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Learning Series - #20

Making sense of the farming industry

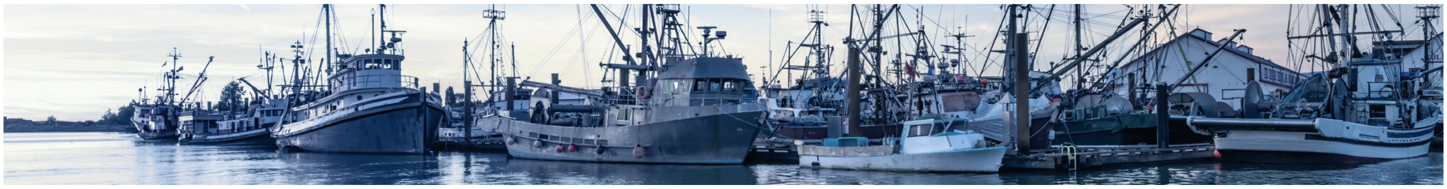
In Canada, supply management is a way for farmers to control, through a marketing system, the supply or quantity of their commercial products. In order to market their products, producers must hold ***quota*** without which they would not be able to sell their products. Each commodity is governed by its own elected provincial marketing board according to provincial legislation and regulations.

What is a Quota?

- A license/permit to produce (production quotas) and/or market (marketing quotas) a supply-managed commodity (dairy, poultry, eggs, fish and in Quebec, maple syrup)
- Represents a share of a market
- Quantity allotments restrict what a farmer can produce or market

What is the value of quota?

- The value of quota is what a buyer and seller negotiate. The quota exchanges are an indicator of that value.
- Sales quota vary by industry
  - In the ***dairy industry***, sales are negotiated in daily kg of butterfat produced - the equivalent of one cow's production.
  - In the ***poultry industry***, quota is sold by units produced or square meters of floor space.
  - The ***fishing industry*** has catch quotas.



The future value of quota and its associated risk is unpredictable and difficult to evaluate.

The farm's revenue, its cost of production, the desired pay-back period and interest rate are required for an economic analysis of the value of quota. Without knowing the cost of production, a reliable value of quota and profitability for any individual farm, is difficult to calculate. The use of industry averages doesn't provide a true picture of an individual farm's profit and affordability of quota.

Simplified example for underwriting purposes

- For a Quebec dairy farm with 75 cows, quota alone can represent an investment of $1.80 million. If the farmer has 75 milk quotas, they are worth $1.80 million (75 multiplied by $24K, where $24K is the monthly milk exchange quota for this province).

  For current prices of dairy quota by province, check Agriculture Canada's website

- Note: Quota is not necessarily related to a farm's number of cows. (i.e a farm has 90 cows but only 75 are producing milk, the remaining 15 cows are still an asset)

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Making sense of the farming industry (cont'd)

Underwriting considerations

1) Farmers tend to have a low cost of living and can write off many costs (gas, utilities, maintenance, insurance, cars, equipment depreciation etc). Most rely on credit which is backed by the value of their assets. The value of a farm can therefore appear to be low on financial statements and usual income replacement multipliers are not appropriate or may have to be modified. Farmers also frequently redirect profits back into the farm.
2) The cash flow statement tracks the sources and uses of cash in the past year. It also adds insight to the understanding of financial position and performance of the farm business.
3) Farmland
   - Its original/historical cost is listed on the balance sheet and not its current market value. Buildings and equipment are recorded at their depreciated value. Most of the farmers' net worth is caught up in land values rather than cash liquidity.
   - Lands close to growing cities are often very valuable. Parts of it can be sold for re-development (office complex, mall, housing, etc).
   - Land ownership can roll to children or spouse tax free upon the death of the owner.
   - Tax rolls and online real estate listings can provide good estimates of their current value.
4) Quota is a very valuable asset because it can be sold or leased.
5) Life insurance strategies for farmers:
   - Farm families commonly use life insurance to equalize inheritance/ estate as not all heirs may want to take over the farm. Through its non-taxable death benefit, life insurance can ensure non-farming siblings will get an equal share of the estate.
   - Permanent life insurance policies can be leveraged. The policy is collaterally assigned to a bank to establish a line of credit. Loan advances will recoup the yearly premiums and will be used to (re)purchase investments or (re)invest in the business.

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