Financial viability after drought

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Take Home Message

- Since the year 2000 farm debt has doubled but so have land values hence current debt has adequate security.
- Farming systems which increase income through intensive cropping and higher inputs also increase costs of farm input and machinery. Higher costs will increase the loss in droughts. Target low cost options in 2007 to reduce the level of new debt and the risk of losses in 2007/08
- In 2007 it will be OK to leave 25 to 40% of area to livestock or fallow. Focus crop selection towards the low cost paddocks.
- Maintain the key assets such as employed labour, family living, education and maintenance of essential pests, weed & disease control. Cost cutting can occur in fertilizing, repairs to improvements, machinery repairs, machinery purchases and discretionary spending on one off family/lifestyle events.
- Large fluctuations in income are a part of farming. A group of Mallee farms has a 10 year average gross income of $270 per cropped hectare however in 2002 the gross income was just $40 per hectare, rose to $400 per hectare in 2003 and peaked at $420 per hectare in 2005. In 2006 gross income was $0 - 50 per hectare.
- Since the 1880's the year following a drought has yields at average or above.

Introduction

Eighty percent of farming businesses in the Mallee/Wimmera will meet the two key criteria for viability (outlined below) and can plan for drought recovery and future growth of their business. The other twenty percent may remain in the industry but will struggle to recover hence may decide to cash in their equity and retire from farming.

Criteria for Financial viability include:

1. Security

a. Debt to land value

Of Total Assets, Mallee Farms typically hold Land as 55%, Machinery is 30%, Livestock is 5% and Off-farm assets (including financial buffers) are 10%. Land is the main security offered for business debt.

The O'Callaghan Rural Management (ORM) Guideline is for Debt to be less than or equal to one half of Land Value. Since the year 2000 debt has doubled but security is OK because land values also doubled.

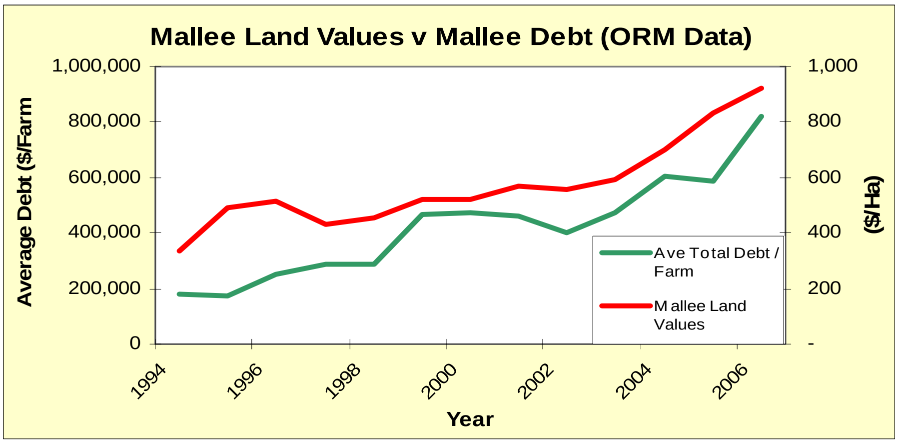

Figure 1: Mallee Land Values versus Mallee Debt

Land Values have continued to rise even when annual profits have been low. Recent drivers of land values have been:

- Low Interest Rates & ability to lock in long term Interest Rates
- More Banks & positive attitude of Banks towards Agriculture
- New more intensive farming systems
- Competition for limited land with neighbours & new Managed Investment Schemes

b. Other farm assets as security

If land is fully secured then other business assets can be leveraged.

1. Equity in existing Machinery can secure some 2007 new borrowings, by either deferring the scheduled payments OR refinancing to take a higher loan against the current market value.
2. Livestock purchases can be secured against themselves i.e. no cost to cashflow in 2007.
3. Inputs such as fertilizer and chemicals can be on deferred payment until after harvest subject to your previous trading record.

Security is measured using your Assets & Liabilities (or Balance sheet). The difference between Assets owned and debt is your EQUITY. This can be measured in dollars or as a percentage.

To monitor business performance and growth, keep track of your equity position for each asset class, then monitor total dollar equity growth per year. If combining profit with equity growth, then since year 2000 the returns from the top farms in the Mallee/Wimmera are 12 - 14% and can match the returns from off-farm.

