

1st International Seminar (Ecuador)

Designing Profitable Dairy Businesses for the Next Decade



**1ER SEMINARIO
INTERNACIONAL**
DISEÑANDO NEGOCIOS
LECHEROS RENTABLES PARA
LA PRÓXIMA DÉCADA

Things the most successful farmers (and their advisors) get right

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Things the most successful farmers and their advisors get right

1. They think big
2. They have well considered goals
3. They use the whole farm approach
4. They distinguish between cash, profit and wealth to judge business performance
5. They understand growth, gearing and the principle of increasing financial risk
6. They know their costs
7. They know how to sensibly value farm assets
8. They understand that risk creates return
9. They appreciate that uncertainty is trumps

Things the most successful farmers and their advisors get right continued...

10. They pursue continual improvement...the Status Quo is not an option
11. They know that the quality of management is the key
12. They understand there are few (if any) economies of scale, and that any economies of size are often eroded by diseconomies of size
13. They recognise that growth and intensification increases mean and variance of profits
14. They reject unsound advice based on average technical ratios
15. They compare themselves with themselves
16. They make good decisions
17. They keep their business afloat

They think big

They understand what is happening beyond the farm gate – in the macro economy – in regards exchange rates, inflation, the markets for inputs they use and the outputs they sell

They do not think the same about the state of what is, and what could be, as their fellow farmers and competitors

They recognise that if things are good they can only get worse, and if things are bad they can only get better...and act accordingly

They understand the difference between real and nominal values and so avoid the trap of 'money illusion'...only real gains matter!

The big challenges for people in agriculture are remaining profitable in the face of continuous changes in prices, costs, weather, trading conditions...along with a plague of farm economic illiteracy and the growth of pseudo-science and anti-science and anti-economics

They have well-considered goals

Goals refers to imagining alternative futures and identifying which future is the one for the farm family and the farm business

“If you don’t know where you want to go then any road will get you there...”

This means identifying goals is critical, and, equally important, identifying the trade-offs that always exist between alternative goals, weighing them, balancing the aspirational and the achievable and their associated risks

They use the whole farm approach

The best farmers (and advisors) avoid the common mistake of decision-makers of seeing the problem/decision only in part. These farmers (and advisors) are masters of information and they pull all the bits of the system together...in their head and on the ground.

The whole farm approach is based on several key steps, which draw upon an understanding of several key principles. The key steps are:

- Start with the farm family and their values
- Understand the internal operating environment in terms of available resources (including biophysical, financial and people), including the quality of resources and the way and how well resources are being combined
- Understand the external operating environment in terms of external influences on decision-making and resource allocation

They distinguish between cash, profit and wealth to judge business performance

Assessing the performance of the farm business, past, present and future using only one of these three measures does not tell the full story

All three are needed:

- ❑ Cash flow tells if the business can pay its bills, including servicing debt
- ❑ Profit tells if the business is any good or not i.e. if it is a good use of the capital that is invested in it
- ❑ Wealth tells if the business is contributing to the goal of creating choices...wealth is the means to this end

They understand growth, gearing and the principle of increasing financial risk

'A crisis takes longer to arrive than you thought it would and arrives more quickly than you have expected'

The relation between debt and equity and total capital and debt servicing is the key to business survival and growth

