

# Developing The Optimum Financial Structure For Your Dairy Operation

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## Improving Profitability & Survivability Through Financial Management: A Lenders Perspective

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# Developing The Optimum Financial Structure For Your Dairy Operation

I would like to begin with a few basic concepts and caveats. Let's start with the caveats. First, while my remarks today are influenced by my many years within the industry at Bank of America, I believe they represent generally recognized guidelines, not company policies. Second, financial management is still more of an art than a science and therefore the perfect universal balance sheet structure does not exist. You need to tailor your structure to your individual operation, operating costs, style and your appetite for risk. Last, I have weathered several industry cycles with you. This is and always will be a cyclical business. But I don't subscribe to the common oversimplifications that in tough times you can still make a small fortune dairying... you just have to start with a large one. Or at the other and recent extreme, there is nothing that \$16 milk won't fix. Success always requires financial planning and management.

A few basic definitions are also appropriate just to be sure we are all thinking of and comparing the same apples and oranges, or more appropriately today, ice cream and cheese:

When I speak of leverage, I am referring to financial leverage or the amount of debt used to purchase assets and occasionally, and hopefully only occasionally, to finance short term operating deficits. Leverage can be expressed as debt to worth (or equity), the ratio most commonly used by lenders; assets to debt, or assets to equity. It can also be stated as debt per cow, but I believe this figure over simplifies the issue.

Operating Cash Flow is also more than net profit plus depreciation. It needs to include recognition of all sources and uses of cash. In simpler times net cash flow after debt service would be close to cash in the pocket after the bills are paid.

I would also like to spend a few moments on financial statements as a management resource. When we as lenders are asked to evaluate the financial health of an existing client or a potential prospect, we focus our attention on three financial statements:

Balance Sheet  
Income Statement  
Cash Flow Statement

All three statements interrelate and are essential to making an informed credit decision. You should be just as focused on these statements in managing your operation. We, of course, also rely upon other tools such as appraisals; budgets; credit reports and our own evaluation of management, but we start with the numbers.

By way of review, the methodology by which the financial statements are prepared depends upon the purpose. For example:

- Financial statements can be presented on a "Cash Basis" of accounting. This is a very common practice in the preparation of tax returns. It is also the least representative of the actual operating results of your dairy. Lenders understand this type of statement, but need more to evaluate financial performance information.

- Financial statements can be presented on an "Accrual Basis" of accounting which follow the rules of Generally Accepted Accounting Principles, "GAAP". Assets are recorded at depreciated cost and liabilities are actual. This is the method that lenders prefer and which you should use in making your management decisions. All assets and liabilities are grouped according to duration, and income and expenses are recognized in the period incurred, not necessarily when actually received or paid.

There are several different levels of Accrual Basis statements. Each includes progressively higher involvement by your independent accountant: 1) Self prepared from your books. Several canned computer programs like Quick Books make these easy to prepare for almost anyone today. 2) CPA compiled from your books. 3) CPA reviewed which includes an evaluation of your accounting procedures and representative amount of verification. And 4) CPA audited. The majority of the financial statements that my group receives now are review level. This is rapidly becoming an industry standard for larger entities.



• Financial statements can also be prepared on a "Fair Market Value". This method provides information about the financial strength of an entity taking into account the estimated market value of the assets. Any potential additional liabilities, i.e. deferred tax liabilities, should also be included to complete the picture. This method is useful for estate planning. In addition to estate planning, these types of financial statements in conjunction with cost basis accrual statements allow the lender to assess the financial strength of a customer/prospect when asset values may be significantly understated at cost. A good example of this can be seen for some dairies located in the Chino, California area. The real estate values reflected on the balance sheet may have a cost value of \$3,400/acre. However, because of urban development this land is now selling for more than 10 times cost. Of course there is a potential tax lia-

bility that needs to be addressed, but wouldn't we all love to have this problem?

Today I want to focus on balance sheet structure, and I will try to answer my assigned question: "How should a balance sheet for a large dairy be structured and managed?" Let's review the type of information a balance sheet provides.

