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Learning Series - #20

Making sense of the Farming Industry

In Canada, **supply management** is a national agricultural policy that enables farmers to control the quantity of their products, particularly in the dairy, poultry, and egg sectors. This system requires producers to hold a **quota**, which is essential for marketing their goods. Each commodity is regulated by its own elected provincial marketing board, operating under specific provincial legislation. Producers operating small farms with products intended for personal consumption are often exempt from these regulations.

Canada boasts a diverse range of agricultural industries that vary by region due to distinct climates and available land. In Eastern Canada (e.g., Ontario, Quebec, Atlantic provinces), notable industries include dairy production, horticulture (fruits and vegetables), and maple syrup from Quebec. The dairy industry is particularly significant, with approximately 10,000 dairy farms contributing to a $6.56 billion industry.In Western Canada (e.g., Alberta, Saskatchewan, Manitoba), agriculture is dominated by grain production (wheat, barley), oilseeds (canola), and significant cattle and pork industries. Alberta leads in beef cattle operations, with around 55,000 beef farms across Canada.

What is a Quota?

It's a license or permit that allows farmers to produce or market supply-managed commodities such as dairy, poultry, eggs, fish, and maple syrup in Quebec. It represents a share of the market, with quantity allotments limiting how much a farmer can produce or sell.

Sales quotas differ by industry:

- In the **dairy industry**, quotas are often negotiated based on daily kilograms of butterfat produced.
- In the **poultry sector**, quotas are sold based on units produced or square meters of floor space.
- The **fishing industry** operates with catch quotas.

Dairy Quota System

The **dairy quota system** in Canada plays a vital role in managing milk production effectively. Quotas are allocated to establish specific production limits, promoting market stability and fair pricing for producers.

What is a Dairy Quota?

- A dairy quota allows farmers to produce a specified amount of milk, typically measured in kilograms of butterfat. This quota is essential for maintaining fair prices and market stability.
- Each province receives a share of national production allocations determined by agencies like the Canadian Dairy Commission (CDC), which are then distributed among farmers according to established policies.

Example of Quota Valuation

For instance, consider a Quebec dairy farm with a quota for producing 1,000 liters of milk:

- **Butterfat Content Calculation**: Assuming 1 liter contains about 3.6% butterfat:
  - Butterfat in 1000L milk = 1000 × 0.036=36 kg
- **Cost Calculation**: If the price per kilogram of butterfat is approximately $24,000:
  - Total Cost= Butterfat Content × Price per kg=36 kg × 24,000= $864,000

Thus, the estimated cost for a quota allowing production of 1,000 liters would be around $864,000.

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Understanding quota costs

- The initial investment of $864,000 from the above example, reflects the market value at that time and is not an ongoing expense.
- Monthly production limits allow farmers to produce up to their quota without direct fees associated with it.

How many cows are needed to produce 1,000 liters of milk?

- High-yielding dairy cows typically produce around 25 to 30 liters per day, with some reaching up to 60 liters during peak lactation.
- The average butterfat production per cow ranges from 0.9 to 1.2 kilograms daily.

Quota allocation process

1. **Stakeholder consultation**: Provincial marketing boards engage with stakeholders to assess market needs.
2. **Production monitoring**: Farmers are compensated only for milk produced within their allocated quotas; excess production may not be paid but can be sold to processing plants.
3. **Production flexibility**: Farmers can manage daily fluctuations while adhering to monthly quotas.
4. **Reallocation mechanism**: Unutilized portions may be temporarily allocated to other farmers.

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

Note: The dairy quota is not directly related to the number of cows on a farm. For instance, a farm may have 100 cows, but if only 75 are producing milk, the remaining 25 cows still represent valuable assets.

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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 rather than its current market value. Buildings and equipment are recorded at their depreciated value. Most farmers' net worth is tied up in land values rather than cash liquidity.
   - Lands close to growing cities are often very valuable. Parts can be sold for redevelopment (office complex, mall, housing).
   - Land ownership can transfer tax-free to children or spouses upon death.
   - Tax rolls and online real estate listings can provide good estimates of 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 receive an equal share of the estate.
   - Permanent life insurance policies can be leveraged; policies can be collaterally assigned to banks to establish lines of credit. Loan advances will recoup yearly premiums and will be used to (re) purchase investments or (re)invest in business operations.

6) Farms without supply management (e.g., beef and pork industries, crop farms) face greater exposure to market fluctuations. They must navigate unpredictable commodity prices influenced by market demand and external conditions.

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Appendix – Information available via financial statements

Farm's revenues:

Items included	Items not included
• Sales from farm production • Gains/losses from hedging strategies • Crop insurance payments	• Government program payments (except crop insurance) • Earnings on investments • Gains/losses on disposals • Off-farm work • Other non-farm income

Farm's expenses:

Category	Breakdown	Examples
Operating costs	Cost of goods sold	• converting seeds into forage, grain and produce. • transforming offspring into meat, eggs or dairy products.
	Direct operation expenses	• operational labor • fuel • custom work • repairs & maintenance, small tools, and supplies • utilities • transportation costs
	Overhead expenses (or fixed costs)	• office and administrative expenses, advertising, and promotion • staff salaries • insurance, and professional fees
Financing costs	Capital related costs (depreciation/amortization)	• the depreciation and amortization of machinery and buildings • leasing & rental costs of capital assets • land clearing costs. • property taxes.
	Interest on financing	• include gains/losses on sales of capital or investments in the 'other income and expenses' section of the financial statement

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