

# AgriMatters

AIB supporting the Irish Agricultural Industry



Spring 2012



**Freemount Macra: AIB/Macra na Feirme Club of the Year 2011**

**CAP Reform / Review and Outlook**



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## Welcome to the Spring edition of *Agri Matters*

### Michael Dowling, Editor, *Agri Matters*

Welcome to the first edition of *Agri Matters* for 2012. In it we are reflecting on the past year, which was, in general, a very good one for farming and the food industry, and looking forward to what this year may bring. At this stage, the prospects are fairly good, even if we are unlikely to see anything like the spectacular growth of 2011.

If there is to be agreement by early next year on the shape of the CAP post 2013, as Commissioner Ciolos believes is attainable, then there will need to be significant progress in the negotiations this year. In recognition of this, we have included a detailed article on the central element of the reform proposals – the future of the Single Farm Payment system. We will come back to other elements of the proposals in later editions.

We are also coming to the point where the dairy industry needs to be gearing up to face the challenges that the ending of milk quotas will bring. Joe Gill, Director of Research at Bloxham Stockbrokers, spells out some of the issues involved for the industry. Tadhg Buckley, one of our team of agri advisers, examines the main factors that need to be considered prior to on-farm expansion.

As usual, we include a commentary on the general economic situation, which remains difficult but seems to be stabilising.

Finally, somewhat belated New Year greetings to all our readers.

Michael Dowling  
Editor



Pictured at the launch of the Green Dragon Innovation Challenge 2011/2012 are (L to R) Dr. Vanessa Woods, Executive Director, Agri Aware; Dr. Anne Finnegan, Agri Strategy, AIB; Bernard Donohue, Chairman, Agri Aware; Kathryn Speedie, Events and Communications, FBD; and Teresa Brophy, Manager, Ireland Market Bord Bia.

# CAP Reform – Concrete Proposals

At the time our last edition was going to press, various leaks of the proposals on the reform of the CAP for the post 2013 period were in circulation. Our article on the subject had, therefore, to be somewhat tentative. Since then, however, the European Commission's definitive proposals on the reform have been published and we now have a clear view of its thinking in regard to direct payments, market measures and rural development. This article deals only with the proposals relating to the first issue mentioned – direct payments. We will come back to the other two aspects in later editions.

The proposals in regard to direct payments are along the general lines of the most recent leaks but the detail is somewhat different. The new system would be built around a more equal division of the Single Farm Payment funding among member States, movement within member States to a uniform payment per hectare either on a national or regional basis and tying payment to meeting certain greening conditions. Were the proposals to be adopted as they stand, there would be little change for Ireland in its Single Farm Payment receipts but very significant changes for individual farmers.