My discussion today will naturally relate to an accrual basis balance sheet. A balance sheet is nothing more than a "picture" of the financial health of an entity at a given point in time, much like your test reports represent your herd. The following examples illustrate the various components of a simple balance sheet. We will look at specific assets and liabilities and how they relate to one another. In addition, I will present some financial ratios and how they relate to the balance sheet.

Let's start with a review of the current assets and current liabilities. As a general guideline, the cur-

<b>SAMPLE DAIRY (1,000 COWS FACILITY)</b>			
<b>ASSETS:</b>		<b>LIABILITIES:</b>	
<b>Current Assets</b>		<b>Current Liabilities</b>	
Cash	\$0	Bank Overdraft	\$125
Accounts Receivable	\$200	Accounts Payable	\$100
Feed Inventory	\$500	Feed Line Of Credit	\$650
Prepaid Expenses	<u>\$100</u>	CPLTD	<u>\$290</u>
	\$800		\$1,165
<b>Intermediate Assets</b>		<b>Intermediate Liabilities</b>	
Livestock	\$1,700	Livestock Line Of Credit	\$1,000
Equipment (rolling stock)	\$150	Equipment Term Loan	<u>\$100</u>
Farm Equipment	\$250	Sub-Total	\$1,100
Less Accumulated Depreciation	<u>(\$735)</u>	Less CPLTD	<u>(\$220)</u>
	\$1,365		\$880
<b>Long Term Assets</b>		<b>Long Term Liabilities</b>	
Land	\$1,600	Real Estate Loan	\$1,400
Buildings & Improvements	\$1,000	Less CPLTD	<u>(\$70)</u>
Quota	\$1,000		<u>\$1,330</u>
Less Accumulated Depreciation	<u>(\$500)</u>		
	<u>\$3,100</u>	<b>Total Liabilities</b>	<b>\$3,375</b>
<b>Total Assets</b>	<b>\$5,265</b>	<b>Net Worth</b>	<b>\$1,890</b>
<b>RATIOS:</b>			
DEBT TO WORTH RATIO		1.79 :1	
(LEVERAGE CALCULATION)			
CURRENT ASSETS TO CURRENT LIABILITIES		0.91 :1	
(WORKING CAPITAL RATIO)			
CURRENT ASSETS MINUS CURRENT LIABILITIES		(\$365)	
(WORKING CAPITAL)			

rent assets should be financed by and exceed the current liabilities. In this example feed inventory and prepaids total \$600M. The outstanding feed line balance is \$650M. In addition, there is a "book", hopefully not an actual, "bank" overdraft of \$125M plus accounts payable of \$100M, which need to be covered by the accounts receivable of \$200M (milk checks).

To emphasize that we always need to put on our management hats and get behind the numbers, there is an issue here that must be addressed. The feed line is over advanced by \$50M and the account receivable is insufficient to cover the combined overdraft and accounts payable by \$25M with no cash reserve. This could suggest that this dairy is having financial difficulties.

The part of the equation I have not shared with you is that this 1,000-cow dairy operation is in the second year of establishing its heifer-raising program. Management has elected to raise its own replacements heifers. This is a very large drain on the cash flow of any dairy operation, as the following spreadsheet will indicate. This spreadsheet assumes ideal conditions with the heifers coming fresh in the 25th month.

As you can see, the feeding cost of raising these heifers in the second year amounts to \$315M (\$427M-\$112M). In addition, management has lost additional cash flow in the amount of \$50M since the heifers were not sold at birth. This results in a cash flow deficit of \$365M (\$1,000/day).

The offset to this negative cash flow is the increased value of the dairy herd, more specifically the heifer inventory. The mature herd, 1,000 cows with a gross value of \$1,200/head, has remained constant while the heifer inventory has continued to grow both in quantity as well as in age. The heifer inventory value of nearly \$160M twelve months earlier has now increased to approximately \$500M. Management needs to have the herd debt increased from \$1,000M to at least \$1,250M, (\$340 additional herd value x .75 = \$255). The \$250M obtained from the increased herd line will be used to bring the current liabilities back into line with the offsetting collateral, pay down accounts payable by \$50M to clear payables and take discounts on heifer related expenses, and to allow for a minimal positive cash balance of \$25M. In addition, this will result in matching longer term assets (the heifers) to longer-term debt.