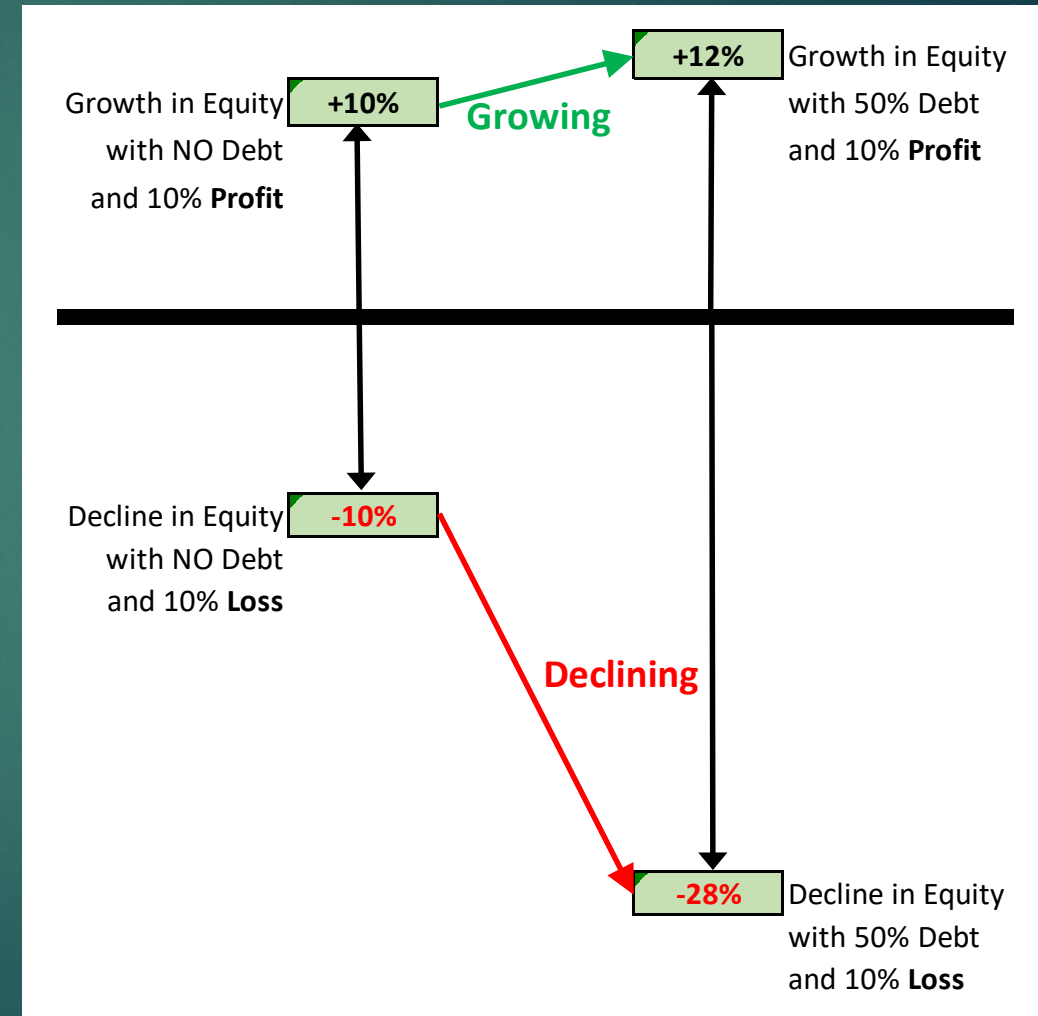
The key principle is that if things go well then higher debt can mean equity grows more quickly than not having debt BUT if they go poorly then equity (net worth) is eroded even more rapidly than it would have grown when things went well...hence 'increasing financial risk'

One common characteristic of farmers who build wealth over time, is that they have the principle of increasing financial risk working for them and not against them

They understand growth, gearing and the principle of increasing financial risk

Principle of increasing financial risk

	Case A	Case B
Assets	\$ 10,000,000	\$ 10,000,000
Equity	\$ 10,000,000	\$ 5,000,000
Debt	\$ 0	\$ 5,000,000
Operating Profit	\$ 1,000,000	\$ 1,000,000
Return on Capital	10.0 %	10.0 %
Interest on Debt at 8.0%	\$ 0	\$ 400,000
Net Profit	\$ 1,000,000	\$ 600,000
Return on Equity	10.0 %	12.0 %
Tax	\$ 0	\$ 0
Consumption	\$ 0	\$ 0
Growth	\$ 1,000,000	\$ 600,000
Growth Rate	10.0 %	12.0 %
Operating Profit	-\$ 1,000,000	-\$ 1,000,000
Return on Capital	-10.0 %	-10.0 %
Interest on Debt at 8.0%	\$ 0	\$ 400,000
Net Profit	-\$ 1,000,000	-\$ 1,400,000
Return on Equity	-10.0 %	-28.0 %
Tax	\$ 0	\$ 0
Consumption	\$ 0	\$ 0
Growth	-\$ 1,000,000	-\$ 1,400,000
Growth Rate	-10.0 %	-28.0 %