Table 1: A typical Asset and Equity mix

Assets	*Ratio of Asset Value*	Asset $'000	Liability $'000	Equity $'000	Equity %
Farm Investments	***79%***	**3,189**	**1,262**	**1,927**	**60%**
Land	*53%*	2,158	757	1,401	**65%**
Machinery	*17%*	685	411	274	**40%**
Livestock	*4%*	142	31	111	**78%**
Produce on Hand	*4%*	155	63	92	**59%**
Farm Cash Accounts	*1%*	49		49	**100%**
Off-Farm Investments	***20%***	**808**	**205**	**603**	**75%**
Investment Shares	*7%*	271	150	121	**45%**
Off - Farm Business	*1%*	51		51	**100%**
Real Estate	*5%*	220	55	165	**75%**
Superanuation	*5%*	210		210	**100%**
Life Assurance	*1%*	56		56	**100%**
Superannuation	***1%***	**44**	**0**	**44**	**100%**
Total	***100%***	**4,041**	**1,468**	**2,574**	**64%**

2. Servicibility

a. Cost of Interest to Income

The portion of income taken to pay the interest bill is now higher than in the late 80's when interest rates were 20%, and is due to debt per business being up to 3 times that of the 1980's. Current Interest rates are historically low hence a larger debt can be serviced.

Banks will encourage new borrowings provided the business can demonstrate a capacity to pay the interest. If cashflow is adequate, then banks can lend at interest only for fixed interest terms of up to 15 years. The ratio of debt to income (value of farm production) has changed since 2004 so that debt is now greater than income, see graph below.

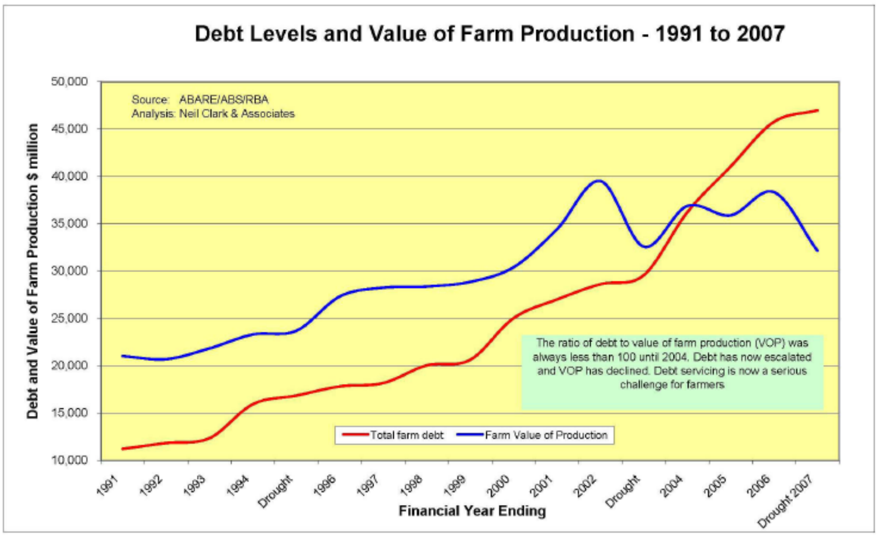

Figure 2: Debt Levels and Value of Farm Production (1991 – 2007)

When debt is above income then debt servicing costs may reduce funds available for other costs such as machinery purchase, property growth or succession planning.

b. Budgeting

If 2006 was a loss year for your business, then the following ORM guidelines can help to prepare your budget when planning for 2007.

Table 2: ORM Guidelines for 2007 - Mallee & Wimmera

	% of Gross Income		Comments
	Typical	2007	
Farm Input Costs	**32**	**28**	
Rates & Office	2	2	
Accountant/Consultant	2	2	
Fertiliser	12	8	Reduce - carry over nutrients
Sprays	12	12	Depends on 2007 Summer.
Seed	2	2	
Livestock & Other	2	2	
Machinery	**28**	**23**	
Repairs	6	5	Delay the non essential
Fuel	8	8	
Freight, Hire and Contract	2	2	
Capital Purchases	12	8	Existing Mach. finance only
Labour and Drawings	**20**	**17**	
Own Drawings	13	12	
Tax on Drawings	2	0	No tax due to loss
Labour Employees	5	5	
Finance Costs	**10**	**15**	
Bank Interest	6	9	Higher debt
Machinery Interest	3	4	
Land Rent	1	2	
Surplus	**10**	**17**	
Debt Reduction	0	14	Focus on debt repayment
Asset Purchases	5	0	The essentials only
Lifestyle/Family, Holidays	3	0	
Tax on extra profit	2	3	Tax on debt reduction