This is where the principle of balance sheet and dairy management are most interrelated. The heifer program maybe a good move for this dairy, but the most appropriate and professional way to finance this shortfall is to project the total program cost at the outset and set up a heifer raising line or within line facility with your lender in advance to keep the structure appropriate. This will reduce your reliance on having to find a very understanding lender, and it will more accurately reflect the true asset and liability position of your operation. This accuracy requirement increases geometrically with size.

Let us now look at some additional structure issues and review the adjusted version of our Sample Dairy Balance Sheet:

Short Term Assets and Liabilities (< 1 year). The type of debt can enhance your flexibility and ability to keep a collateral coverage balance.

Revolving credit lines for feed purchases and inventory accumulation greatly enhance your ability to buy in season or at bargain prices. They require the self discipline to ensure that the advance rate is within your loan agreement at all times. The maximum is usually between 75-100%. This type of financing can also facilitate keeping outside payables at a minimum and allow you to take advantage of any payment discounts. Many of you also use revolving lines to manage income tax liability through year end prepayments.

Generally, most dairy balance sheets consolidate intermediate and long term assets into long term assets. The same is true for intermediate and long term liabilities, which are consolidated into long term liabilities. Another feature of dairy balance sheets is the inclusion of the current portion of herd debt without a corresponding current herd asset. This usually results in a minimal or negative working capital position. Working capital (current assets less current liabilities) is normally considered to be your cash and near cash coverage for short term payables. In most businesses a ratio of current assets to current liabilities in excess of 1.25 is enough to yield an adequate positive margin. Because of the unique dairy statement structure the negative working capital position is not by itself a problem as long as cash flow and collateral coverages are adequate and your lender understands the nature of your business.



**PROFORMA - ALL COW REPLACEMENTS PURCHASED**

<b>Herd Maintenance Expense</b>		
Self Raised Allocation (-)		\$0
Purchased cows (-)		(\$455)
Cull Cow Income (+)		\$145
Unadjusted Maintenance Expense		(\$310)
Discretionary Herd Adjustment		\$0
Adjusted Herd Maintenance Expense		(\$310)

<b>Mature Herd Maintenance Expense:</b>		<b>Quantity</b>
Culled cows:		322
Plus dead cows:		57
<b>Number of replacements required to maintain herd size:</b>		<b>379</b>
Number of self-raised heifers transferred into mature herd:		0
Number of purchased of cows required to maintain herd size:		379
<b>Number of replacements required to maintain herd size:</b>		<b>379</b>

Total cash needed to maintain mature herd size:		\$455
Less cull cow income:		\$145
<b>Mature Herd Maintenance Expense:</b>		<b>\$310</b>

Heifer Value Per Head:		\$0
Purchase Cow Value Per Head:		\$1,200

**Assumptions:**

Herd size: 1150 hd. (milking + dry cows)  
 Total cull rate: 33% (includes assumed 5% death rate)  
 Cow purchase price: \$1200/hd.  
 Cull price: \$450/hd.

**PROFORMA - ALL COW REPLACEMENTS SELF-RAISED**

<b>Herd Maintenance Expense</b>		
Self Raised Allocation (-)		(\$379)
Purchased cows (-)		\$0
Cull Cow Income (+)		\$145
Unadjusted Maintenance Expense		(\$234)
Discretionary Herd Adjustment		\$0
Adjusted Herd Maintenance Expense		(\$234)

<b>Mature Herd Maintenance Expense:</b>		<b>Quantity</b>
Culled cows:		322
Plus dead cows:		57
<b>Number of replacements required to maintain herd size:</b>		<b>379</b>
Number of self-raised heifers transferred into mature herd:		379
Number of purchased of cows required to maintain herd size:		0
<b>Number of replacements required to maintain herd size:</b>		<b>379</b>

