Livestock Enterprise Management: Key Financial Considerations

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Recent IRS Ruling: Capital Purchases

- Buy a boat, write it off (Section 179z)
- Boats now considered essential for SW VA livestock producers
  - Scouting pastures
  - Checking cows
  - Feeding
  - Transporting to market

- Disclaimer: Um, no. Fake news.
What’s Going On Out There?!

- Disruption in supply chain
  - Concentration in processing
    - Capacity issues (retail vs institutional….)
      - Lower demand for live cattle = lower farm-level prices
      - Lower supply of available meat = higher retail prices
        - Impact on longer-term consumer demand?
        - Reaction of the meat substitutes?
Simplified Livestock Industry “HACCP” Diagram

Inputs → Farm-Level Production → Transport → Marketing & Processing → Transport → End User

Regulation

Environment
Doc White’s Crystal Ball (Magic Eight Ball!)

- Looking for large structural changes to the US system
  - Move away from the concentration of processing?
    - Local “breaking stations”
  - Move away from JIT inventory systems?
    - Decreased efficiency may lead to higher consumer prices
      - Impact on demand?
What Else Is Going On Out There?!

- Lower expected imports (USDA)
- Record beef production expected in 2021 (USDA)
- Increased lamb/sheep production expected (USDA)

May 18, 2020 Livestock, Dairy, and Poultry Outlook, LDP-M-311, USDA ERS
So What?

- Not much upward pressure on farm-level livestock prices
  - Potential cash flow & liquidity issues
- How to prepare for the next few years?
  - Change herd size?
  - Change production (rations, etc.)?
  - New enterprises?
  - New marketing plan?
Stick to the Fundamentals

- **Revisit your goals and core values**
  - Critical to your decision making!
  - “Maximize Profit” vs “Minimize Losses” = different choices
  - “Minimize Taxes” vs “Maximize What’s Left After Taxes”
- Have a plan
  - And 2 back-up plans
- You’re already used to making decisions in uncertain times
  - Stick to your fundamentals
Fundamental Thought Process

• “If it costs more than it’s worth, don’t do it”

• Partial Budget
  • “Good Side”
    • Added Revenues
    • Reduced Expenses
  • “Bad Side”
    • Reduced Revenues
    • Added Expenses

• If the Good Side > Bad Side: Your profits should increase
Sell 750-lb Calves vs 550-lb Weaned Calves

• Assumptions:
  • Spring calving (Feb/Mar)
  • 550-lb calf at weaning (Oct) $134/cwt (Sept 2020 futures, no basis)
  • 100 days to reach 750 lbs $120/cwt (Jan 2021 futures, no basis, $12 slide)
  • Pasture cost
    • Hay equivalent @ $120/ton; pasture lbs DM/acre = 300 x average height (inches)
  • $15/head “other cost”
    • Vet, grain, interest, etc.
  • 1% death loss, 2% shrink
# Sell 750-lb Calves vs 550-lb Weaned Calves

## Partial Budget

<table>
<thead>
<tr>
<th></th>
<th>Good Side</th>
<th>Bad Side</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Added Revenue:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>750-lb Calf</td>
<td>$873</td>
<td>550-lb Calf</td>
</tr>
<tr>
<td><strong>Reduced Expenses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feed (Hay Eq)</td>
<td></td>
<td>$93</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>$15</td>
</tr>
<tr>
<td><strong>Total Good Side</strong></td>
<td>$873</td>
<td><strong>Total Bad Side</strong></td>
</tr>
</tbody>
</table>

**Net Change in Profits = $28/head**

- Breakeven Selling Price (adj. for death loss & shrink): $116/cwt
- Maximum Cost of Gain ($/lb gain): $0.68/lb gain
Financial Management Tips

• Develop an improved financial record keeping system
  • **Enterprise accounting**
    • Must know your Cost of Production (COPs)!!!
      • $/cwt, $/acre, $/cow, $/lb of gain
  • **Accrual basis or accrual-adjusted records**
    • Good COPs = based on accrual-based enterprise accounting
      • Requires BOY & EOY balance sheets
    • Bad COPs = based on cash-based Schedule F

55-70% difference between cash and accrual net income!
Cost of Production (by enterprise)

- Short-Run COP = Total Variable Costs / Output
  - Try to cover the SR COP most years

- Long-Run “Geek” COP = Total Expenses / Output
  - Includes Owner Labor, Interest Forgone….

- **MUST cover LR COP on average**
  - Otherwise, “living off depreciation”, “recreational farming”
  - Or answering this question, “Honey, why can’t we go on vacation...?”
Benefits of COPs

- Breakeven selling prices
  - Useful for hedging & contracting!
- Maximum input prices
- Buy vs produce decisions
  - Feeds, replacements, etc.
- Marketing decisions
  - Add more gain or not?
Cost of Gain

• SR Cost of Gain = Total Added Variable Costs / Total Gain
• LR Cost of Gain = Total Added Cost / Total Gain

• **Compare to value of added gain**, not the price/cwt
  • 600-lb calf @ $140/cwt = $840
  • 700-lb calf @ $130/cwt = $910

$70/cwt value, not $130/cwt
Financial Management Tips Again

- Develop a monthly cash flow statement (aka cash budget)
  - Farm and household cash flows
  - Helps you plan for the upcoming year
  - Identify periods of cash surplus or deficit
    - For debt prepayments, savings/liquidity, capital purchases
  - Estimate operating loan/line needs & repayment
  - Scheduling of term debt payments
  - Improve communication with your creditors
Son of Financial Management Tips

• Talk with your lender
  • Maintain constant, open communication
  • Discuss your operating needs – Op Loan/LOC
    • Options for repayment of operating debt this fall
    • Needs for next year if 2020 isn’t a good year
Return of Financial Management Tips

• Have a tax management plan
  • Including SE Taxes and Income Taxes = ~25-35%
  • Need to spend $3-4 to save $1 in taxes
    • What if you use the other $2-3 to build liquidity, pay down debt, etc.?
  • Prepaying expenses – need an exit plan
    • And it is an unsecured transaction
  • Carryback/carryover of losses
    • 2 years back, no time limit forward
Tax Move: Prepaying Expenses

• Last year you prepaid $50,000 for feed/fertilizer in December
  • 30% taxes (including SE)
  • Save $15,000 in taxes

• Assume this year is a bad year (low price)
  • There’s no cash or LOC available for this year’s prepayment
  • Already expensed the $50,000 last tax year
    • Nothing to offset the revenues for this tax year
  • Your taxable income will be $50,000 higher in a bad year
Tax Move: Buying Assets You Don’t Need

• Need to spend $30-40,000 to save $10,000 in taxes
  • Hurts liquidity, profitability, & financial efficiency

• Borrowing funds to make (unneeded) purchases for tax purposes
  • Hurting liquidity, solvency, repayment ability, profitability & financial efficiency
  • Guess what your lenders use to evaluate your financial condition
    • Go ahead, guess

Mmph, why give money to the government? Mmph!
Same Old Same Old

- Build your emergency savings (usable liquidity) to 3-6 months
  - Working Capital/Expenses > 25%

- **Have a clear, defined marketing plan**
  - Price protection is critical!
  - Stick to your fundamentals!

- Have a risk management plan
  - Back-up markets, liability insurance, estate/transition plan