What you must consider before going for growth

Average dairy herds are growing in size – but significant expansion is not for everyone. So how can you decide what's right for you? *Olivia Cooper* finds out

Many dairy herds are in desperate need of investment, and increasingly farmers are taking the plunge with a rapid expansion in cow numbers. If they are going to replace a parlour, surely it would be more profitable to increase the herd size at the same time?

Not necessarily. While the numbers stack up for some businesses, for others expansion could prove a financial disaster, says Pat Tomlinson, associate director at accountant Old Mill.

"Against the backdrop of the current economic climate, it is critical both the borrower and the lender look at whether expansion is the right thing to be doing.

"It's very easy to jump on the bandwagon of expansion, but it isn't universally right for everyone. Expansion is only right when the business is getting everything it can out of the existing resources. Every pound you have invested should be working as hard as it can be, and technical performance should already be as good as possible within the current system."

OBJECTIVES

Producers should first take a strategic view of the business and discuss plans with partners and younger family members who may take over the farm in the future. "Quite a lot of older family members are expanding for the younger generation, but their sons and daughters don't want that pressure. Make sure they are as hungry for it as you are."

Having drawn up medium and long-term objectives, producers should then consider their limiting factors – land, labour, capital, buildings and so on. What are the most efficient ways to overcome those limitations? Instead of buying more land, could they rent some extra, or just buy in feed and forage? Another alternative could be to contract out heifer rearing, or sell beef youngstock instead of finishing them. Collaborative ventures, including machinery and labour sharing, may also be suitable, particularly when pairing expanding farmers with those looking for a quieter life.

COSTS

Next, work out how much money the expansion will cost and generate forward budgets, including cash flow, profitability and accurate costs of production.

"Don't just look at gross margins or margin over purchased feed – fixed overheads will change when you're expanding by more than a few cows, and are often overlooked," says Mr Tomlinson.

"Ask whether you already have a competitive cost of production, and will the investment increase or decrease that cost?" Milk price may also be affected, through volume bonuses or the ability to switch milk buyer.

"That shouldn't change your decision, but it may help justify it. But it's important to work out what your costs of production will be first, then see whether the required milk price is sustainable."

DECISION MAKING

Having produced realistic budgets, some producers may decide that expansion is not worth the risk, and instead consider different options like heifer rearing or alternative enterprises. ➔p8

JIM WILEMAN

CASE STUDY

The Martin family, Cornwall

Land availability has been no barrier to expansion for the Martin family, who, despite only owning 70 acres, have grown cattle numbers sharply in recent years.

Donna and Tim Martin first rented Trethick Farm, St Mabyn, Cornwall, in 1990, having started out on a 60-acre County Council farm in 1984. Initially milking 100 cows across 200 acres, they took every opportunity to expand as neighbouring farms and land became vacant.

But the big change came in 2000, when the family, including daughter Emma (pictured) and son Richard, took on an extra 450 acres and installed a new parlour. "We had the ethos that if we have the room, we fill it up to get the most out of the land and sheds," says Emma Martin.

"The parlour became a limiting factor, so we put in a 50x50 herringbone with a view to milk 500 cows." However, over the years the herd grew from 300 Holstein Friesians to 970, plus 630 youngstock.

"We now have 1,000 acres around the farm, plus 70 acres which we own five miles away for youngstock. We also take grass keep for the heifers in the summer, and people grow maize and corn for us as well." The cows are split into three milking groups, averaging 9,400 litres, with the high yielders housed year round for the first time last summer. "It would have been too much to manage three milking groups at grass, and it worked really well keeping them housed."

But capital outlay has been kept to a minimum, by using second-hand buildings and basic equipment where possible. "The cows perform just as well as if we'd spent a lot of money – we just have to work a bit harder to get there," says Ms Martin. "The banks haven't always been in agreement with our plans so we have shopped around for the best deals. Initially we didn't have the assets and track record they wanted, but now we have a proven record they are more confident in lending us money."

With the equivalent of 11 full-time staff, including the four family members, they are careful to work within their own specialisms. "Richard does the arable side, I'm the herdsperson, my mother does the paperwork and my father oversees the whole operation."

Anyone who is seeking to expand should ensure they are passionate about the job and are already doing it as well as they can be, she adds. "Once you start adding cows it's a lot more stressful and complicated – if you're not already doing a good job you could make things a lot worse. Look around as many other farms as you can to get new ideas, and make sure you have a committed team behind you."

> **"Anyone seeking to expand should ensure they are already doing the job as well as they can be"**
> EMMA MARTIN

KEY QUESTIONS TO ASK WHEN LOOKING TO EXPAND

- Do I – and my partners – want to expand?
- Can we afford it?
- Will it make us more profitable?
- Is it worth the extra risk and hassle?

