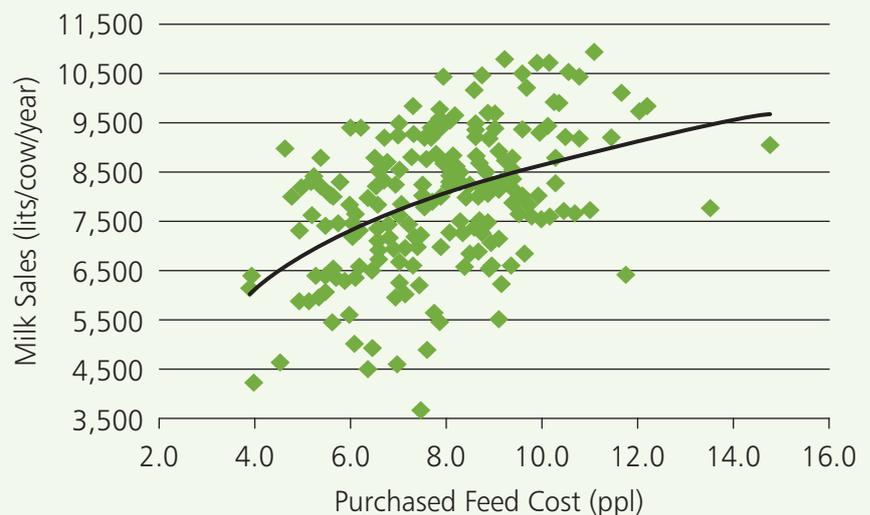
Technical efficiency

Increasing technical efficiency must remain high on the agenda and the focus on cost management has to remain a priority. There is still a wide range in margin over purchased feed (Graph 1), and this remains a greater issue than simply the cost of feed or indeed the system that cows are on. Issues such as fertility (the average herd has a 94% calving percentage) and other factors such as genetics and herd health will drive this performance too, and the evidence is that there are still improvements that can be made in these key areas.

In addition, the issue of replacement policy identifies areas where performance can be driven forward. The average farm has 180 cows and 130 head of youngstock.



Graph 1: Milk Sales v Purchased Feed Cost



Assuming that the first calving age for heifers averages out at 28 months and a replacement rate of 25% is applied, then the supply of heifers needed to keep herd numbers level would only be 100. Assuming no expansion is planned, the extra heifers on the farm are absorbing cash in the form of feed, bedding, time, facilities and most importantly, actual cash.

Overheads and investment

Overhead costs are likely to be affected by increasing fuel prices and labour costs making it more challenging to implement further economies. With improvements still required on technical performance, the challenge is also to ensure that these overhead costs remain in proportion to the output of the business. This is more likely to be achieved by further growth in output through more effective technical performance.

A further impact on 2017 financial numbers is the residual effect of historic decisions on cost structures such as loan repayments and depreciation. Successive investment in the business and evidence that banks are restructuring debt onto long-term loan arrangements will have a medium term impact on profitability and cash flow as banks seek more aggressive repayment on debts arising from forbearance offered during those times when lower milk price was seen.

A marathon, not a sprint

All the indicators are that the recovery will take time. Milk prices are recovering but margins this year will not surge ahead. The evidence from FBA suggests that being “average” or in line with the average is not sustainable from a cash flow point of view. It also suggests that more needs to be done to improve technical performance to drive this profitability – this in itself is a medium term goal that requires planning and management commitment. A three year horizon is the minimum period that managers should use. But the short-term also needs consideration in the light of the volatility that we expect to see.