## Key elements of current proposals:

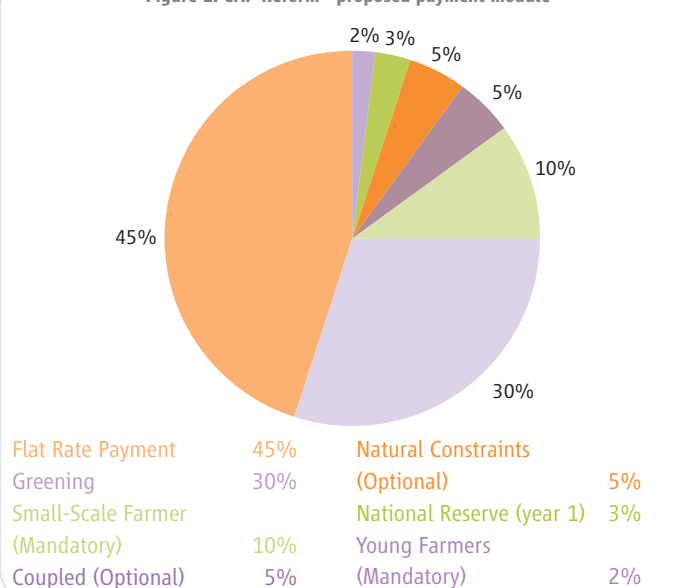
- The historical reference for the Single Farm Payment would be phased out fully by 2018.
- A uniform national or regional payment per hectare would be phased in.
- Member States would be required to set aside 30% of their direct aid envelope for 'green' top-up payments. These payments would be for compulsory measures in addition to cross-compliance, which would require beneficiaries to practice crop diversification, maintain permanent pasture and designate 7% of their land for ecological purposes. Organic farmers would be automatically entitled to these payments. Farmers with permanent pasture would not be required to designate any of their pasture land as an ecological area but would still be subject to that requirement in respect of any arable part of their holding.
- Member States would be required to allocate up to 2% of the national total for additional payments to young farmers (under 40 years of age) starting up or who have started agricultural activity within the previous five years and up to 3% for allocation to a national reserve. Young start-up farmers would have priority for allocations from the reserve.
- Member States would have the option of setting aside 5% of the national envelope for additional area-based aid for farmers in less favoured areas (these payments would be additional to those in the general less favoured area scheme and, we believe, would not be made in Ireland).
- Payment amounts between €150,000 and €300,000 would be progressively reduced and no payment would be made above the latter amount.
- A special simplified support scheme for small-scale farmers would be introduced, with a payment of up to €1,000 a year.
- Between 5% and 10% of a member State's direct aid envelope could be used for coupled aid to sectors important to a specific region for social or economic reasons.
- Direct aid would be targeted at active farmers, i.e. those whose direct payments are 5% or more of their non-agricultural revenue or who meet minimum agricultural activity levels laid down by member States. This rule would not apply to those who received less than €5,000 in the previous year.

The division of the overall funding among member States would be on the basis that the gap between a member State's average payment per hectare and 90% of the Community average payment would be reduced by one-third over three years, with a consequential reduction (between 3% and 7%) in the payments to member States with higher than average payments per hectare. As Ireland is at almost exactly the EU average (€270/ha), this proposal would leave the Irish receipts almost unchanged at about €1.26 billion.

The shape of the Single Farm Payment system would, however, be very much different if these proposals were adopted in anything like their current form.

The following illustration sets out graphically how the national funding would be divided between the different allocations.

Figure 1: CAP Reform - proposed payment module



Payments would be based on area declared in 2014: however, except in a small number of defined circumstances, eligibility would be confined to those who activated at least one entitlement under the present system in 2011. Member States would be empowered to apply only 40% of the basic premium in the first year and use the balance to provide transitional aid to those farmers whose entitlements were less under the new system than under the present one. That aid would be phased out over the period up to 2019, from which there would be a uniform payment per hectare at national or regional level.

It is clear from reactions from different member States that some of the details of the proposals are not being accepted as it stands. In particular:

- The three crop diversification would apply to holdings in excess of 3ha. This figure is seen as far too low.
- The 7% requirement for ecological focus areas is regarded as excessively high.
- A requirement to maintain permanent grassland would be seen as problematic if there were no provision for re-seeding (at least where no ploughing was involved).
- The extent – and even the principle – of the capping proposed is regarded as unacceptable by many, especially in Germany and the UK.

*continued on next page*

### CAP Reform continued

We would expect some, if not all, of the concerns on details such as these to be satisfactorily resolved in any final agreement. Concerns on the percentage of the payment reserved for the greening measures, the principle of which seems to be widely accepted, may be more difficult to assuage. There seems to be strong objections in many Member States to the level of the provision to be made for these measures, while from his public stance the Commissioner is very wedded to this proposal. Nevertheless, one could envisage a lower percentage of the funding being allocated to greening in any overall compromise.

From an Irish point of view, the principal issue must be the proposal to replace the historical basis for the Single Farm Payment system by a uniform payment per hectare. In our analysis of this proposal we are assuming that the Irish system would continue to be operated on a national rather than a regional basis.

While the transitional arrangements would ensure that there would be little change in the early years of the new system, there would be significant repercussions towards the end of the decade. Assuming that Ireland used the option of allocating 5% of the national envelope for a coupled aid and allowing for some other small specific allocations, the eventual uniform payment per hectare would be about €250 (including the greening premium). Currently, there are 72,000 farmers with payments greater than that figure and 56,000 with lower value payments.

