



Working with Your Lender

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Futuring the Dairy Farm Business:

In, Out, Moving Ahead

November 4, 2010

Dairy Practices Council

Agenda

Are you: IN, OUT, MOVING AHEAD? (or stuck in the mud!)

1. Farm Records

- Good financial information.
- Good financial decisions.
- Good financial RESULTS!

2. Dairymen use of futures and other risk mitigation strategies.

- Futures & options strategies, including managing input costs and risk mitigation tactics.

3. How lenders want to work with dairymen.

- Be prepared to borrow, 12 questions provide an outline for developing the documentation needed in a loan request or business plan.

Working with Your Lender

“There's nothing that cleanses your soul like getting the hell kicked out of you.”

- Woody Hayes

This statement pretty well sums up the dairy industry since the fall of 2008.

Addendum: Commodity Futures Price Historical BFP Milk (weekly average)

Following is a chart of historical weekly BFP Milk futures.



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Working with Your Lender

Through our contacts with farmers during 2009, two broad categories of dairies needing financial assistance have emerged:

1. Efficient dairies facing temporary cash flow problems that need assistance to overcome difficulties. Normally, they need more working capital.
2. Heavily indebted dairies, with low profit (or losses) and inadequate repayment capacity.

In both situations the cash flow budget is critical and will help to minimize the cost of financing the business and avoid the risk of extending credit beyond agreed limits.

Farm Records

The size and capital intensity of today's commercial farms and ranches make it almost impossible to operate or to grow without using credit. But the current level of financial stress and the increasing emphasis on risk management are going to make the loan process more rigorous. This will mean a more financial performance-based approach to borrowing.

PNC supports the Mission of the Farm Financial Standards Council. We consider FFSC to be the definitive resource of financial guidelines to benefit agricultural producers. You can visit their website at www.ffsc.org

Several reputable record keeping systems are available for management and financial purposes. Examples might include: Fin Pack, Farm Business Farm Management (FBFM), CPA prepared, and others that support dairymen. *(Handout of historical dairy financial performance from Nietzke & Faupel, P.C.)*

Farm Records

- Today's business environment in agriculture is becoming increasingly complex. Producers need to process large amounts of information from a variety of sources in order to operate efficiently and effectively. The accounting systems that farmers and ranchers employ must generate information for management decisions, external reporting to creditors, government agencies and others.
- Records must be kept in such a form that they can be easily converted into information - Before keeping a record, the eventual end use must be decided upon so that the form in which the data are recorded will facilitate later analysis and interpretation.
- Record keeping systems must be simple - Dairy farmers have enough to do without burdening themselves with complex record keeping systems that are difficult to understand and time consuming to complete.
- Duplication must be avoided as much as possible - Some data may have to be recorded more than once in different forms, but this must be reduced to a minimum.
- Records must lead to actions being taken - Unless a record is specifically intended to be used for some future action or in management planning it should not be kept.

Farm Records

- You need to know where you are at, before you decide where you want to go. You can't play football without a goal line and a plan to score.
- Decisions fall into two major categories: managerial and financial. These decisions should consider:
 - How do my management results compare to other similar dairies?
 - How do I monitor my financial health?
 - Measures of managerial and financial performance.
 - Potential credit requests.
 - What are my costs of production.
 - How do I integrate production and financial information.
 - Cost/profit centers to maximize overall profitability.

Farm Records

“Success - it 's what you do with what you've got.” – **Woody Hayes**

- Formulate overall strategies and long-range plans.
- Make effective resource allocation decisions.
- Cost planning and cost control of operations.
- Decisions when contracting or utilizing futures contracts and options.
- Performance measurement and evaluation of people, including comparisons of actual results with planned results.
- Meet external financial, regulatory and legal reporting requirements because lenders, regulations and statutes typically prescribe the accounting methods to be followed.

Dairymen Use of Futures Contracts and Options

Dairymen have managed production risk with top notch husbandry practices. But no amount of husbandry can address market risk – the uncertainty of prices at market time, owing to shifting supply and demand factors.