"Sometimes significant outlay is needed and after you've repaid the debt there won't be enough left to make it worthwhile. But the decision to say no is just as important as the decision to say yes. Doing the budget helps you make up your mind before approaching the bank and crystallise your strategic direction. Rather than spending the next few years worrying about lack of investment in the dairy, it frees you up to think about doing something else."

Significant expansion in herd size is often more transparent than small and regular growth, he adds. "You can see exactly what you've done, and how it's affected performance and profitability. If you're expanding by creep, you never quite know what has changed and why – it's easy to blame changes on something else. It's also easy to push the system a bit too far – a few too many cows a cubicle – and you rarely see much increase in profits, either."

NEW REGIMES

However, in the first year following a major expansion, many producers experience a drop in herd performance, as cows and staff take time to get used to the new regime. "It can take a while to get back in control of everything, so budget for a 10-20% fall in technical performance in the first year, as well as a 20% contingency fund across the whole capital expenditure. That way both you and your lender are expecting it."

Producers should also be prepared to change the way they run the herd, warns Mr Tomlinson. "It can be a big barrier – a successful dairy farmer with 250 cows probably does most of the work himself, but take that to 400 cows and you need a new level of management. Learning how to manage the cows from afar, by delegating and managing staff, is therefore essential. "You need good protocols and controls in place."

JIM WILEMAN

Expansion isn't right for everyone – it is critical both the borrower and lender look at whether it is the best option.

TAX TIPS

Minimising tax is an essential part of planning any change in herd size, and can add tens of thousands of pounds to a business's bottom line, says Old Mill's Andrew Vickery.

Following the abolition of Agricultural Buildings Allowances, farmers have to be particularly careful about how they class expenditure on buildings, plant and infrastructure. "You really need to make the most of capital allowances," he says.

Although the annual investment allowance is reducing from 100% relief on expenditure up to £100,000 to just £25,000 from April this year, with annual write down over that level dropping from 20% to 18%, farmers will still receive the same amount of tax relief, albeit over a longer period, he explains.

"The cost of any repair work can be entirely offset against profits in the year it is incurred – so make sure invoices are correctly worded." The same goes for new investment – ensure anything that can be classified as plant and equipment is, and isn't incorrectly put down as building work. For example, new slurry stores and silage clamps will generally qualify for capital allowances, as will rainwater harvesting or solar technology. "It's usually just the actual building structure which you can't claim against."

If new projects are being funded by a loan, it may be worth securing debt against non-farming assets like rented cottages, to reduce potential inheritance tax charges, says Mr Vickery.

Those with their own money to invest could consider doing it through a Self Invested Personal Pension. "That way you get tax relief on the initial pension contribution (to fund the cost of the new building, for example), and reduce income tax as the business rents the building back from your own pension fund. However, if you are selling capital assets to fund the expansion, be aware that you may be liable to capital gains tax on that sale."

Producers may also minimise income tax by forming a limited company – potentially cutting tax charges from between 29% and 52%, depending on profits, to a flat rate of 20% on profits up to £300,000. When making a change to the business structure, it may also be possible to move to a herd basis, treating cows like a capital asset rather than a trading asset, to minimise tax on any future herd sale.

However, before changing business structure, producers should consider factors like inheritance tax relief, particularly where the business includes non-farming assets like rental properties. Any changes may also impact on future single farm payments following CAP reform, warns Mr Vickery. "If a father and son partnership is looking to separate, for example, it may be that only one will be able to claim the single payment from 2014 onwards. So far, nothing regarding CAP reform is set in stone, but it must be part of the decision-making process."

A banker's eye view

Historically low interest rates are making borrowing particularly attractive at the moment, says Euryn Jones, regional agricultural manager for HSBC in Wales.

"And we don't expect base rates to increase until some point in 2013. We are also able to offer historically low fixed rates for up to 10 years, which gives borrowers a degree of confidence that at least one financial aspect of their project is fixed."

Agriculture is an attractive sector for banks, but every loan application must be considered on its own merits, he adds.

KEY CONSIDERATIONS ARE:

- The ability of the business to service the borrowing and repay the capital over a period of years.
- The bank needs to have a good understanding of the financial situation of the business, and get to know the people they are lending to.
- They need to know a customer's track record in farming, and in servicing past borrowings, as well as their current profitability and cash flow generated from existing capital in the business.

Only then can bank managers consider future plans, which should include budget and cash flow projections for up to three years, and all expenditure like tax and personal drawings.

"It's important projections are realistic and relate future physical performance to current performance like yields, calving index and concentrate use."

Collateral is another consideration and may require an independent valuation, says Mr Jones. Producers should also be realistic about time scales and the overall budget. "There can be delays in getting planning permission, as well as with builders and suppliers. It is important to ensure that the people carrying out the work are competent, but even then it's not unusual to overrun."

It is helpful to get advice from an independent consultant, he adds, particularly for large-scale expansion. "And if you don't have the best track record, a professionally presented loan application can help."