We estimate that payment of that uniform rate would result in, on average, a loss of some €150/ha for those currently above €250/ha and a gain of about €110 for those below. The picture is more stark as one goes up or down the payment scale. For instance, there are 28,000 farmers with payments of over €400/ha and they stand to lose about €300/ha on average; and there are 27,000 farmers with payments of less than €150/ha and their average gain would be about €170/ha. These gains would be increased or the losses reduced if the farmers concerned qualified for a coupled payment.

In terms of sectors, there would, on average, be losses for tillage farmers and cattle fatteners and gains for sheep and suckler producers. Dairy farmers, on average, would not be significantly affected - although, of course, some individual dairy farmers would. In regional terms, there would, on average, be gains for Border areas and the West and losses for the East and South. One thing is clear: the proposal as it stands represents, in general, a transfer

## Dates for your Diary 2012

March 12-13:	Agricultural Research Forum - Tullamore Court Hotel, Tullamore
April 25:	Bioenergy 2012 - Hodson Bay Hotel, Athlone
June 30:	Sheep 2012 - Teagasc, Athenry
July 6-7:	Emerald Expo - Cillin Hill, Kilkenny
August 12:	Tullamore Show & AIB National Livestock Show - Butterfield Estate, Tullamore

of income from more intensive to less intensive producers in every sector and in every region. This has obvious consequences for individual farmers and their families but it could also adversely affect the long-term growth prospects for the industry as a whole. If the final agreement is for a system that is somewhat along the lines of what is now on the table, then, if growth prospects were not to be affected, Ireland would require sufficient national flexibility to allow for a much lesser payment adjustment over a very much longer period.

The other big issue causing concern within Ireland is the proposal to base entitlements on areas declared in 2014. This has the potential to cause significant over heating in the land market in the meantime. In a recent interview in the *Irish Farmers Journal*, Commissioner Ciolos did, however, indicate a willingness to continue to work towards finding a solution to this problem.

Finally, a word of caution: what is now on the table is a set of Commission proposals on a revised payments system. It has yet to be negotiated in the Council of Ministers and the European Parliament and, indeed, the overall EU budgetary framework has yet to be decided by the European Council. The final CAP agreement could be for a completely different system, although that is unlikely. What is likely, however, is that the detail of the ultimate agreement will be somewhat different to what was initially proposed. Therefore, any farmer making business decisions based on that proposal needs to be aware of the fact that changes arising from the negotiations could ultimately undermine those decisions.

## 2011 a good agri year – 2012 to follow suit?

By almost any standards, 2011 was an exceptionally good year for the agri food sector. The headlines: exports rose by about €1 billion to almost €9 billion; aggregate farm incomes were 33% up on 2010, despite very high input costs; farm-gate prices in most sectors were at, or close to, historic highs; and weather conditions, for once, were generally in the farmer's favour. All in all, the year saw a very good start to meeting the Food Harvest 2020 targets.

The export figure of close to €9 billion is a historic high and represents a 25% increase over two years on the somewhat depressed level of exports in 2009. The export surge was led by dairy and meat but encompassed almost all sectors with prepared foods being particularly strong. The figure is, of course, provisional at this stage but, if confirmed, it would indicate that almost 30% of the export target in Food Harvest 2020 has already been achieved.

The CSO advance estimates for aggregate farm income in 2011 indicate

that incomes before land rental and interest rose by about 33% to €2.6 billion and by some 44% when the latter two elements are taken into account. The figures for last year are slightly exaggerated as there was an exceptional carry-over of €125m to €150m in direct payments from 2010 into 2011 because of delayed payments due to the digitalisation of maps. Nevertheless, income levels last year were at record levels in current terms, and - if one discounts 2005 when there was a large double payment of some direct subsidies on the introduction of the Single Farm Payment system - in real terms were at their highest level in the past 15 years. On the basis of the CSO advance figures for aggregate farm income, we estimate that average family farm income last year was about €23,000, an increase of 30% on 2010.

While the importance of direct payments in overall farm income declined somewhat in 2011, on average they remained the single biggest element, particularly in the livestock sectors.



