REAL DATA ON THE NZ DAIRY FARM FINANCIAL SITUATION

Susan Kilsby and Mark Grenside

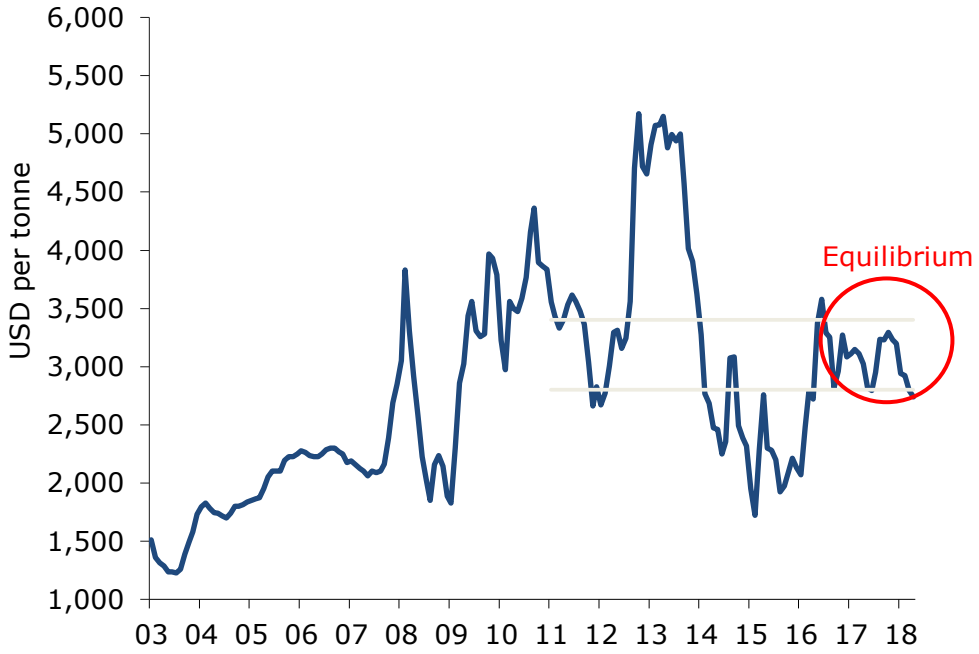
Dairy farming is a key driver of the New Zealand economy. In recent decades output has expanded to meet international demand for high-quality food and ingredients. Against a backdrop of significant lifts in both farm assets and debt, dairy's new challenge is to create resilient businesses that meet consumer expectations of quality, sustainability and traceability.

ANZ data indicates farms with low operating costs relative to milk production will be more resilient to milk price volatility and higher costs. Farm systems need to be able to make a profit when milk prices are good and at least break even when returns are low. Efficient use of resources including high pasture utilisation and cost control will be paramount for business sustainability.

Prices

Dairy commodity prices were relatively stable prior to 2008. At this time there was excess supply, in the form of stocks, relative to demand. Global demand lifted primarily due to additional demand from developing nations, which led to a global shortage of dairy products – particularly protein.

Figure 1. Dairy commodity basket historical price trend



Source: ANZ, GDT

NZ dairy farmers were highly responsive to the higher price environment due to farm gate returns being directly linked to global market prices and virtually no restrictions on expanding production. NZ's milk output lifted through the conversion of additional land to dairying and more intensive dairy practices.

Supply channels were already in place for the supply of dairy commodities from NZ through to the main growth market in Asia – particularly China.

Milk quotas that previously limited production within the EU were removed in 2015. As a result, when global prices for dairy commodities are high European farmers now react by increasing supply. This limits the potential for dairy commodities to persist at exceptionally high prices, as a supply-induced correction will occur.

Dairy farmers in Europe and North America are somewhat protected from low global commodity prices due to their vast domestic markets helping to stabilise prices. Subsidies also assist these farmers to maintain supply when margins are low. US production has grown at an average rate of 1.5% for the past five years, while in the EU the rate is above 2% due to the surge in production associated with the removal of milk quotas in 2015.

Dairy farmers in New Zealand will continue to face volatile returns at the farmgate level with significant exposure to downside risk and limited upside risk at this juncture.

Capital gains have traditionally provided a "get out of jail" card for farmers with highly leveraged properties. However, farm prices are now easing. Demand for dairy land is waning as the higher returns from dairying relative to alternative land use are now decreasing and risks to future income streams are factored into investment decisions.

