

Managing your earnings in 2022 Can we impact 2023 and beyond?

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So far, 2022 is shaping up as a year where cash and profits may rebound within the dairy industry to levels that have not been seen for a few years. While inflation and supply chain issues are driving costs up on dairy farms, milk prices are strong and appear to have generated stronger cash positions through the first third of the year. With the strong cash positions, questions are starting to be asked about potential strategies to maximize the opportunity associated with the stronger positions this year. How long will the milk price stay strong enough to offset rising input costs? Will a smaller national heifer inventory and milk processing limitations slow the growth of milk production? Will supply chain issues continue to impact both farm production and processing capacity? With the uncertainty towards what earnings might be over the course of the year and into the next, there is the potential for earnings to decrease or turn negative.

Questions to ask

With an expectation for the earning levels to decrease at some point, whether driven by the increase of costs or lower milk prices, the key objective during times of strong earnings is to improve the financial health of the business, along with positioning the business to succeed when earnings decrease.

To meet this objective, two questions can be asked:

- What can be done over the remainder of this year that will increase profit generation through increased production or lower costs in 2022 and beyond?
- What can be done over the remainder of the year to increase the businesses' ability to meet cash commitment challenges during the next low earnings cycle?

To answer the first question, managers need to know the current state of their business. How is revenue being generated, and how much does it cost to do so? By analyzing your business, you may identify areas in which a few changes could lower your cost to produce milk or maintain the cost to produce milk while producing more hundredweights. Examples of this are changes that affect labor efficiency, feed efficiency, fertilizer use, and culling decisions. Start by analyzing your five largest expense items to determine if you are receiving the greatest return possible from those inputs.

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Before making a change, carefully analyze it to determine if it meets your long-term goals. The decision must make sense for next year and beyond, or for when the returns may be significantly lower, not just now when returns may be higher than average. You don't want to make long-term cash commitments based on short-term cash excess or cash generation. Also, you don't want to make this change for tax savings only. If an investment does not make long-term sense for profitability, then the one-year tax savings is likely not enough to justify the investment.

The second question: "What can I do now to maintain my ability to meet cash commitments throughout a low milk price cycle?" deals more strictly with cash flow budgeting and positioning your business. If you are not already projecting future cash needs, you may want to start. While they are not always accurate, budgeting future cash needs for the next twelve months allows you to identify times where you may need to generate additional income or minimize expenses.

With an accurate financial analysis of current performance and thorough monthly cash flow projections in hand, it is easier to determine the best use of cash within the business.

What should you do first?

With many different uses of profit, it can be difficult to prioritize. It can be tempting to pay for a capital project with cash, but this might not have the desired impact for improving the ability of the business to manage cash during a down cycle. When focusing on the use of profit within the business, it is important to think about how different investments fit into the business and how they can impact the business. There are two important objectives to keep in mind, the ability to increase the future earning potential of the business and the ability to allow the business to handle the next down cycle more efficiently. Depending on the choices made this year, you may impact one, both, or none of these areas. The following areas can help focus the decision making on where to use profits this year.

Five Uses of Profit/Cash Within the Business

To improve the financial health of the business there are five areas where cash can be invested. These areas are meeting critical needs, improving operations, building reserves, building borrowing capacity, and funding long term investments. Let's consider each use in turn.

1. Meeting Critical Needs

Low dairy farm profitability over the last few years have made it difficult for some farms to meet all their cash commitments. In 2021, some dairies may have delayed investments or postponed expenses, thus hindering the farm's ability to efficiently maintain day to day operations or operate at the lowest possible cost. Catching up on delayed investments and unpaid expenses should be the first use of profit. Paying down an open account with a supplier to qualify for cash discounts is one example. Another example is repairing or replacing essential equipment, such as a skid steer, that is not fully operational. If the business is at the limit of its borrowing capacity, repaying operating credit lines could also be a priority so the business can borrow again when a need arises. This also can lead to lower interest costs, resulting in lower operating costs.

2. Improving Operations

A second area to consider is what could be done to improve the current operations by investing additional capital. Most farms have a long list of ideas for ways to increase milk production, improve labor efficiency and effectiveness, or lower costs. With the higher earnings cycle underway, you must determine investment priorities. From analysis of the current operations, where are the opportunities to improve operations? Improving cow flow leaving the milking parlor, updating ventilation systems, upgrading mixer wagons to improve mixing and reduce time spent feeding, providing additional training to boost employee performance, and implementing lean manufacturing concepts are all examples for improving operations. With so many options, the management challenge is to determine which improvements will have the greatest impact on performance.