The following table shows the position over the past three years:

Table 1: Direct payments as a % of farm income			
	2009	2010	2011
Direct payments as a % of farm income	120	86	74
Direct payments as a % of farm revenue	27	23	23

When direct payments are excluded, trading farm income last year, excluding depreciation and interest, rose by about 40% to €1.3 billion. The years ahead should see a continuation of good trading conditions and strong returns. Nevertheless, direct payments will remain a critical element. This underlines the crucial importance of the outcome of the current negotiations on the CAP post 2013 (see separate article in this edition).

With one or two notable exceptions, 2011 was a very good year in most sectors. While cattle slaughterings were down about 5% and live exports by over 30%, income in the sector was well up due to a rise of almost 20% in beef prices. Prices in the sheep and pigs sectors rose by 9%, with a similar percentage increase in pig slaughtering and, in contrast to the trend over most of the past decade and a half, a slight increase in sheep throughput. Due to the sharp increase in feed costs (pig feed in the autumn was 25% higher than in the first half of 2010), the profitability of pig production was, however, under pressure throughout the year.

Milk prices at about 34c/litre were at their highest ever level (although in real terms still close to 20% below their level when quotas were introduced). Annual milk output was up about 5%. Due to a sharp reduction of supply in the final quarter in the face of a looming major quota over-run, Irish milk deliveries in the first nine months of this quota year were about level with the quota. While this was a big improvement on the position at the half-year stage, whether it will enable the country to avoid a superlevy penalty will, however, depend on continued very tight production discipline in the remaining period up to the end of March.

Grain growers had an extremely good year in terms of both price and output. Prices at harvest were 6% or so above the very high prices of harvest 2010 and output was up by about 30%, due mainly to very high yields per hectare. In fact, Irish grain prices were higher in 2011 than in any of the past 20 years, with the exception of 2007 when there was an exceptional spike in grain and other commodity prices. In contrast, last year was a very difficult one for potato growers and came after a challenging year also in 2010. Prices fell by over 30% and were back to the level of a decade ago. Many growers saw much, if not all, of their profit disappear.

While markets were generally very strong in most sectors last year, so too were the prices of the main agricultural inputs. Energy, feed and fertiliser costs rose by between 15% and 25%. While these additional costs could be reasonably well absorbed in most sectors, they did bring notable pressure in the pigmeat sector in particular.

#### How is 2012 likely to compare?

The short answer is: probably reasonably well. With so many variables that can influence the outcome, it is always difficult to predict how an agricultural year will pan out. It is particularly perilous to seek to do so in the first months of the New Year. But the omens for 2012 are reasonably promising.

The high cattle prices have carried over into the New Year and cattle supplies are likely to stay tight both in Ireland and the EU. International prices are also strong. Pig and sheep prices are holding up. Feed costs are beginning



At the AIB Agri customer seminar in Fermoy were Donal Cashman, AIB Fermoy; Laurence Shaloo, Teagasc, Moorepark; Tadhg Buckley, AIB Agri Adviser and Karl O'Doherty, Branch Manager AIB Fermoy. AIB hosted 37 Agri customer seminars in 2011 at which they outlined their outlook for the farming sector. The seminars were attended by over 3,500 agri customers.

to come down. While finished cattle prices look set to remain high so too will the price of calves and stores and so margins could remain tight on cattle feeding farms.

Milk prices internationally have been softening somewhat in the past few months and are unlikely to strengthen significantly in the face of increasing supply. It is likely that Irish prices will hold in the first half of the year but could weaken a little in the second half. They should remain, however, quite high by historical standards. With underlying production potential now higher than our quota level, staying within quota will again be a struggle for the industry generally.

As in the case of milk, grain prices have on average also been dropping over the final quarter of 2011. This pattern has not been consistent and there have been periods of strengthening prices within the general downward movement. From the current (late January) vantage point it does look as if prices for this year's harvest will be a bit below last year's levels but still high by the standards of Irish prices over the past decade.

From the point of view of an industry so heavily export-oriented as the food industry, what happens on our main markets is, of course, of critical importance. Obviously, there are serious concerns about the health of many EU markets, both in and outside the Eurozone, and nobody can be definite about when, and in what way, the current crisis will be brought to an end. Our food exports have been very resilient in the face of market uncertainty and we would be hopeful that they will continue their growth in the current year. One helpful by-product of the current difficulties is that the comparative weakening of the euro is improving the competitiveness of our exports.