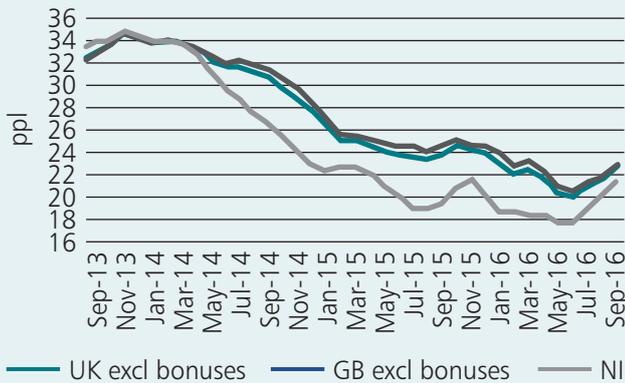
And what about support payments? These will be higher this year as a consequence of the improved £:€ exchange rate but beyond 2020 the prospects remain uncertain.

Farmers in the FBA sample have reacted to the economic environment, continuing to pursue technical efficiency and taking some very tough decisions. Given the long term nature of dairying and the ongoing residual effect of previous decisions on many components of their finances, then this twin strategy is undoubtedly an approach that they will continue to benefit from. The best will plan ahead not just on the basis of this year’s expectations, but also the year’s beyond allowing for continued volatility.

MARKET INDICATORS

In each quarterly issue we will report key trends in major price movements influencing dairy farm profitability

Milk prices



Milk prices continue to recover in response to reduced production in New Zealand, Australia and Europe. Consequently GDT prices are strengthened and this is working through to farmgate prices.

Feed prices

Cereal prices continue to strengthen with Liffe wheat prices rising by 40% since April. Soya prices have eased in response to harvest forecast.

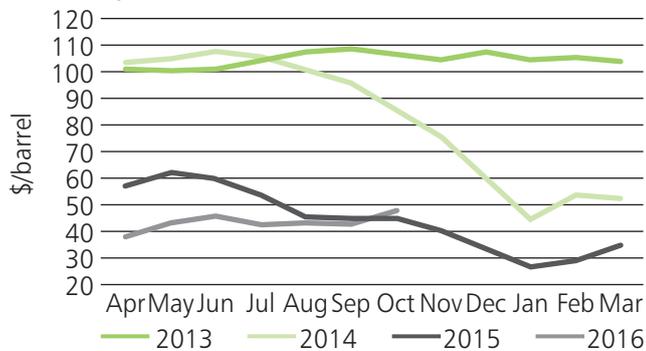
Liffe B grade wheat prices



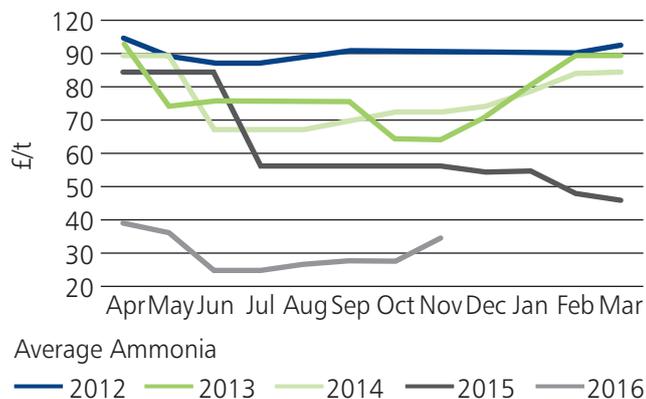
Input prices

Crude prices have risen steadily throughout 2016, now approaching \$50 per barrel, up from around \$27 per barrel in January. This is impacting on the costs of many inputs on farm. Ammonium nitrate (delivered) prices are increasing but are still around £50/t less than 12 months ago.

Crude oil price



AN fertiliser (Delivered)



Exchange rates

The volatility in exchange rates is having a significant impact on farm prices. Anything priced in dollars or Euros has suffered as exchange rates have fallen.



	Q3 15	Q4 15	Q1 16	Q2 16
EUR vs USD	1.10	1.10	1.10	1.10
EUR vs GBP	0.88	0.92	0.96	0.96

Ref: HSBC September 2016

Each 10 cent swing in the £:\$ rate will affect wheat prices by +/- £11/t. For soya the swing is +/- £22/t. When considering oil prices a 10 cent swing will impact the price of diesel at the pumps by +/- 3 pence per litre.