3. Building Reserves

If the current operations are running smoothly, or the necessary changes are underway, the next use of profit can be to build reserves within the business. By building reserves, the business has something to draw against when the next low earning cycle comes along. Paying for inputs ahead of time, while also impacting taxes, is a primary way to build inventories which can be drawn down when cash flow becomes restricted. Another source of reserves is building cash balances that may be invested off the farm in accounts, such as money markets, that earn higher interest rates than savings and checking accounts but are available for use by the business when needed. This decision doesn't lead to a tax deduction for the current year, so the tax implications need to be considered when building cash reserves.

4. Building Borrowing Capacity

In conjunction with building reserves, accelerating principal payments to build borrowing capacity within the business is an alternative to consider. Making ongoing debt payments is a normal course of operations, but during high earning cycles, the business can choose to accelerate principal payments, therefore accelerating the reduction of principal and decreasing the amount of outstanding principal that requires interest payments. When the next low milk price cycle arrives, there will be less interest being paid due to lower principal, and there is also increased borrowing capacity that can be tapped into to help cash flow or take advantage of different opportunities. Depending on which loans are paid down, or paid off, the monthly cash commitment required to service principal and interest may also be decreased, which improves the ability of the business to meet cash commitments. It is important to remember that making principal payments is not a tax deduction and accelerating principal payments may impact the farm's future tax liability.

When considering whether to build working capital or build borrowing capacity, talk with your lender and review their policies towards lending additional capital to your farm for operating expenses. If you have a good working relationship with your lender, it may make sense to accelerate principal payments when you have excess cash on hand, and borrow more money in the future, if needed. If there are concerns or high costs associated with future borrowing, then it may make more sense to pay only the scheduled principal payments and put extra profits toward building up working capital reserves.

5. Funding Long Term Investments

The last area profits can be used is for long term business investment. These are investments that are necessary for long-term success and to achieve business and family goals. However, this type of investment may have a slow payback. While they may be good long-term investments, they might also add to the cash commitments of the business. Buying land, building a new barn, adding to feed or manure storage, or building a new milking center are all long-term investments with potential to help farm families progress toward their longer-term goals. It is important to have a business plan when opportunities present themselves, so they can be evaluated in terms of how they support the business mission and progress toward its strategic goals.

Conclusions

By thinking about how profits can be used within the business, focusing on different areas and priorities, the manager can better use the earnings from high cycles to both impact the future success of the business, and impact the ability to navigate the next down cycles. When thinking about all uses of profits within the business, the following question needs to be asked: *“Are you doing this because you can, or because you should?”*

Risk management is an additional area where the farm may commit more resources when cash is available. Depending on the level of risk that the managers are comfortable with, understanding of various risk management tools, and financial risk, additional time and money can be utilized to try and minimize the impact on cash flow if there is a negative change in milk prices or various input prices.

Don't forget the tax implications that this year might build and the impact that some of these decisions will have on the amount of tax owed. Tax planning can be used to minimize the taxes that will be owed in 2023 for the 2022 business year.

Work with your tax accountant and determine what impact different decisions will have on taxes and what your total tax bill will be. With this information, you can better plan your cash needs for next year. Waiting until February or March to determine what your tax bill will be can severely impact your cash flow and disrupt your ability to meet planned cash needs. While planning for taxes can minimize the cash needed to pay the income tax bill, it is important to remember your long-term business goals. Do not necessarily focus on paying no taxes. The only way to not pay any taxes in the long-term is to not make any money, so the focus needs to be on maximizing after-tax revenue, not minimizing taxes paid.

While the focus of these areas is on improving the business, profits can also be used in support of family goals. Taking a much-needed vacation, investing off the farm for retirement or in other family needs, or pursuing something that is of value to the family should be considered also. These types of uses of profit are generally after tax so tax implications need to be considered.

Coming off of what hopefully will be a good year is no time to rest on your laurels. Projections for next year are only projections and a financial crunch may not actually occur. But a good planner prepares for every eventuality to minimize its potential impact. By planning for financial stress, you also increase your business' ability to take advantage of opportunities that arise.