Benchmarking is NOT Going Away

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Just like any game or business there are rules that must be kept. If rules are broken there is a penalty that has to be paid. The business of milking cows is no different. In good times of high milk prices, it is easy to justify maybe stretching the rules. The problem comes when the rubber band is pulled too far and it does not have any more give.

Here are eight key financial rules that should not be broken at any time. They are written in the Book of Experience. These were paid for and written by dairy producers of past generations. They are recorded in the halls of lending. There are other rules to keep in mind, but if you respect these you will probably not be disqualified.

- 2:1 liquidity
- No more than 20% of milk check to pay principal and interest (P & I)
- 85% expense rate
- $3K to $5K debt/cow and no more than $20 of debt per CWT of milk sold in a year
- +30% equity
- 3-year asset turnover rate
- 8% ROA, 6% ROE
- Know your cost of production

2:1 Liquidity: This is the dollar amount of current assets that you have to current liabilities. Current assets are cash, feed on hand, and other assets that are cash or will be turned into cash in the next 12 months. That is measured against the current liabilities. These are unpaid bills and principal due in the next 12 months. There should be $2 of current assets for every dollar of current liabilities. A 1.5:1 ratio will work, but you do not want to get it any skinnier than that. This ratio is important because it says you have more dollars available to pay your bills than you have bills. To calculate: divide the current assets by current liabilities.

No more than 20% of the milkcheck should be used to pay principal and interest; 15% is better. If you use more than 20% you will not have enough money left over to pay the rest of your bills. To calculate: add up your yearly principal and interest paid and divide it by your yearly gross income.

You cannot spend more than 85% of your milk check on all expenses. To calculate: add up all of your yearly expenses, including family labor and income taxes, and divide that number by your total annual farm income.

Dollars of debt per cow should not exceed $5,000. If it does the dairy's ability to service debt will be difficult. To calculate: total liabilities divided by total number of cows. Another way to look at debt is to have no more than $20 of debt per 100 pounds of milk sold per year. To calculate: total liabilities divided by the hundredweights of milk sold annually.

ATO or asset turnover: You need to turn your assets every three years. An example would be if you have a $1,000,000 farm and you generate $330,000 in gross income $1,000,000 divided by $330,000 is 3, or 3 times. If it takes more than three years to turn your assets, you have too many assets or not enough gross income. To calculate: total assets divided by gross income.

Total ownership equity should remain above 30%. Anything less than that and the lender will become uneasy, and you should be too. To calculate: net worth divided by total assets.

ROA (return on assets) 8%. To calculate: net income plus interest paid in a year divided by total assets. **ROE (return on equity) 6%.** To calculate: net income divided by total equity or net worth.

COP (cost of production): it is critical today for dairy producers know their cop. To calculate: (a simplified way) use the Schedule F expenses from your income taxes add in family living and income taxes paid; divide by the hundredweights of milk sold annually. (If you pre-paid expenses, those should be subtracted from your expenses. If you have year-end supplier outstanding bills, those should be added to your expenses.) If you are keeping track of all your expenses on a program such as Quick Books you can use those expense figures to add up your expenses.