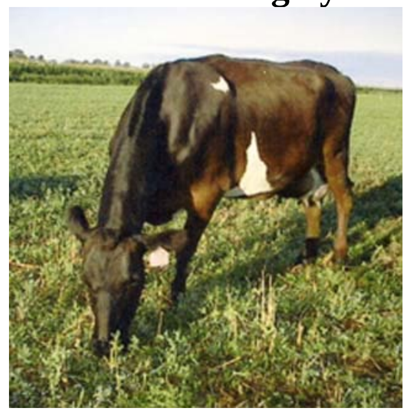
Natural Resources Conservation Service
Conservation Information
Michigan

Capital Management Issues with the Transition to Grazing Systems



There are costs to install and start-up operations when implementing grazing practices. Establishing pastures and fencing to provide paddocks for grazing in rotation are major start-up costs. The transition to a grazing system alters labor and management, as well as changes equipment and machinery needs. With the change to a grass/forage-based feeding program, some field crop machinery is no longer needed. “Dumping Iron” refers to the sale or liquidation of equipment.

Sometimes, individuals getting into grazing hold on to equipment “just in case.” This holding of machinery for risk management adds extra financial stress to the transition to grazing. Holding unused equipment forces the income from grazing to support the cost of depreciation and interest on the equipment and puts pressure on cash flow needed for a successful transition to grazing.

<u>Internal Rate of Return (IRR)</u> is the compounded interest rate the assets will return. Expenses for capital items that do not generate income cause a negative effect on IRR. The costs of holding on to unused equipment or machinery reduce IRR. If the IRR is less (you earn less return) than the cost of borrowing, it is not profitable to borrow for capital purchases. When the cost of borrowing money and internal rate of return are equal, the investment will break even. Profitability and IRR are enhanced when there is less debt to service.

If the farm has purchased something or owns something not used by the grazing animals that does not generate its own income; then the grazing animals have to pay for it. Debt becomes a weight on the animal and a drag on IRR. An animal can only stand (generate enough income) to service a certain amount of capital purchases or debt. That is why you often see analysis or discussions on “acceptable levels of debt per animal.” Dumping Iron enhances the profitability and reduces financial stress during the transition to grazing.

Case Study - Dumping Iron

The purpose of this case study is to look at the decisions that were made regarding the cattle and machinery capital assets and to show the importance of management decisions about these capital assets when considering implementing a grazing plan.

Resource Setting

Triple H Farms in Clinton County is owned and operated by Howard and Mary Jo Straub who have farmed at their present location since 1972. The Straub's ran a confined dairy operation until 1994, when they started using rotational grazing. The herd is seasonal and they have 132 acres of pasture. All replacement animals are raised on the farm. The study is about decisions they made ten years ago.

Howard and Mary Jo Straub with their daughter Terry

The Straubs participate in the Dairy Farm Business Summary, a software program from Cornell Cooperative Extension that provides financial analysis. The summary output includes helpful information on returns to assets and profitability. Howard says the report is good information that lets you know what the farm actually made.

Problems/Opportunities

The decision to be seasonal meant the breeding and culling had to be adjusted to get to the target seasonal dates. With the start of grazing, some machinery was not needed. Selling equipment would affect their income taxes because of recapture of depreciation and capital gains. The problem was to liquidate the equipment in a manner that was the most advantageous to minimize tax consequences.

Solutions/Actions Taken

With breeding management and culling, it took four years to get the herd to a seasonal calving rotation. Cows culled for breeding dates out of the seasonal goal were sold to other dairy farms.

They sold some production equipment in 1994. They marketed the equipment over time offering it for sale before the time of year it would be used. A few pieces of equipment not needed for grazing were leased until it came off the tax depreciation schedule. A local bookkeeping service was used to provide a computer generated payment schedule and leases. These lease arrangements allowed them to liquidate capital assets (dump iron) in a timely and organized way. The Straubs utilized custom hire for baling of hay rather than purchase equipment.

Results

The recapture of depreciation on taxes was avoided through the utilization of leases. Cash flow was enhanced by the sale and lease of equipment. They took the time and effort to market and lease machinery. The Straubs went into the decision to dump iron with an attitude that if they later found they needed to buy equipment, they could always buy it. Howard said, "If you do not use it, sell it." With this thinking, they were able to avoid making the grazing operation pay for unneeded equipment. It took three years to have all the equipment gone. It is important to seek tax council and do some financial analysis that allows for the sale of equipment with the minimum extra losses or expenses. Recently, they did make the decision to purchase some hay equipment instead of custom hire.