They know their costs

All costs are measures of opportunities given up

Another form of cost are the 'hidden' costs of depreciation of assets...hidden because they are not annual cash costs

Depreciation of livestock capital from aging is 'hidden'...as can be the impact of increased culling rates

The relevant costs are marginal (additional) costs, not average costs of production

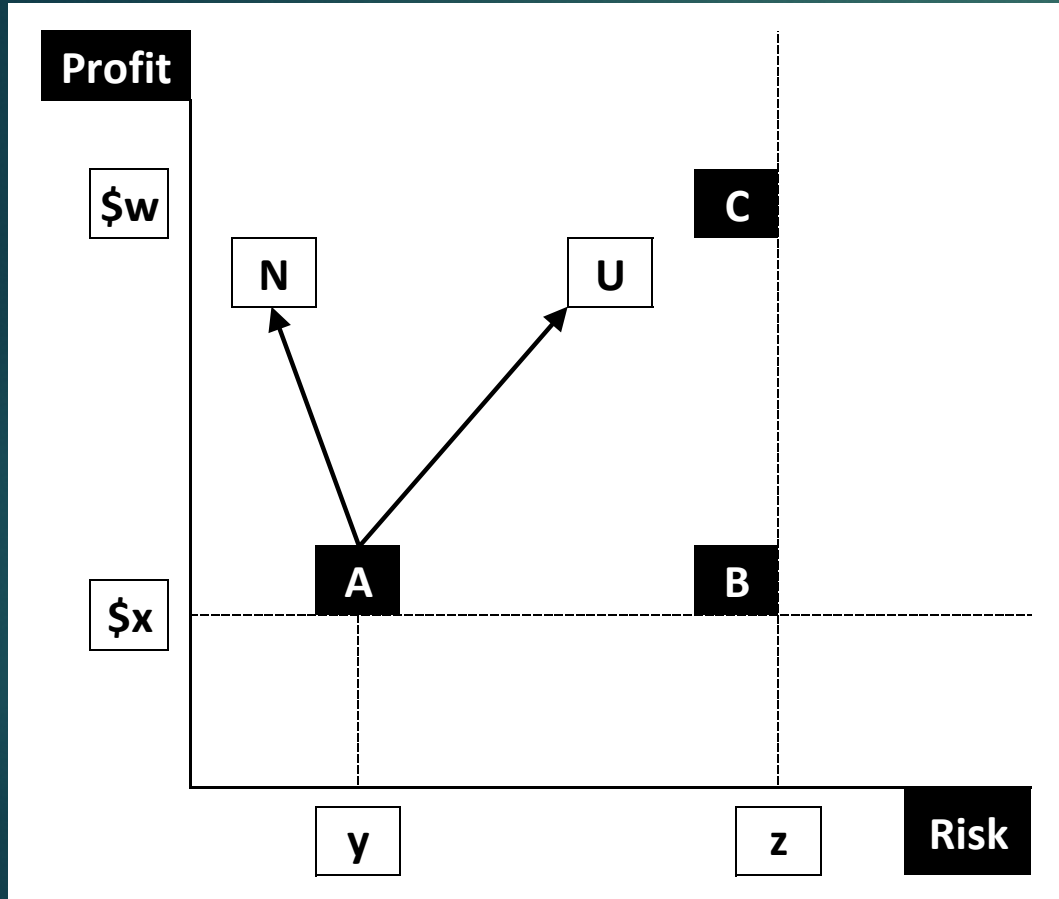
They know how to sensibly value farm assets

The economic value of a capital asset is determined by what this asset will earn over its lifetime, and the rate of return on capital that the person doing the valuing is happy to accept for capital they invest

A powerful concept is called '**regression to the mean**' – if an asset is valued in real terms considerably above a medium term average of the recent past, and unless some part of the world has changed fundamentally to create a new form of value for the asset, then above average values will tend back towards the mean

The key is not to pay too much for assets!