Total cash needed to maintain mature herd size:		\$379
Less cull cow income:		\$145
<b>Mature Herd Maintenance Expense:</b>		<b>\$234</b>

Heifer Value Per Head:		\$1,000
Purchase Cow Value Per Head:		\$0

**Assumptions:**

Herd size: 1150 hd. (milking + dry cows)  
 Total cull rate: 33% (includes assumed 5% death rate)  
 Cow self-raised price: \$1000/hd.  
 Cull price: \$450/hd.

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Again, the type of debt can be important. Monthly herd line payments can be deferred, if the line is revolving, during seasonally low months and overpaid or caught up when cash flows are normally higher. The requirement here is normally that the annual reduction equates approximately to the amortization agreed upon or that the herd value increases correspondingly. At the very least, herd value and vitality must not deteriorate. Many dairyman also use the herd line as a sort of "bank" during good times by building equity for expansion and lowering leverage and corresponding cash flow demands. Since the interest rate is normally higher than the return on other investments it is a good strategy so long as the ability to reborrow remains.

A second minimum requirement is that you pay-down or keep enough margin to ensure your ability to keep the herd vital and the numbers at least constant.

Intermediate Assets and Liabilities (2-7 years): Multiple structures are usually available for secured term loans. On the fixed asset/long term debt side,

the principle of matching asset life to debt term is a key management principle.

Herd debt is generally an exception. Most lenders set amortizations at 3-7 years. If the collateral margin and herd vitality is properly maintained, a revolving structure is virtually interest only "permadebt". The principles of vitality and equity banking discussed earlier are critical especially since a 35% turnover rate suggests a maximum useful life of 3 years. This is well below even the shortest amortization. To offset this however, is the vitality principle. In effect, unlike a machine that wears out, the herd asset remains as good or better than it was on the day it was first financed. An advance rate of 75% of appraised - not market value is usually maximum. A lower advance increases your flexibility and perhaps survivability in a prolonged industry downturn.

Equipment should be financed or leased for 3-5 years and never more than 7 for the most durable at an 80% maximum (leasing excepted). The most conservative approach is to never exceed your realistic estimate of useful life in your operation. If

				Month 3	Month 12	Month 18	Month 24
<b>Mature Herd</b>				1000	1000	1000	1000
45%	Heifers			38	38	38	38
45%	Bull Calves			38	38	38	38
10%	Death Loss			8	8	8	8
<b>Total Calves</b>				83	83	83	83

  

				Month 3	Month 12	Month 18	Month 24
<b>Beginning Heifer Inventory</b>				81	418	643	868
Months	Day Old	Value \$100	Rate/Day \$100.00				
1	30	\$138	\$1.25	38	38	38	38
2	60	\$175	\$1.25	38	38	38	38
3	90	\$213	\$1.25	43	38	38	38
4	120	\$250	\$1.25	0	38	38	38
5	150	\$288	\$1.25	0	38	38	38
6	180	\$325	\$1.25	0	38	38	38
14	420	\$625	\$1.25	0	0	38	38
15	450	\$663	\$1.25	0	0	38	38
16	480	\$700	\$1.25	0	0	38	38
17	510	\$738	\$1.25	0	0	38	38
18	540	\$775	\$1.25	0	0	43	38
19	570	\$813	\$1.25	0	0	0	38
<b>Ending Heifer Inventory</b>				118	456	681	906

  

<b>Heifer Program Herd Value</b>		Month 3	Month 12	Month 18	Month 24
		\$20,856	\$157,713	\$312,231	\$517,375

  

<b>Aggregate Feed Costs To Raise Heifers</b>		Month 3	Month 12	Month 18	Month 24
		\$9,056	\$112,163	\$244,181	\$426,825
<b>Aggregate Lost Revenue Potential From Sale Of Heifers</b>		Month 3	Month 12	Month 18	Month 24
		\$12,500	\$50,000	\$75,000	\$100,000
<b>Total Aggregate Cost Of Establishing A Heifer Program</b>		Month 3	Month 12	Month 18	Month 24
		\$21,556	\$162,163	\$319,181	\$526,825



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you know feed wagons only last 3 years on your dairy, don't finance them for 5 even though the terms are available. This will preclude having to expense excessive repairs until the balance is below salvage value.