All in all, we would expect 2012 to be a year of modest agri growth. Exports should continue their movement towards the 2020 target of €12 billion but at a slower pace than last year. Agricultural prices are likely to remain high but down from last year's levels. Feed costs will, however, also be down. Incomes should again improve but the percentage increase will likely be in single figures and, therefore, well below the fairly spectacular outcomes of the previous two years.



## The Irish dairy industry faces great opportunities amid significant challenges

**Joe Gill is Director of Research with Bloxham Stockbrokers and was named the No. 1 Equity Analyst of the Irish food sector in the latest finance survey of institutional investors.**

For the past 29 years, the Irish dairy industry has operated within a quota system that effectively limited production of raw milk to about five billion litres. Over the ensuing period some consolidation among processors has taken place and the number of dairy farmers has contracted, while the value of output from milk factories has increased. The sector now faces a radical shift in its structure and potential performance as the quota system is set to be abolished in 2015. This article discusses the challenges in front of the industry and outlines a number of issues that must be addressed by processors, politicians and farmers as the quota era comes to an end.

In 1983, Ireland and New Zealand produced broadly similar volumes of milk at farm level. Around that time the New Zealand Dairy Board sent a delegation to Ireland on a study tour designed to learn from what was perceived to be a leading global dairy processor. In 1983 the EU introduced quotas for milk as a means of controlling excess production and supporting farm milk prices. Rolling ahead 29 years, Ireland continues to have a quota-based dairy industry. New Zealand, in contrast, had no limits on expansion and they currently produce about 17 billion litres of milk, or three times what is supplied in Ireland.

In New Zealand they adopted an aggressive strategy of consolidation and investment to ensure their future growth. Processing telescoped into one key manufacturer – Fonterra – while average farm sizes grew sharply as farmers focused on leanly produced grass-based milk. In that same period consolidation took place in Ireland. The number of dairy farmers has declined by over 50% in the past 15 years, while a number of mergers occurred too. Waterford and Avonmore combined to form Glanbia. Kerry acquired Golden Vale. Ballyclough and Mitchelstown merged to become Dairygold and Connacht Gold and Lakeland were created in the northern parts of the Republic. Despite these significant changes, the industry in Ireland looks fragmented compared to that of New Zealand or other export dependent dairy countries such as the Netherlands or Denmark.

The abolition of quotas creates scope for an industry-wide debate about how best to develop the sector over the coming decades. How should Ireland set about preparing for a liberalised market and what industry decisions are needed to best support such change? Our view is that a post quota world will be defined by greater levels of volatility in both value and price as commodity markets respond to changing supply and demand patterns across the world. Clearly, rising populations will raise demand for all food products including dairy but supply factors will ebb and flow too based on farming investment plans and weather effects. Combined, these factors will create a turbulent but growing marketplace for Irish milk. It is also probable that the product mix in Ireland will not change dramatically in the next decade with butter, powders and cheese dominating the portfolio. A cursory look at these commodities on world markets over the last four years shows that they are inherently volatile. Against this backdrop we outline here a number of developments that we deem optimal for the sector's growth:

