UNIVERSITY OF MINNESOTA

College of Veterinary Medicine

VETERINARY CONTINUING EDUCATION

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Dairy Expansion: A Lender's Perspective

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I. Lending Institutions as Investors

A. Lenders earn most of their money on net interest margin
B. Most institutions are levered at 85-93%
C. Invest bondholder's/depositor's money
 -Provide return to investor/depositor
 -Cover overhead
 -Accumulate capital
 -Cover potential loan losses
D. Need to make solid loan decisions with minimal losses
E. As loan size and risk increases, the lending institution needs to increase it's level of analysis in order to support and document the soundness of the loan.
F. As a result of this, information demands of the borrower increase with size and risk.

II. Expansion Lessons from the Past(Mistakes Made)

A. Inadequate business planning and structuring
B. Expansion based on inflation as a business hedge
C. Expansion beyond management skills of the manager(s)
D. Inability to manage people
E. Inability or unwillingness to provide compensation necessary to attract and retain top quality employees
F. Casual attitude towards finding ways to produce milk at the lowest price/CWT
G. Continuing emphasis on total farming operation vs. "dairying"
H. Lack of attention to financial management principles
I. Use of systems that weren't designed well for larger operations

III. Five Credit Factors

A. Character
 -Management
  Production management
  Financial management
  People management
 -Credit history
 -Integrity

B. Capital
-Owner equity
-Working capital

C. Capacity
-Earnings ability
-Debt repayment capacity
-Cash-flow

D. Collateral
-Security for the loan
-Source of loan repayment if primary sources break Down

E. Conditions
-Loan terms
-Loan covenants
-Interest rate risk
-Performance reporting

IV. Business Planning

A. Characteristics of a good plan
-Is written down
-Is completed through an extensive process involving all of the operation's stakeholders(including outside consultants)
-Should be a requirement for a dairy expansion

B. What is the current status of our business?
-Are we doing everything today to maximize our current operation's profitability before we expand?
-Have we made solid earnings at least during the past three years?
-Do we have at least an 18,000 pound herd average?
-Are we in the top 25% of producers(especially for major expansion)?
-Do we have a good record keeping system and do we know how to use it in our decision making ?

C. What are our interests and skills?
-Managing cows vs. people
-Ability to delegate authority to specialists(internal and external)

D. What are our expectations about the future?
-What's milk price going to be? $11? $12? $13?
-How do we plan to use technology?
-What are industry trends and how do they affect us?
-What access do we have to quality services and markets now and how

might that change in the future?

E. What do we want to accomplish?
- -What size operation do we want to have?
- -How rapidly do we want to achieve that?
- -What return on assets and equity do we expect? Could we do better investing in other opportunities?

F. What opportunities exist for our farm?
- -Does our plan include the ability to easily expand in the future?
- -How do we keep up with the latest technology and production techniques?
- -Can we continually reduce our break-even cost to stay competitive?
- -What about zoning and waste management issues?

G. Selecting the farm plan that's best for us.
- -Production plan
- -Marketing plan
- -Financing plan
- -Labor management plan
- -Capital budget plan
- -Construction plan
- -Cow procurement plan
- -Have plans reviewed by consultants

H. Is our plan feasible?
- -Cash flow projections
- -Balance sheet projections
- -Cow flow projections
- -Are they realistic based on industry standards?

I. What might prevent us from implementing our plan?
- -Sensitivity analysis(what ifs)
  - Can plan stand a $2 drop in milk price?
  - What if feed prices increase 20%
  - What if interest rates go up two points?
- -Herd health plan
- -Have we planned for potential cost overruns?
- -Any other contingencies we need to plan for?

J. How do we monitor progress?
- -Do we have access to industry standard information? (production and financial)
- -Can we compare budget to actuals each month?
- -How do we deal with lack of performance?

K. How do we document, share, and revise our plan?
-How do we assemble it?
-Who should we share it with?
-How often should we revise it?

V. Lending Standards and Criteria

A. Capital-measured by the balance sheet on a pro forma basis
1. Owner equity
-50% is normal
-35% is low acceptable for large expansion if all other factors are well managed.
-30% may be acceptable if contracts assure income and there is limited production risk.(contract quality affects this level)
2. Working capital
-10% of adjusted gross income(feed costs deducted from gross income)
-Is a critical issue going into an expansion
-Keeps unit able to pay for short-term emergencies
3. Capital is an important measure of the unit's ability to withstand future risks.

B. Capacity
1. The ability of the business to:
-Pay all operating expenses
-Pay for family withdrawals
-Pay interest expenses
-Pay for capital asset replacement
-Pay income taxes
-Make term debt repayments
-Have at least a 15% cushion

2. Assumptions about repayment capacity should be based on historic actuals even though a new facility should help improve cow comfort, feed intake, etc.

3. Allowances need to be made during the construction phase for cash flow problems and for the inability to pay term debt principal during that time.

4. Sensitivity analysis(what-if) is an important part of the capacity analysis. (i.e. what happens if prices drop x%, etc.)

5. Industry outlooks are an important factor in determining prices to be used in analyzing capacity.

C. Collateral

1. Security for the loan is secondary in importance to capacity, but it is the secondary source of repayment if other sources break down.

2. Generally all of the assets of the business are secured.

3. Collateral evaluations will be conservative but reflect current market values
   -Facilities-generally a 40% discount although as more large facilities are built and sold in this region, the discount should be less.

4. Normally want to see at least a 25% down payment on facilities and livestock loans, but many other factors influence what the lender is willing to live with in this area. As risk increases, lenders typically ask for more down.

D. Conditions
1. Loan conditions are established based on the conclusions reached in analyzing the other credit factors.

2. As businesses get more complex, lending arrangements might need to be structured in a more complex manner.

VI. Summary

A. Successful lenders to the dairy industry in this region recognize the importance of the need to look at expanding dairy operations differently than they might have in the past.

B. Dairying is a complex business that takes the best in business management skills to succeed.

C. Dairy managers will continue to place more importance on their relationships with specialists and consultants.

D. There's a bright future for the dairy industry in this region if we are willing to look at the opportunities that exist rather that focusing only on the obstacles.

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