- Producers (dairymen) can use the futures markets (BFP milk, Corn, soybean meal, etc.) as a temporary substitute for a cash sale or cash purchase to be made at a later date, as a way to hedge their price risk.
- A Futures Contract is a standardized agreement stating the commodity, quantity, quality and delivery point or cash settlement.
- An Option is a choice. It is the right, but not the obligation, to buy or sell something – in this case, a Futures Contract – at a specific price on or before a certain expiration date.
- Futures Contracts and Options are bought and sold through commodity brokerage firms that execute trades.
- PNC supports dairymen by providing lines of credit to support hedging activities initiated through commodity brokerage firms.
- PNC supports dairymen by financing contracting activities that are focused on risk mitigation.

Dairymen Use of Futures Contracts and Options

Dairymen use of other risk mitigation strategies.

- Contracting versus production of feedstuffs.
- Contract production of replacement heifers.
- Alternative marketing channels for milk.
- Sale of minority interest to an investor. This allows deferment of dividends (cash outflow) during times of extreme financial stress.
- Other opportunities exist to explore risk management strategies, such as the American Dairy Products Institute, "Financial Risk Management for the Dairy Industry".

How Lenders Want to Work with Dairymen

To help you prepare, the following 12 questions provide an outline for developing the documentation needed in a loan request or business plan. Your answers to these questions should be supported with a 2010 cash flow projection.

Note: The PNC Cash Flow Projection Worksheet is available in electronic format (EXCEL spreadsheet) by contacting Tom Stocksdale at Thomas.Stocksdale@PNC.com.

Or you can call Tom at 330-202-5414 or his assistant, Jan Weyandt at 330-202-5411.

How Lenders Want to Work with Dairymen

1. How much money are you going to need?

- Lenders don't want to loan all they feel comfortable with and then suddenly find they need to loan significantly more in order to see the situation through to completion.

2. What is the money going to be used for?

- Be specific. It's not enough to say "operating expenses." Plans need to be supported not just by budgets, but by documentation showing that they reflect past experience. If you're projecting improved performance, you need to be able to demonstrate both how and why.

How Lenders Want to Work with Dairymen

3. How will the loan affect your financial performance?

- It is obviously important to know what your net worth, financial structure, historical cash flows, profitability and risk exposure are at the time of the loan request, but what will things look like after the loan is made?
- Will your risk profile in terms of working capital, leverage and debt repayment capacity change materially?
- Have you compared your dairy to similar dairies and do you have a plan?

How Lenders Want to Work with Dairymen

4. How will the loan be repaid?

- Will it be from operating profits, from non-farm income, from the sale of the asset being financed, from refinancing or from the liquidation of other assets?
- How predictable and dependable is the source of repayment?

5. When will money be needed and how will it be repaid?

- This two-part question should be answered by the projected cash flow budget. Answering this question makes sure both you and the lender know how the business operates.
- Almost as many credit problems have resulted from a lack of understanding and communication, as have resulted from unrealistic expectations. Marketing plans and trigger points, contract terms and conditions, and various pooling arrangements are often not adequately communicated or documented.

How Lenders Want to Work with Dairymen

6. Are your projections reasonable and supported by documented history?

- Many loans have not been made that probably could have been repaid simply because of a borrower's inability or unwillingness to provide the lender with complete and well-documented historical information on his financial position and performance. It is extremely important that borrowers be objective in their cash-flow projections, not just for the lender but also for their own management purposes.

How Lenders Want to Work with Dairymen

7. How will alternative outcomes affect your repayment?

- Due to the numerous factors affecting production agriculture, cash-flow projections frequently vary from the actual outcome. The importance of making sound projections and analyzing "what if" scenarios is even more important considering the increased volatility that producers have to deal with. Even under marketing and production contracts with established price bases, quality discounts and premiums can still result in a great deal of uncertainty.
- While nearly all farmers and ranchers are on a cash basis for income tax purposes, downturns in profitability can lag accrual income by as much as two years. Most lenders will adjust cash basis information for changes in inventories, accounts receivable, accounts payable and accrued expenses to get more accurate estimates of income.