1. **Farm scale must increase.** With an average dairy herd size of just 61, compared to 500 in New Zealand, Ireland's farm structure is too fragmented for the challenge ahead. By scaling up the average size of farms, producers are better equipped to manage the ups and downs in a commodity marketplace by keeping their unit costs at low and efficient levels.
2. **Large processing assets must be built in optimal geographic locations.** Factories that can compete with world leaders are needed in Ireland to ensure an ability to produce high quality bulk dairy products at prices that support export demand. By constructing dryers with efficiencies akin to those in New Zealand, Ireland has the potential to lift output while improving its competitiveness on world markets.
3. **The Irish Dairy Board must be managed as an asset in support of industry investment.** The Irish Dairy Board (IDB) is owned, indirectly, by Irish farmers and exists as a key asset for the industry. Greater efforts are required to structure the IDB in a manner that assists the capital expenditure needs of the sector while preserving the commercial future of the marketing and distribution company itself.
4. **Debt levels should be constrained at farm and factory level as this process unfolds.** A key challenge as this process unfolds is to keep debt levels at farm and factory level low. Given strong market conditions during 2010 and 2011 profitability and income levels in Irish dairying have been relatively high. Associated cash flows must be diverted into reserves that can be tapped to finance on and off farm assets required to handle potential growth in supply. Using excessive levels of debt to provide such expansion would risk financial collapse if dairy markets declined quickly, as was evident as recently as 2009.
5. **Equity investment must be considered very carefully, especially in a co-operative context.** The last great round of expansion in the Irish dairy sector was during the 1970s and 1980s when the EU effectively provided the equity finance needed to finance new processing plants. This time neither the EU nor Irish taxpayers have any funds to support such expansion. Other forms of finance are needed. Equity finance in the co-operative world is hard to generate given the specific attributes of co-op shares (i.e. no potential capital gains). The stock market quoted food companies could access capital this way but would need a strong argument to convince institutional investors about the long-term returns available from processing in Ireland. Devising structures that address these issues will be critical as this process evolves. Forming entities that can generate returns for equity investors in a new generation of dryers will be an important input to growth. Joint ventures could provide such a scenario without compromising the co-operative ethos in the sector.

Ireland stands on the cusp of a new era in its dairy industry and one that will be defined by strong growth in milk production and increasing levels of price volatility. Exploiting the opportunities implicit in that scenario will demand strategic thinking at Government, processor and farm levels. Learning critical lessons from mistakes of the past, and adopting best practices from other parts of the global dairy industry, will be key to optimising the probability of success.



## Economic Outlook

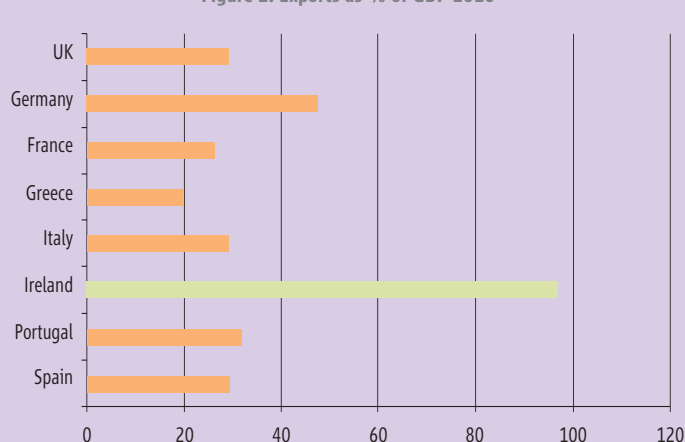
The Irish economy picked up some pace in 2011 with GDP growth averaging 0.7% year-on-year in the first three quarters of the year. However, the recovery in the economy is proving to be uneven in both pace and depth, with output much stronger in the first half of the year. Meanwhile, a two-tier economy is very much in place. The export sector continues to perform strongly, with export growth up an average 1.6% in the first three quarters of the year. This has been reflected in a solid performance by the industrial sector, with the agricultural sector also benefiting strongly from the pick up in demand for Irish goods. Bord Bia recently reported record food and drink exports in 2011, with sales up some 12%. Furthermore, 85% of food and drink exporters were reported as seeing prospects for this year as either good or very good.

As Ireland looks to export its way out of recession, the traded sector has benefited from a significant real internal devaluation, with an 18.5% fall in unit wage costs relative to other industrialised countries seen over the 2009-12 period. Reflecting this improvement in competitiveness, the HICP (eurozone harmonised measure of inflation) in Ireland fell 3.3% in 2009/10, in contrast to a rising HICP rate in many eurozone countries.

As a result of the strong external performance, the balance of payments has moved into surplus, with 2010 recording the first surplus since 1999. The fact that exports are an enormous part of the Irish economy at almost 100% of GDP, and performing well, also marks Ireland out from other periphery eurozone economies. As can be seen in Figure 2 below, the export sector makes up a much smaller proportion of GDP in countries such as Spain, Portugal, Italy and Greece. These countries also continue to have big current account deficits. Ireland, meanwhile, remains a key location for Foreign Direct Investment (FDI), with recent reports from the IDA showing that 13,000 new jobs were created from FDI in 2011. This is up 20% on 2010, with a 17% increase seen in the number of investments.

