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Squire Patton Boggs has more than 100 lawyers in 25 offices across the US, UK, Europe, Middle East, Asia Pacific and South America working on both domestic and cross-border cases and restructurings. Our UK practice covers all formal categories of insolvency ranging from all forms of receivership, administration and liquidation to bankruptcy and voluntary arrangements. We also have a specialist contentious team. Our clients include clearing banks, asset based lenders, the major accountancy firms and insolvency practitioners and we have particularly strong sector experience in the fields of retail, media and leisure insolvencies, as well as pensions-related insolvency issues.

In Practice

Author Jennifer Moore

The real cost of a pint of milk

KEY POINTS

- The fortunes of agricultural businesses have always been vulnerable to natural and economic forces such as climate change, world commodity pricing and exchange rate movement;
- Nowhere is this more evident today than in the current crisis facing the UK dairy farming industry, where the unique political and environmental conditions of 2014 have driven milk prices down to some of the lowest levels seen in recent years;
- This perfect storm is testing the viability of many of the UK's dairy farmers, leading to the possibility of an increase in agricultural insolvencies to come.

MILK PRICING

At its most basic level, the current milk pricing crisis stems from an imbalance in supply and demand in the global dairy market. Last year saw a previously unseen reduction in demand for globally traded dairy products from two major players: China and Russia. Firstly, China's demand for the period 2013/14 fell well below expectations. This was then compounded by the one-year import ban on dairy products implemented by Russia in August 2014. It is estimated that between them, China and Russia account for around 30% of the global market in dairy products and that the loss of the Russian market alone may have already cost the UK dairy farming industry as much as £350m.

Had this sharp fall in demand occurred in isolation it would have been problematic, but fatefully it coincided with a time of high production due to near perfect weather conditions and low input costs for feed, fertiliser and fuel. This was further exacerbated by the fact that many producers had deliberately increased production levels in response to the unusually high milk prices seen in late 2013. Unfortunately, production capacity cannot match the speed and extremity of the recent fluctuations in milk price, leaving dairy farmers playing a game of catch up with regard to appropriate production levels in such a volatile market, meaning production in the UK increased by over 8% last year at a time of falling demand.

Unsurprisingly, such a sharp fall in demand against a background of rising supply has created significant downward pressure on milk prices. In December 2014, the average price of milk offered to UK farmers was 27.85p per litre (which was an 18.7% decrease on the December 2013 price). Production costs were 30p per litre for the same period, according to the National Farmers Union.

AGRICULTURAL INSOLVENCIES

Milk price heavily influences business profitability and as such, it is widely accepted as one of the key economic indicators for the dairy industry. As a result of this, confidence in the dairy sector is low and stakeholders in the industry will begin to look closely at their investments.

The number of dairy farmers in the UK has been steadily falling for the last 20 years. In 1995, there were 35,741 dairy producers in the UK and 2015 is predicted to be the year where numbers dip below 10,000 for the first time. What is unclear, however, is what proportion of farmers exiting the sector are doing so as a result of the failure of their business and importantly, whether this figure increased during the preceding year.

This is largely because dairy producers in the UK come in all shapes, sizes and business structures, many of which are not monitored with regard to insolvency regimes. There are proportionally more SMEs in UK dairy farming, with high numbers of family enterprises, sole traders and partnerships. While current insolvency statistics do record personal insolvencies, they do not adequately cover unincorporated partnerships. Similarly, they do not record the vast numbers of asset-poor tenant farmers who will simply give up their tenancies or farms where the value is all in the land and any enforcement action would normally be limited to repossession and the appointment of an LPA receiver.

The overall picture in relation to the number of insolvencies in the agriculture sector as a whole may be woefully incomplete, but they are occurring and the dairy sector looks set to be the next pressure point given the current milk pricing crisis. As agriculture is a specialist industry, stakeholders need to be alive to the fact that when agricultural insolvencies do occur, they can present specific issues on enforcement which can make possession proceedings or trading the business an unattractive option, particularly with regard to animal welfare and environmental and health and safety concerns.

The breadth of security a farm can grant to leverage its assets is impressive. If the business owns freehold land then a legal charge may be given, but as many farming businesses are family operations, if a matrimonial home is involved then there are circumstances where a spouse can challenge the charge or resist claims for possession.

If the farmer in question is a tenant farmer, occupying land under an Agricultural Holdings Act Tenancy (pre 1996) or Farming Business Tenancy (post 1996), then there is likely to be little value in the farmer's interest in the land for security purposes and lenders will need to look to other assets for security.

Other types of security frequently seen in the farming industry are guarantees (from both corporates and individuals) and debentures (the sole preserve of corporates). However, they potentially leave a hole in a lender's security net in relation to farming enterprises run as sole traders and partnerships, which traditionally comprise the majority of the farming sector. This was addressed by the Agricultural Credits Act 1928 (ACA), which introduced agricultural charges – which are unique to the farming industry. It is essentially a form of debenture that can only be granted by a farmer who is not an incorporated company and enables a farmer to grant fixed and floating charges over

In Practice

Biog box

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stock, such as crops, horticultural produce, livestock and agricultural vehicles and plant.