How Lenders Want to Work with Dairymen

8. How will you repay the loan if your plan fails?

- No commercial lender wants to enter into a situation in which foreclosure is the only alternative if things do not go as planned. Contingency planning is critical. Recognize what could go wrong and what you plan to do if it does.

9. How much can you afford to lose and still maintain a viable operation?

- Recognize that a viable net worth is not anything above zero. Most commercial lenders require some minimum equity position, e.g. 40 percent, below which they will not continue financing without an external guarantee. With this in mind, the answer to the question must be based on the effect of various combinations of both potential operating losses and declines in asset values. Lenders call this shock testing.

How Lenders Want to Work with Dairymen

10. How will the loan be secured?

- You need to recognize that collateral is adequate only if, under the worst conditions, enough could be collected to generate sufficient cash to repay the loan and cover all the costs involved. Except for control purposes, the primary purpose of collateral is to provide insurance in the event of default; therefore, the important lending consideration is not what it is worth at the time of the loan request, but what its expected value is at the due date of the note or at the date of the next scheduled payment.
- The changing nature of security has become one of the most significant factors affecting agricultural lending. More loans are now dependent on soft in addition to hard assets, i.e. key personnel, contracts and leases. There are also more joint ownership arrangements and market risks related to specific attribute raw materials rather than straight commodities. All of these make it more difficult for the lender to assess a net realizable value. For example, what's an empty dairy facility really worth in today's environment?

How Lenders Want to Work with Dairymen

11. What risk management (mitigation) measures have been/can be implemented?

- This can cover anything from formal risk-management tools to management strategies. The major issue here is to make absolutely sure that both the borrower and the lender understand how these measures work. For example, incorrect use of commodity futures and options can increase rather than reduce risk. It is also critical that the lender is supportive and committed. A lender's unwillingness to finance margin calls can destroy a successful hedge.

12. What have been the trends in your key financial position and performance?

- The first issue is do you know? The second is, if the trends are adverse, what are the specific short-and long-term plans for turning things around? If they are to keep doing what you've been doing and hope things get better, you're setting yourself up for a rejection. Timely action, willingness to change and the ability to manage problems are hard to measure, but as risk increases, they become critical in the credit decision process.

Working with Your Lender

A lender's request for accurate and complete information shouldn't be viewed as questioning your ability, character, judgment or management expertise; it's just good business, for you and the lender.

Key Points

1. Use farm records to capture accurate information.
2. Make decisions based on facts.
3. Take reasonable steps to protect yourself from risk.
4. Make reasonable plans and test them for unforeseen circumstances.
5. Don't borrow more than you can reasonably be expected to repay. Credit should be for sound and constructive purposes.

Addendum: USDA 2010 Milk Forecast (Jan. 12, 2010)