**Long Term Assets and Liabilities (>7 years):** Plant and property loans should to some degree reflect the age of the plant. Refinances of older barns should be shorter. Amortizations up to 30 years are sometimes available with the more common being 15-20. Note maturities are frequently shorter at 5-7 years. This can be a negative in that you must refinance sooner. It can also be a positive in that the shorter term rates are usually priced lower. It can also allow refinancing at a lower or zero prepayment penalty if interest rates move down significantly or if you want to tap into appreciation equity for expansion or to remodel. Customary maximum advance rates are 60-75% of appraised values. I would recommend financing at the maximum each time due to the modest additional fees incurred on the higher amounts and the flexibility equity in herd and feed provides.

**Net Worth:** The last major statement category then is net worth. The simplest definition is that this is the plug figure to make both sides balance. But in reality it is the most important number of all and deserves careful planning and attention. It represents your ownership of the business, your cushion against adversity, your safety net for survival. It also represents your savings account for the future. It should be considered permanent capital. It is also the number that ultimately regulates leverage by determining along with cash flow how much debt you can support. Always remember leverage translates into risk.

How much risk – leverage – is too much, too little, or just right like Goldilock's porridge? A long standing lenders rule of thumb for dairy is 1.5 to 1, or 60% debt/40% equity. Less leverage translates to less risk and depending on your nature perhaps a better night's sleep especially in tough times. For example, it might also mean lost opportunities if you don't leverage your equity to buy the adjoining section of alfalfa ground that only comes up for sale once in a generation. Leverage is normally sig-

nificantly increased in conjunction with any kind of expansion or relocation. It may rise to double or more. I don't want to infer that there is no ceiling, because there is. It is just not an absolute. Some operators are comfortable with and experienced at managing higher levels of debt. Again, management and preplanning are essential. Most lenders will raise their debt to worth guidelines when the operating management has a history of successful debt reduction and can present a realistic plan for an orderly programmed reduction, normally from increased cash flow, especially if the net margin is substantial.

While it is still debt there are vehicles available to reduce the primary lender's risk exposure. These would include debt subordinated to the loan or guarantees (usually from related operations or family members), and guarantees under governmental programs such as Rural Community Development or the Small Business Administration.

#### Cash Flow & Debt Coverage:

Debt by its very nature requires repayment, but certain forms of debt are sometimes considered almost self liquidating. This might be illustrated by feed lines which are paid down from conversion to milk and subsequent collection of milk receivables as the feed is used. Monthly payment of feed debt therefore doesn't need to be included in cash flow computations since the feed used is expensed. Installment debt is paid from cash flow. For illustration lets use our sample dairy again.

Net margin equals revenue from all sources i.e. milk sales, calf sales, dividends etc., less all feed and herd replacement costs and operating expenses except interest and depreciation (also known as cash before debt service), less current portion of long term debt (CPLTD). The larger the margin the more "cushion" the operation has against adverse occurrences and the faster net worth will build. The debt coverage ratio is simply the earnings before interest (because it is included in the debt payments), taxes (because they are influenced by debt cost), depreciation (which is a non-cash charge) and amortization of any intangibles or capitalized expenses (EBITA) divided by the CPLTD (principal and interest).

A ratio of 1:1 essentially means there is nothing left after the bills are paid. Generally coverage at

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1.2:1 provides an acceptable margin. If the herd line is revolving this ratio can occasionally fall below 1:1 for a short period without severely hampering operations; but you always need to cover interest and some principal and eventually make up the lost reduction of principal.

