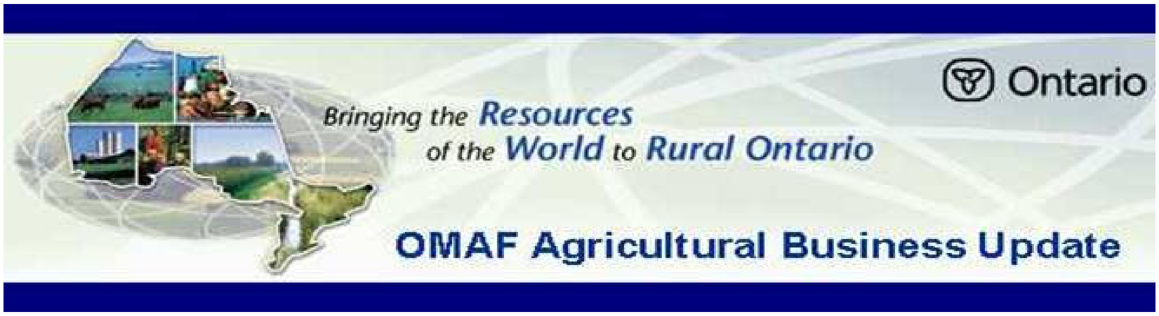

ISSUE 2 – November 7, 2003

Decision making around BSE – Take it a step at a time.

John Molenhuis, Business Analysis and Cost of Production Program Lead

The discovery of BSE in Canada has had a big impact on the livestock industry. There are many production issues associated with the crisis but for many, it boils down to cash flow management. Will I have enough cash coming into the farm to meet all my payment commitments? Is selling my livestock now at its current price the best option for me or should I hang on and hope market conditions improve? I have no other option but to sell now, will it be enough to keep my farm afloat? These are some of the questions being asked. Tough questions but even tougher still is trying to find the answers.

Wading through all the scenarios and options to calculate your cash flow can be a confusing task. If we break the task into smaller steps, finding the answers may become more manageable. There is a computer tool that has been developed that can assist in the process called the Cost of Production and Debt Servicing Calculator. This decision tool was developed in response to the impact of BSE on beef, veal and sheep operations in Ontario. As the name implies it emphasizes calculating your cost of production and determining your debt servicing capacity or in other words the cash available to make your payments. The tool works you through the steps of calculating:

- cost of production
- annual net cash income
- debt service requirements
- debt service capacity
- debt servicing options

You can download a free copy of the Cost of Production and Debt Servicing Calculator from the Ontario Ministry of Agriculture and Food, Business Development Web Site: http://www.gov.on.ca/OMAFRA/english/busdev/downtown.htm, or contact the Agricultural Information Contact Centre at 1-877-424-1300 to receive your free CD copy.

To illustrate the process, an example of a beef feedlot calf to finish operation is presented in Table 1. The sample numbers were prepared solely as a general guide and are not intended to recognize or predict the returns and costs from any one particular farm operation.

Knowing your cost of production for each enterprise is an important first step in calculating your debt servicing capacity and predicting your cash flow. The Calculator allows you to choose your enterprise and work through their respective Cost of Production (COP). If there can be cost savings anywhere in the budget, this could lead to better cash flow. Concentrate on those top five costs that have the biggest impact on your net return. The COP will project net cash income and will complete Lines 1 to 3 in the Table.

Table 1. Feedlot example – 500 head marketed

Proposed Option – $5,000 NISA withdrawal and $6,006 Principal deferral

Debt Servicing Capacity Calculation	Line	Current Position	Proposed Option
Farm Cash Revenue	1	$ 728,000	$ 728,000
Minus Farm Expenses	2	$ 702,231	$ 702,231
Equals Net Cash Income	3	**$ 25,769**	**$ 25,769**
Add Interest Payments	4	$ 23,585	$ 23,585
Add Net Income from Other Farm Enterprises	5	$ 15,000	$ 15,000
Add Owner's contributions	6	$ 6,000	$11,000
Minus Owner's withdrawals	7	$ 30,000	$ 30,000
Minus reserve for asset acquisition	8		
Equals Cash Available for Loan Payments	9	**$ 40,355**	**$ 45,355**
Plus Current Principal and Interest Payments	10	$ 50,428	$ 50,428
Add Proposed Option Change	11		$ 6,006
Cash Available After Loan Payments	12	**($ 10,073)**	**$ 933**

From the table you can see that currently the feedlot enterprise has negative cash available of $10,073 (line 12). The next step is to then come up with an option that will hopefully result in this becoming positive. A positive value indicates you will be able to cash flow your way through the crisis provided all revenues and expenses you entered in the COP remain at the levels you expected.

The options available to explore are:

- principal and interest deferral – you defer all or part of the term loan principal and interest owing
- principal deferral – you defer all or part of the term loan principal owing
- reamortization of term loans – increase the number of years that it will take to pay off the loans to reduce your annual payments
- term out portion of operating loan – take a portion of the operating loan and term it out over a number of years to reduce your annual payments.
- evaluate alternate marketing strategies such as retaining livestock and finishing them further
- in case there is another option that is not included above, the farmer can create their own.

Under the proposed option in the feedlot example, the farmer was able to withdraw $ 5,000 from their NISA account. This shows up in Line 6 under Owner's contributions. They then chose to defer $ 6,006 (line 11) of their principal owing on their farm mortgage. The net result of these changes is the feedlot operation now generates positive cash available after payments of $ 933. This is what you are looking for. If the cash available remains negative, you need to explore other options or complete further financial analysis to try to create a financial plan that will work.

Of course in farming projected returns are subject to the risk of fluctuations in both the revenue and expenses. This is especially true in these uncertain market conditions. It was mentioned earlier that the cash available projection is dependent on the expected revenues and expenses entered in the COP's to remain the same. What happens to net return if something changes? Each COP has a risk analysis section. Risk analysis allows you to change selected risk factors and see the affects it has on your net return. In the feedlot example presented in Table 1, if the Sale price per head was 10% higher than projected and the purchase price per head was 10% less than expected, the net cash income would increase from $25,769 to $ 137,500. A difference of almost $110,000! The pendulum swings the other way as well though. A decrease in sale price by 10% and a 10% increase in the purchase price result in a negative cash income of $ 86,000.

The goal is for farmers to calculate their cost of production, work through the debt servicing options and find one that will improve their cash flow position. Ideally one of the options will generate a positive cash flow. With this in hand they can then approach their lender and present the option. There is no guarantee the lender will agree with the option proposed. However, the more prepared you are before you go in, the better your chances of convincing the lender that this is a viable option.