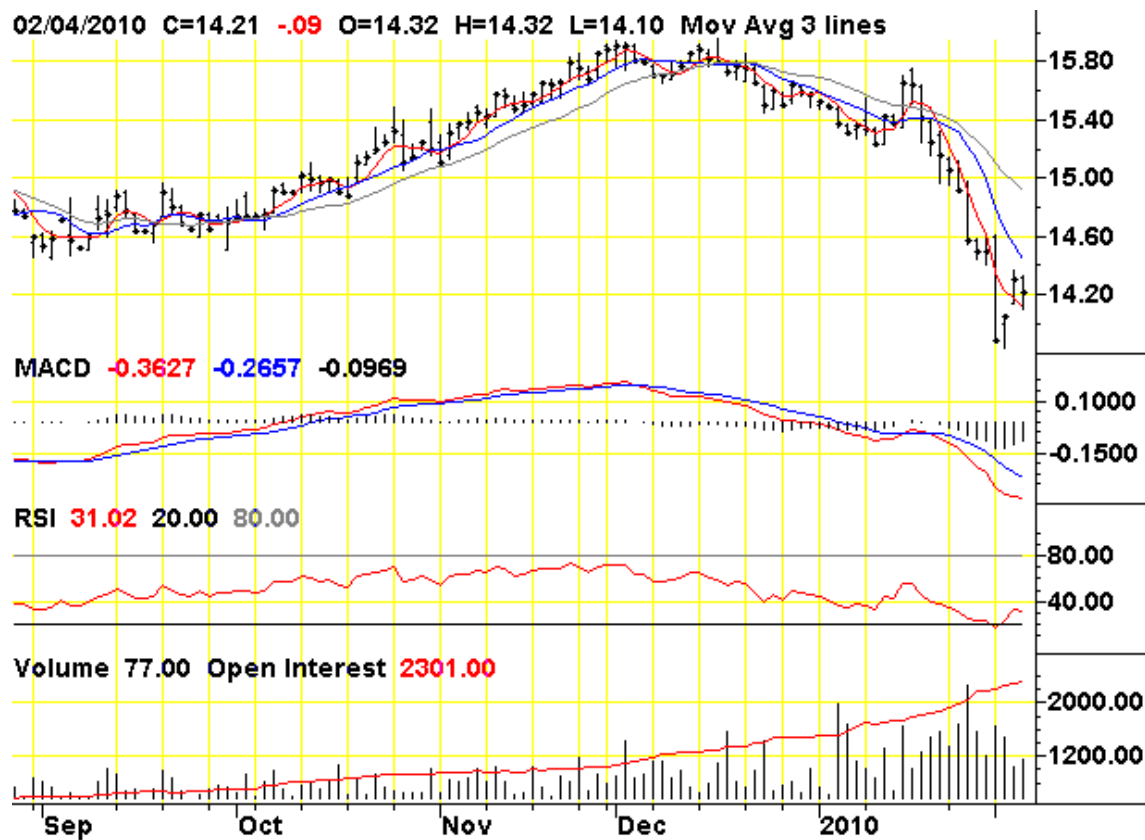
- The milk production forecast is raised for 2010 reflecting the relatively slow pace of cow liquidation in late 2009. Commercial dairy exports for 2009 are adjusted reflecting stronger skim-basis sales, but slightly weaker fat-basis sales. Import forecasts are reduced for 2009. Trade forecasts are unchanged for 2010. Fat and skim-solids ending stocks are forecast higher for 2009. Ending stocks for 2010 are raised on a skim-solids basis but are lowered on a fat-basis. Forecasts of butter and cheese prices are lowered as milk production forecasts are raised. However, relatively strong international demand should support prices for nonfat dry milk (NDM) and whey. The 2010 Class III price is lowered from last month as lower expected cheese prices more than offset stronger whey prices. The Class IV price forecast for 2010 is raised from last month as stronger NDM prices more than offset weaker butter prices. **The all milk price is reduced to \$16.20 to \$17.00 for 2010.**

Addendum: Dairy Margins (CIH Margin Watch - Feb. 1, 2010)

- Dairy margins were mixed since the middle of January, holding steady in nearby Q1 but deteriorating sharply in Q2 while deferred margins in the second half of 2010 were also steady over the past two weeks. A sharp selloff in milk futures has been noted since the middle of the month, as commercial disappearance of American cheese is down from a year ago while powder prices have suffered sharp losses recently based on nonfat dairy milk trade.
- Corn prices continue to slip following the USDA's January crop report although the rate of decline has slowed over the past week. Soybean meal prices have accelerated their decline on indications that the South American crop is larger than previously expected based on private forecasts.
- Please visit www.cihmarginwatch.com to subscribe to the CIH Dairy Margin Watch report.

Addendum: Commodity Futures Price Quotes for BFP Milk (Feb. 4, 2010)

- The attached spreadsheet shows average 2010 BFP Milk futures price at \$14.60.
- Following is a chart of June 2010 BFP Milk futures.



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