Comments on the Budget:

- The ORM database of 220 farm businesses indicates that cost efficiency (not maximising income) drives profit.
- When budgeting, use “average income” and match costs to average income. Then as the season unfolds, costs can be varied in line with potential income.
- In 2007, budget profits at 15 - 20% of average income. Then after next harvest these profits can go to debt reduction or wealth creation.

Planning for 2007

Cost Control

Examine all business costs to work out which inputs are bringing the best returns, and then reduce those that are not. 2007 may be time to spell high cost paddocks so that problems such as weeds or low fertility can be addressed. By removing some paddocks to pasture, green manure or fallow, the 2007 debt will be less resulting in less debt to repay in 2008.

Budgeting for lower costs and lower income can still achieve good profits and is better than the risk of larger losses in another low income year.

ORM's solution to rising costs is to focus the crop selection towards the low cost paddocks. It will be OK to leave 25 to 40% to livestock or fallow. Use low cost weed control and defer fertilizer inputs until the season unfolds. The right crop mix for you will depend on your current financial viability and your attitude to risk.

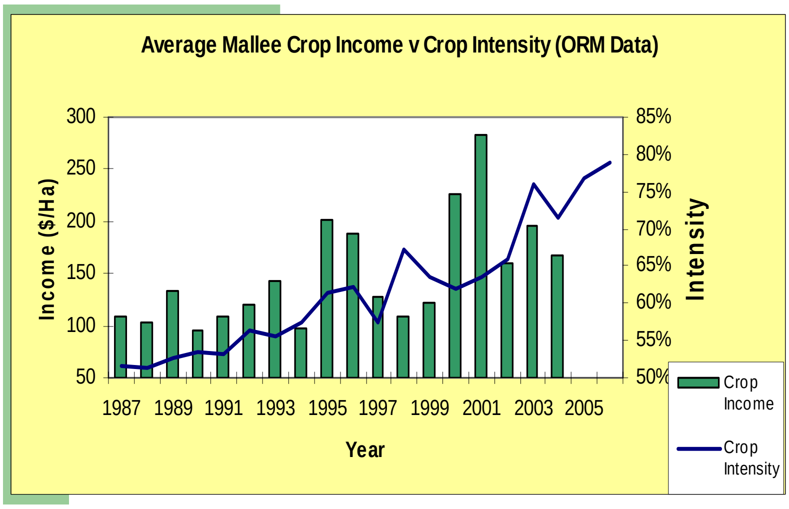

Figure 3: Average Mallee Crop Income compared to Cropping Intensity

Higher crop intensity results in higher income in the good years, however income in the mid 1990's was similar to that achieved in 2003 and 2005 but in the mid 1990's was at 20% reduced crop intensity. If income can be similar at 60% verses 80%, then profits can be higher at the lower crop intensity due to the saving in costs.

Enterprises with lower cost need priority. These can be:

- Cereals with low nutrient requirements and low disease risk
- High yielding cereal varieties with low protein requirements for the feed market
- Fallow in high cost paddocks
- Sheep/cattle for low cost weed control and diversified cash flow
- Hay crops for the export and/or domestic markets

Decisions for 2007

Strategies available to improve profits in 2007 include:

- **Focus on the lower cost enterprises** *eg:* cereals verses canola.
- **High cost paddocks are not cropped** *eg:* paddocks with brome grass or herbicide resistance. Alternatives include hay, green manure or fallow.
- **Minimize machinery capital purchases**, and defer machinery finance repayments.
- **Reduce stress by planning early**. Know your position and have a plan, it does help.
- **Delay input costs** to be "just in time".
- **Seek good advice** then fine tune it to suite your business. Remember that many who provide advice have a specific focus. Your skill is to sort the advice and apply it to your business needs.