Where appropriate, they also extend to a tenant's right to compensation under the Agricultural Holdings Act 1986, in relation to improvements, damage by game, disturbance and other tenant rights (which would capture compensation payable on the milk quota). There are, however, specific exclusions to the scope of agricultural charges including:

- chemical fertiliser (this does not extend to manures);
- land;
- milk quota (excluding the compensatory rights noted above); and
- leased assets;

Subsidies under the Single Payment Scheme, which ended in December 2014, are excluded; it is therefore reasonable to assume that those under its replacement, the Basic Payment Scheme, will be as well (although specific security could be taken to capture this). Interestingly, any such subsidies due to a corporate would be caught by a debenture.

Agricultural charges require registration with the Agricultural Credits Department of the Land Charges Registry within seven days to be enforceable against third parties. Uniquely in relation to fixed charge assets, under an agricultural charge a farmer is free to deal with the assets, providing he accounts to the lender for the proceeds. Further, any livestock and crops bought in substitution to those owned at the time the charge was taken will form part of the fixed charged assets recognising the unique needs of the farming industry.

Agricultural charges are prevalent in the dairy sector and over the next 12 months lenders will have to become more familiar with their quirks before contemplating enforcement.

OUTLOOK FOR 2015

This year will see various reforms to the EU Common Agricultural Policy (CAP) come into force. It is anticipated that the abolition of the EU milk quota on 31 March 2015 will result in at least a short term increase in milk production. This is likely to be led by countries such as Germany and the Netherlands, which have the existing infrastructure in place to produce above their existing quota levels, and Ireland, which has traditionally produced within 0.5% of its national quota (unlike the UK where production has been consistently approximately 10% below quota) and has set a target to increase milk production by 50% by 2020.

If demand remains static, any such increase in milk production will ultimately place a further unwelcome squeeze on milk prices, which will hit the less efficient dairy farms hard, particularly those who are already struggling to deal with the current depressed milk prices. However, the Russian trade ban is due to end in August 2015 and if demand from China were to also recover, then the resulting combined increase could alleviate the predicted downward pressure on milk pricing upon the quota being lifted.

There is also strong support for further reforms to the EU CAP to safeguard the UK's dairy industry. Currently, under the EU CAP, the UK government can only intervene to buy milk if the price falls below 17p per litre. In January 2015, the Environment, Food and Rural Affairs Committee recommended that the current intervention rules be reviewed before the abolition of the milk quota, which could conceivably result in a scenario where intervention became necessary due to a market flooded with cheap milk. It remains to be seen over the coming months whether any commitment to raising the intervention price will be secured at EU level. If this was possible, it could be fundamental in preventing many dairy farmers going out of business in the eventuality that prices were driven down to untenable levels.

Elsewhere, the already shrinking margins of UK producers are coming under increased pressure from the supermarket price wars, with the major discounters forcing prices below that of bottled water. This is problematic for the UK in a global market where milk can already be offered at a bargain basement price of 16p per litre by some of the Baltic states.

The current UK parliament is due to end in May 2015 and the months following a general election are notoriously uncertain for industry as a whole while the dust settles and the new government begins to implement campaign policies; this could indirectly put added pressure on an already weakened dairy sector in areas such as taxation and input costs.

CONCLUSION

This year looks set to be a period of unprecedented uncertainty and change for the UK's dairy farmers, particularly with regard to how the reforms to the EU CAP will affect milk pricing. Even though volatility has become the hallmark of milk pricing in the last few years, it seems unlikely that milk prices will stabilise anytime within the next 12 months in what can only be described as an unsettled political and economic landscape, making forward planning difficult for the industry as a whole.

Casualties will be inevitable with greater numbers ultimately exiting the sector either by choice or necessity, particularly at the SME end of the scale where it will be difficult for producers to capitalise on potential export opportunities and be internationally competitive at a lower milk price. Particularly at risk will be those farms that invested heavily during the past two years in response to the then rising global demand and prices, and tenant farmers who had rents set while the going was good in the latter half of 2013.

It would certainly seem that only producers who are able to operate profitably at a lower milk price and react quickly and dynamically to market developments, through strategies such as diversification, will prosper during the coming year. It will be important for farming businesses and stakeholders alike to be proactive in fully understanding how the changes to the EU CAP will affect them.

However, we should not lose sight of the fact that worldwide demand for dairy products is expected to continue to grow at approximately 2-3% a year; so, for those who can successfully weather the volatility that has become synonymous with the industry over the last few years, current short term difficulties will hopefully be replaced by opportunity in the long term.