The domestic side of the Irish economy, however, remains very weak with consumer and Government spending, as well as construction activity, all continuing to decline in 2011 and likely to do so again in 2012. While this part of the economy has undergone a huge adjustment process over the last 3-4 years, de-leveraging by households and the banking sector, as well as major fiscal tightening and a continued slump in construction activity all continue to weigh on the domestic economy.

Figure 2: Exports as % of GDP 2010



Source: Thomson Datastream

Meanwhile, the labour market, although showing signs of stabilising, is weak and looks set to remain so for some time yet. On the plus side though, the rate of contraction in this sector has eased considerably. Domestic demand contracted by some 3.5% in 2011 after falls of 5% in 2010 and 12.5% in 2009. It is forecast to fall by around 2.5% in 2012 before turning flat in 2013. Thus, as we move forward in terms of the recovery process, the drag from the domestic economy is abating. Indeed, even as it currently stands the strong rate of growth in the export sector is now more than offsetting weak domestic demand, ensuring a return to growth for the economy as a whole.

Underpinned by this strong external performance, GDP growth of 0.5% is anticipated for 2011 as a whole. Growth is forecast to pick up to 1.0% this year and 2.2% in 2013, though the ongoing fragile recovery in the global economy, as well as the eurozone sovereign debt crisis, do pose downside risks to these forecasts.

Table 2: Economic Forecast – Ireland

Annual % Change Unless Otherwise Stated				
	2010 (e)	2011(f)	2012(f)	2013 (f)
Real GDP	-0.4	0.5	1.0	2.2
Real GNP	0.3	-1.3	0.5	1.5
Consumer Spending	-0.8	-3.0	-1.2	0.0
Government Spending	-3.8	-3.2	-2.5	-2.0
Fixed Investment	-24.9	-15.0	-5.0	2.0
Exports	6.3	4.0	2.7	4.0
Imports	2.7	0.0	0.3	2.5
HICP (%)	-1.6	1.2	1.9	1.5
Unemployment (%)	13.6	14.4	14.6	14.4
General Govt. Deficit (as % of GDP)	31.3*	10.1	8.6	7.5

\* Includes full upfront support to parts of the banking sector

Source: AIB Economic Research Unit



Overall Male Champion at the National Charolais Show was 'Royal Descartes' shown by Leigh Foley for his father Kevin, Inchiquinn, Killeagh, Co. Cork with Eamonn O'Reilly, Agri Adviser AIB, class sponsor.



# Profitable Farm Expansion

**Tadhg Buckley, Agri Adviser, outlines the key considerations to take into account prior to expansion.**

The capacity of the agri-food sector to expand was recognised in the Food Harvest 2020 report and our expectation is that on-farm investment will increase over the medium-term. As we discuss in our Review and Outlook article, 2011 has proven to be one of the most profitable years for most farm sectors and has led to a very positive sentiment in the sector. When planning on-farm investment it is unwise to base any investment decision on the performance of the farm in a very good year or indeed a very bad year. We advise farmers to take a multi-annual view of their farms and examine the performance over the previous 3-5 years, accounting for variances in profitability.

The key driver of expansion is to increase the profitability of the farm. It is, therefore, worth asking the question prior to embarking on expansion: what is the proposed expansion worth to the business? In order to achieve profitable farm expansion there are a number of key conditions that need to be met. While in this article we will look closely at the dairy sector (which in 2015 will be given the first major opportunity to expand production in over 30 years), these considerations are applicable to other farm sectors.

## Considerations prior to expansion

### 1. Low variable cost base

The competitive position of your existing business prior to expansion is vital in achieving profitable expansion. For a dairy business, the level of variable costs in particular is the key. Expansion should allow a farmer to reduce his/her unit fixed cost as the fixed cost base is spread over a larger production base. However, variable costs are likely to increase in line with production – therefore, they need to be at a competitive level prior to commencing expansion.

