Economic downturn has its upsides

What impact is the credit crunch having on UK dairy businesses?

There's a mixture of good and bad news for dairy producers trading in the current economic climate. We spoke to two agricultural finance experts to find out what falling interest rates and input costs, as well as a weak pound, mean for your business.

The global financial downturn has, so far, had a limited direct negative impact on the UK dairy industry, according to Promar's principal consultant John Warrington.

"Although consumers are economising they still need to eat so demand for food is reasonably consistent. But they will change what they eat and what they spend on food. In fact farmers are being urged to meet the ever-increasing global demand for food for a continually expanding population," he says.

That said, the global credit situation is having some impact on farming in this country. The first and most visible effect has been as a result of the currency markets.

"In a financial crisis the money markets favour stronger economies and the immediate upshot was a rise in the value of the US dollar against sterling," he explains. "Within just a few weeks the pound went from being worth $2 to just $1.50.

"And the dollar position affects the cost of all farm commodities that are traded in dollars, including feed, oil, energy and fertiliser, making prices higher in sterling. For example, the price of soya recently fell by 40% in dollar terms, but only by 20% in sterling."

Barclays' national agricultural specialist Euryn Jones points out that input prices have fallen. "Fuel prices have dropped back and we're expecting to see a fall in fertiliser prices too," says Mr Jones.

Producers' favour

He says that the weakness of sterling of the Euro has also worked in producers' favour, helping to insulate dairy businesses from the full extent of the fall in global dairy commodity prices. As CowManagement went to press, pound sterling was worth 0.90 Euro.

"Globally, dairy commodity values are falling. But in the UK we have been protected against this by the fall in the value of sterling. There are other mitigating circumstances in the UK too, due to the fact that milk supply is still on a downward trend."

If sterling begins to strengthen again against the Euro, however, this would put downward pressure on farmgate prices.

The general economic downturn means that interest rates are also extremely low – down to a base rate of 1.5% compared to 5.5% in January 2008. And there's even more good news for businesses with loans as the base rate is expected to be cut even further to just 1% in February and is also expected to remain low throughout 2009," says Mr Jones.

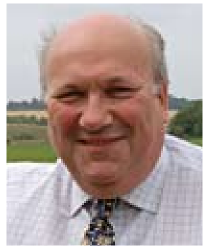
So, how can producers make the best of low interest rates?

"Given that interest rates are so low, now may be a good time to consider fixing your business interest rate on any outstanding loans in order to make the most of current rates and add protection from any future economic volatility.

"Interest rates being offered by banks are higher than the base rate, but they're still low and it's certainly something that's worth looking at."

Under pressure

Mr Warrington is less optimistic. He believes that as the flow of credit has tightened, banks are under pressure to reduce their own risks. "I've heard comments about the banks reducing their lending and increasing their charges, which has led to cash flow problems for businesses.



John Warrington

Euryn Jones

"Agriculture is still seen as a reasonable lending proposition, but banks are unlikely to look twice at anything other than a cast-iron proposition. Anyone looking to borrow money will need to make sure they have got their facts and figures absolutely watertight.

"And banks will also want to improve their margins and there are clear signs that they will do so by increasing the lending rate, charging a higher percentage above base rate for loans.

"This will make new borrowings more expensive and will increase the cost of some existing borrowing if terms have to be renegotiated. It will pay to reduce borrowings if possible and look at ways to consolidate funding to achieve the most favourable rates."

Mr Warrington's message is that cash is king. "This will certainly be the mantra of the supply trade, which will be squeezed from both sides as its suppliers chase for payment while customers try to extend credit terms.

"Agricultural merchants are unlikely to look favourably on producers who see them as a source of cheap credit. I think we will see preferential terms made available to producers who pay promptly while late payers will be penalised more heavily."

Slurry regulations

One threat to dairy businesses that's looming, according to Mr Jones, is the potential investment required to meet the new NVZ and slurry storage regulations that are set to come into force this year.

"That remains a significant concern for many producers. We carried out a survey at the 2008 Dairy Event and found that a significant proportion of dairy businesses are faced with having to make a considerable investment to comply with the regulations – an investment on which there will be no financial return."

Moving forward, to remain competitive and profitable in 2009 and beyond, Mr Jones would like to see more producers looking closely at their business's performance and comparing it to other dairy businesses.

"Benchmarking is a valuable tool, but it's something that relatively few producers are doing. Yet it's an excellent way to monitor how your business is performing in relation to other comparable dairy farming businesses and to identify areas where improvements in efficiency can be made.

"Producers would benefit also from monitoring their actual performance and comparing it to projections. It's a very good way to control your business, make the most of any opportunities and ensure that you're prepared for whatever the future may throw at your business. It allows you to plan effectively and enables you to know exactly what's going on."

"The credit crunch will not affect dairy businesses to the extent that it will affect other industries," adds Mr Warrington. "Times will be tough, rather than calamitous, and those producers who are running efficient businesses, where investment is funded from their own generated cash, will find that the impact should be manageable.

"But, as ever, those businesses who need to borrow more money to fund a less profitable business – let alone reinvestment – will find things much harder."

Rachael Porter