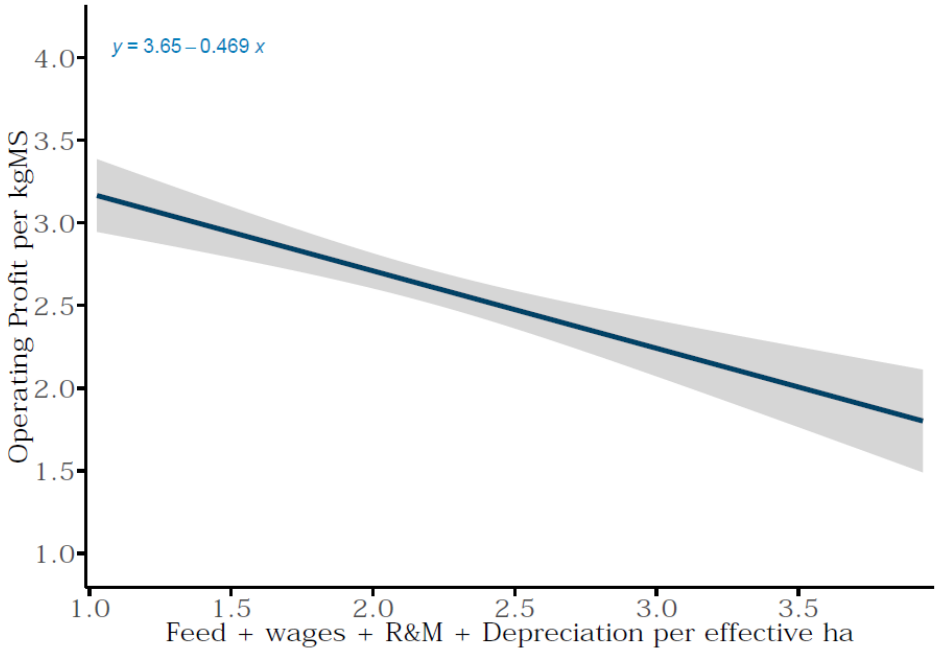
Costs

Some costs associated with operating dairy farms will also certainly increase in the future.

Resilient farmers will be those that can weather the downturns i.e. the farmers whose costs are low per unit of milksolids produced.

Analysis of ANZ data from 2013 to 2017 shows low-cost systems generally have higher operating profits. The data was grouped into low and high cost systems based on expenditure on feed, wages, repairs & maintenance and depreciation relative to milk production.

Figure 2. Costs versus operating profits – Waikato sample



Source: ANZ Analysis

ANZ data for Waikato dairy farms shows operating profits fell on average by 50c/kg milksolid (MS) for every additional $1/kg MS spent on these inputs. Canterbury data

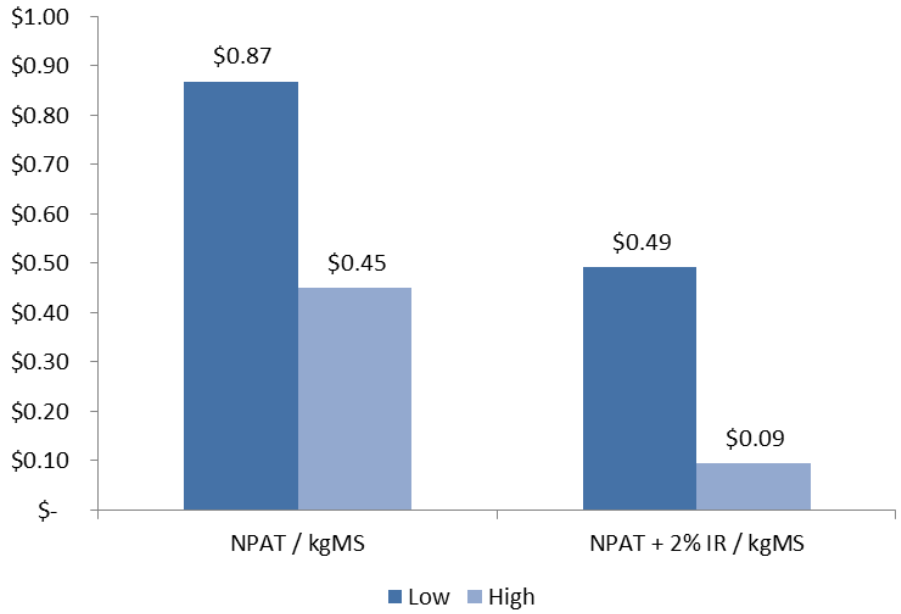
revealed a similar tendency, although slightly less pronounced, with a 40c/kg MS drop in profit per kg MS for every extra $1/kg MS of costs. This indicates a portion of the additional expenditure is costing more than the revenue it is generating.

ANZ data also reveals that high-cost systems tend to be more leveraged than lower-cost systems. Waikato dairy farms that fell into the highest-cost third based on spending on feed + wages + repairs & maintenance + depreciation had an interest cover of 2.6x, meaning their income was 2.6 times their interest cost, or 39c of every $1 earned is being spent on interest. Meanwhile the Waikato clients that fell into the lowest-cost third had an interest cover of 3.3 times, meaning that on average 31c of every dollar earned is spent on interest.

Net profit after tax is higher on the farms with lower costs, when measured on a per kg MS basis. Therefore these low-cost farms are more resilient to potential increases in costs or decreases in income.

Highly leveraged systems – which are more prevalent in the high-cost farm systems – are less able to cope with low-income seasons or cost increases. For example a 2% increase in interest rate costs would decrease the profits on our Canterbury sample of farms. But on the low-cost farms the increase in interest rates would reduce profits by nearly 50% per kg MS, whereas higher-cost farms would have profit per kg MS reduced by 80%.

Figure 3. Change in net profit after tax with a 2% increase in interest costs on Canterbury farms between 2013-2017.



Source: ANZ Analysis

The ANZ data indicates farms that are able to operate at low costs are therefore more resilient and therefore will be better placed to cope with any future shocks in income or costs, whether they be market or regulatory related.

We are now in an environment where capital gains can't be relied on, and market uncertainty prevails, which highlights the need to consistently achieve positive operating returns. Low-cost operating systems that efficiently harvest pastures will be more resilient during periods of low returns. Containing operating costs requires close scrutiny of all spending to ensure that it is generating a return.