George Ramsbottom of Teagasc recently carried out an analysis of the benefits of expansion for low cost (LC), average cost (AC) and high cost (HC) dairy farmers. The following table is based on the 2010 National Farm Survey and shows the financial performance of the three categories:

Table 3: Financial performance of dairy farmers			
€/cow	Top 1/3 (LC)	Middle 1/3 (AC)	Bottom 1/3 (HC)
Gross output	1,631	1,556	1,390
Variable costs	495	591	709
Fixed costs	520	540	591
Net Margin	615	424	- 90

As illustrated in the above table there is a substantial difference in net margin between low cost, average cost and high cost enterprises. This is driven by a combination of the difference in gross output (€/cow) and variable costs (€/cow).

### 2. Stocking rate on milk production platform

In order to expand efficiently, in particular for Spring-milk systems, grazed grass will need to continue to form the vast bulk of the dairy cow's diet. Therefore, the milk production platform available will have a major influence on how much a dairy farmer can expand on a profitable basis. For any business there is a level beyond which it is unprofitable to further expand i.e. law of diminishing returns. When assessing a dairy farmer's business, this principle is most appropriately tested by examining the stocking rate on the milking platform.

### 3. Infrastructural cost of expansion

Another major consideration is the capital expenditure required to achieve the proposed expansion. In terms of a dairy farm, the main areas of capital expenditure are milking facilities, wintering accommodation and milk quota (pre-2015). In some cases farmers future-proofed their business over the past five years by installing capacity beyond their current requirements. This was done in the knowledge that they would be expanding output in

the medium-term. For others, a substantial revamp of milking facilities or additional slurry storage may have to be constructed in order to expand. The cost of expansion will vary greatly in these two different scenarios.

### 4 Age profile and potential successor

It is likely to take 10 years or more to see the full benefits of substantial expansion. In addition, the initial expansion phase is likely to involve a heavier workload for the farmer. When considering expansion the farmer in question must take a long-term view of the enterprise examining:

- The long-term plan for the operation
- If a likely successor has been identified
- If there will be significant off-farm financial demands on the business in the intervening period (such as family education costs)

### Financial benefits from expansion

In the case of increasing cow numbers, the cost of expansion can range from €2,000/cow to €6,000/cow depending on the level of investment required. If we take, for example, a 6% fixed interest rate with a 10-year repayment schedule the annual cost of expansion/cow is as follows:

Cost/cow	Repayment/cow/year
€2,000	€274
€4,000	€548
€6,000	€822

It should be noted that the additional net margin/cow will be higher on the additional cows under expansion than the farmer's current net margin/cow as fixed costs will not increase in line with expansion. George Ramsbottom has done further work on this, assuming that on expansion, variable costs/cow increase in line with increased production while fixed costs increase by 50% of the production increase. The following table projects the residual net margin per extra cow based on an expansion cost of €2k, €4k and €6k/cow.

Table 4: Projected residual net margin per cow based on expansion cost			
€/cow	Top 1/3 (LC)	Middle 1/3 (AC)	Bottom 1/3 (HC)
Additional net margin/cow (from expansion - no investment)	876	695	385
Residual/cow (€2k investment)	602	421	111
Residual/cow (€4k investment)	328	147	-163
Residual/cow (€6k investment)	54	-127	-437

*Note: All of the above calculations exclude the cost of quota. If expansion is planned prior to 2015 and quota must be purchased based on the above calculations, the bottom 1/3 of producers could not justify any expansion.*

As this table shows, the highest cost producers can just about justify an investment of €2k/cow while the lowest cost producers can justify up to triple that investment. Obviously, every case will be different as the cost of capital expenditure will vary. However, the key message remains the same – based on the above calculations only the top 1/3 of dairy farmers could justify expansion with a significant per cow cost.

### Conclusion

As Irish agriculture is now more exposed to the influence of world markets, volatility is a phenomenon that we are likely to experience more of in the future. Managing volatility will be a key component in any future farm expansion plans. As such, proper financial planning will be required prior to expansion, with expansion plans stress tested for periods of depressed commodity prices.

Prior to embarking on any expansion there are a number of factors that need to be taken into consideration. As analysis from George Ramsbottom of Teagasc shows, high-cost producers will find it difficult to make a positive return from high cost expansion.