The debt coverage margin (ratio) like net worth also determines maximum leverage since you wouldn't want to and shouldn't be able to borrow beyond your ability to make the payments with some margin. The amount of margin required is influenced by the probability of negative cash flow variances, such as current industry conditions and the share of the margin based on projection. The higher the reliance on forecasts, the higher the required fudge factor.

I've said a lot about the impact of leverage, so let's look at the effects of some relatively minor changes in operations in our sample 1,000 cow dairy.

Scenario #1 reflects the changes to our Sample Dairy when the owner elects to purchase \$200M

worth of equipment, say a mixer/feeder truck and a loader, with 100% lease financing. Note that while the net cash flow margin decreased over 50%, the leverage ratio only increased modestly from 1.79:1 to 1.93:1. The operation is still profitable – all the bills can be paid, but the level of risk is increased. A small (\$.25) drop in the milk price will now produce a slightly negative cash flow. There went the new pickup.

A 10% increase in feed expense drives the cash flow negative by almost the herd payment. The pickup, vacation, and college for the kids are now at risk. The reverse is true, of course, if leverage is decreased or the cash flow margin is increased.

To further illustrate the effect of extra leverage, let's look at these numbers if we add an additional \$200M in new debt and equipment.

Leverage increases to 2.04. As long as everything remains steady the margin is now negative at (\$16) with cash flow at .98. Still no pickup unless it was in the second \$200M, but not disaster either.

	Current Sample Dairy Operation	Scenario #1	Scenario #2	Scenario #3
<b>MILK PRODUCTION</b>				
Pounds Of Whole Milk Produced	23,725,000	23,725,000	23,725,000	23,725,000
Milk Prices Per CWT	\$14.25	\$14.25	\$14.00	\$14.25
<b>DAIRY HERD</b>				
Milking Cows	1,000	1,000	1,000	1,000
<b>OPERATING INCOME:</b>				
Total Income From Operations	\$3,392	\$3,392	\$3,333	\$3,392
<b>OPERATING EXPENSES:</b>				
Total Feed	\$1,637	\$1,637	\$1,637	\$1,865
<b>HERD REPLACEMENT COSTS:</b>				
Total Herd Replacement Costs	\$230	\$230	\$230	\$230
<b>OPERATING OPERATING EXPENSES:</b>				
Schedule 1	\$807	\$807	\$807	\$807
Interest Expenses (Includes Lease Interest Pmt.)	\$200	\$217	\$217	\$217
Total Operating Expenses	\$2,894	\$2,951	\$2,951	\$3,179
Net Income From Operations	\$498	\$441	\$382	\$213
<b>CASH FLOW ASSESSMENT</b>				
Earnings Before Int., Taxes, Deprec. & Amort.	\$718	\$718	\$652	\$490
CPLTD To Be Serviced (Principal)	\$600	\$667	\$667	\$667
Total Principal & Interest To Be Serviced	\$600	\$667	\$667	\$667
Net Margin	\$118	\$51	(\$8)	(\$177)
Debt Coverage Ratio	1.20	1.08	0.99	0.73
Leverage Position	1.79 :1	2.04 :1	2.04 :1	2.04 :1



However, similar negative changes as scenario 2 & 3, i.e. milk price and feed price moves produce cash flow coverages of .90 and a more serious .67.

I realize that this is a simplistic approach, but it does show that you need to plan ahead, manage costs and to some extent luck out on the timing. Most of you use management tools such as hedging and contracting to decrease risk in the cost of feed. Interest expense can also be managed using tools such as fixed rate money market based financing and some of the newer Capital Markets products such as Swaps, Caps and Collars. Controlling input costs becomes more important as leverage increases.

Looking ahead, market price and supply forecasting will continue to increase in accuracy and income protection through the futures market will help us to manage the revenue variable more effectively. However, never fix revenue without fixing costs.

My initial charge was to answer the question: "How should a balance sheet for a large dairy be structured and managed?"

As we have seen, the question is easy. The answer is more difficult. The best we can do is: It depends!

Since I have been unable to provide you with a simple answer, I hope I may have at least provided you with some food for thought. The dairy industry continues to change with increasing frequency and magnitude. To be a survivor in the future, you will need to manage that change. With this in mind, I would pose a few general questions for you to consider:

- Is my dairy operation being managed as efficiently as possible?
- Do I know what it costs me to produce a hundred pounds of milk? What is my absolute break even milk price?

	Current Sample Dairy Operation		Scenario #4		Scenario #5		Scenario #6	
	Dec-98		Dec-98		Dec-98		Dec-98	
<b><u>MILK PRODUCTION</u></b>								
Pounds Of Whole Milk Produced	23,725,000		23,725,000		23,725,000		23,725,000	
Milk Prices Per CWT	\$14.25		\$14.25		\$14.00		\$14.25	
<b><u>DAIRY HERD</u></b>								
Milking Cows	1,000		1,000		1,000		1,000	
	(\$000) PER CWT		(\$000) PER CWT		(\$000) PER CWT		(\$000) PER CWT	
	Dec-98	Dec-98	Dec-98	Dec-98	Dec-98	Dec-98	Dec-98	Dec-98
<b>OPERATING INCOME:</b>								
Total Income From Operations	\$3,392	\$14.30	\$3,392	\$14.30	\$3,333	\$14.05	\$3,392	\$14.30
<b>OPERATING EXPENSES:</b>								
Total Feed	\$1,637	\$6.90	\$1,637	\$6.90	\$1,637	\$6.90	\$1,865	\$7.86
<b>HERD REPLACEMENT COSTS:</b>								
Total Herd Replacement Costs	\$230	\$0.97	\$230	\$0.97	\$230	\$0.97	\$230	\$0.97
<b>OPERATING OPERATING EXPENSES:</b>								
Schedule 1	\$807	\$3.40	\$807	\$3.40	\$807	\$3.40	\$807	\$3.40
Interest Expenses (Includes Lease Interest Pmt.)	\$200	\$0.84	\$234	\$0.99	\$234	\$0.99	\$234	\$0.99
Total Operating Expenses	\$2,894	\$12.20	\$2,968	\$12.51	\$2,968	\$12.51	\$3,196	\$13.47
Net Income From Operations	\$498	\$2.10	\$424	\$1.79	\$365	\$1.54	\$196	\$0.83
<b><u>CASH FLOW ASSESSMENT</u></b>								
Earnings Before Int., Taxes, Deprec. & Amort.	\$718		\$718		\$659		\$490	
<b><u>CPLTD To Be Serviced (Principal)</u></b>								
Total Principal & Interest To Be Serviced	\$600		\$734		\$734		\$734	
Net Margin	\$118		(\$16)		(\$75)		(\$244)	
Debt Coverage Ratio	1.20		0.98		0.90		0.67	
Leverage Position	1.79 :1		2.04 :1		2.04 :1		2.04 :1	

- As the key cash drivers change, what effect will they have on my cash flow and ultimately my ability to continue to service debt? What happens to my cash flow margins if both costs go up, and milk prices go down. This should not be construed to be an Armageddon scenario. It happens.
- If my plans are to upgrade or expand the dairy, does my historical cash flow have an adequate margin available to service the increased debt? If not, are my projections for costs and incremental cash flow realistic?
- How much financial cushion do I have to fall back on during difficult times in this cyclical industry?
- Does my lender understand my business and concur with my current and future plans?

In addition to these questions I would like to leave you with a few summary concepts:

- Your financial structure should be the result of

intentional and planned management actions within reasonable guidelines and standards. It should match or at least lead to your personal goals.

- Leverage can increase risk and returns. It must be recognized and managed at a level equal to your personal risk appetite. Increased risk management techniques should accompany increased leverage.
- Explore all aspects of major undertakings such as expansions, heifer programs and changes in your operating perimeters. Analyze the impact on your break-even and arrange the required total financing package before spending the first dollar.
- Finally, include your professional advisors; CPA, attorney and lender when formulating your plans.

Remember: financial management is still an art, and you are the artist.

## Notes