They understand that risk creates return



RETURNS and RISKS from investment

A preferable to B, same profit but B has more risk

C preferable to B, same risk but C more profitable

A vs C depends on attitude to risk and return

N higher profit, lower risk...not usual

U higher profit but higher risk...the usual case

The key is the farm decision-makers weighing up the return/risk combination or trade-off that they are prepared to be exposed to

They understand that risk creates return...

It is worthwhile separating business risk (from income & profit volatility) and financial risk (from amount of debt)

Think of risk as a commodity that can be sold by people who do not want to bear it to people who are willing to bear it

Characteristics common to farmers who build wealth over time include:

- ❑ They understand fully the relative roles of business risk and financial risk
- ❑ They are venturesome but sound
- ❑ They take risks they understand, and are judicious with the unknown
- ❑ They face the brutal facts...they don't self-delude
- ❑ They act in counter-cyclical ways
- ❑ They put the portfolio principle to work for them
- ❑ They make prudent use of insurances for the major insurable risks
- ❑ They minimise the risk of family discord by managing the relationships well

They appreciate that uncertainty is trumps

Anticipating the future is unavoidable, though the wise person knows that they do not know what is coming

The future will be a different world...they will do things differently there:

- ❑ Much about the present will be present in the future
- ❑ Some important principles that work now will still work in the future
- ❑ Much of what we believe to be right now will come to be known to be wrong
- ❑ Major factors affecting future lives will be things currently unimagined

While risky events such as a drought should entail no surprise, uncertainties or unpredictable rare events with big impacts are replete with surprise

Uncertainty requires having a buffer of plenty of equity, which means having a reserve of borrowing capacity and having a range of assets of varying degrees of liquidity for when things go awry

They pursue continual improvement...the Status Quo is not an option

'If a farm business is standing still it is going backwards'

The inevitable cost-price squeeze which creates the imperative for continual improvement in productivity is one of the few constants in farming

In 1968 in 'Farm Management Economics', Makeham wrote there were two major challenges facing farmers. These were:

1. how to incorporate new technology profitably into the existing business organisation; and
2. how to be sufficiently flexible, mentally and financially, to adjust resource management to meet both changed economic circumstances and widely varying climatic conditions

They know that the quality of their management is the key

The common characteristics of good managers are:

- ❑ they are passionate about farming
- ❑ they want to be the best at what they do
- ❑ they look forward (management economics) not backward (accounting)... 'we can do better than hoping the past will continue in the future'
- ❑ they minimise the risk of family discord by managing family partners and succession with care, consideration and generosity of spirit
- ❑ they manage surpluses from the good times to set them up to exploit the bad times
- ❑ they expand their business by strategically building up and running down equity percentage over time
- ❑ they live and breathe the principle of comparative advantage...that is, do what they are relatively best at

They know that the quality of their management is the key continued...

- ❑ they do not change activities to chase short term price fluctuations
- ❑ they do change activities in response to significant medium-term changes in markets and seasons
- ❑ they periodically step aside from the business and take a dispassionate view of what is going on
- ❑ they keep in close touch with the detail of what is happening on the ground at all times, even whilst delegating for efficiency
- ❑ they screw the overhead costs down as tight as can be done
- ❑ they have an eye for the main chance...that is, they are abreast of market and technological developments, without necessarily being the first movers or the leading innovators
- ❑ they know their system comprehensively and especially what in their system makes the profit

They understand there are few (if any) economies of scale

Economies of scale in dairy are not possible given vast majority of costs are directly related to numbers of cows or hectares

There are some economies of size, most notably the potential to negotiate reduced unit costs of input and increased unit price of output

Economies of size are eroded by diseconomies of size from:

- ❑ Lost management efficiency common to all businesses as they increase in size
- ❑ Lost efficiency as critical management time allocated to pasture management and cow/feed interface is reduced
- ❑ Increased management and office/overhead costs with multi-farm 'corporate' ownership

They recognise that growth and intensification increases the mean and variance of profits

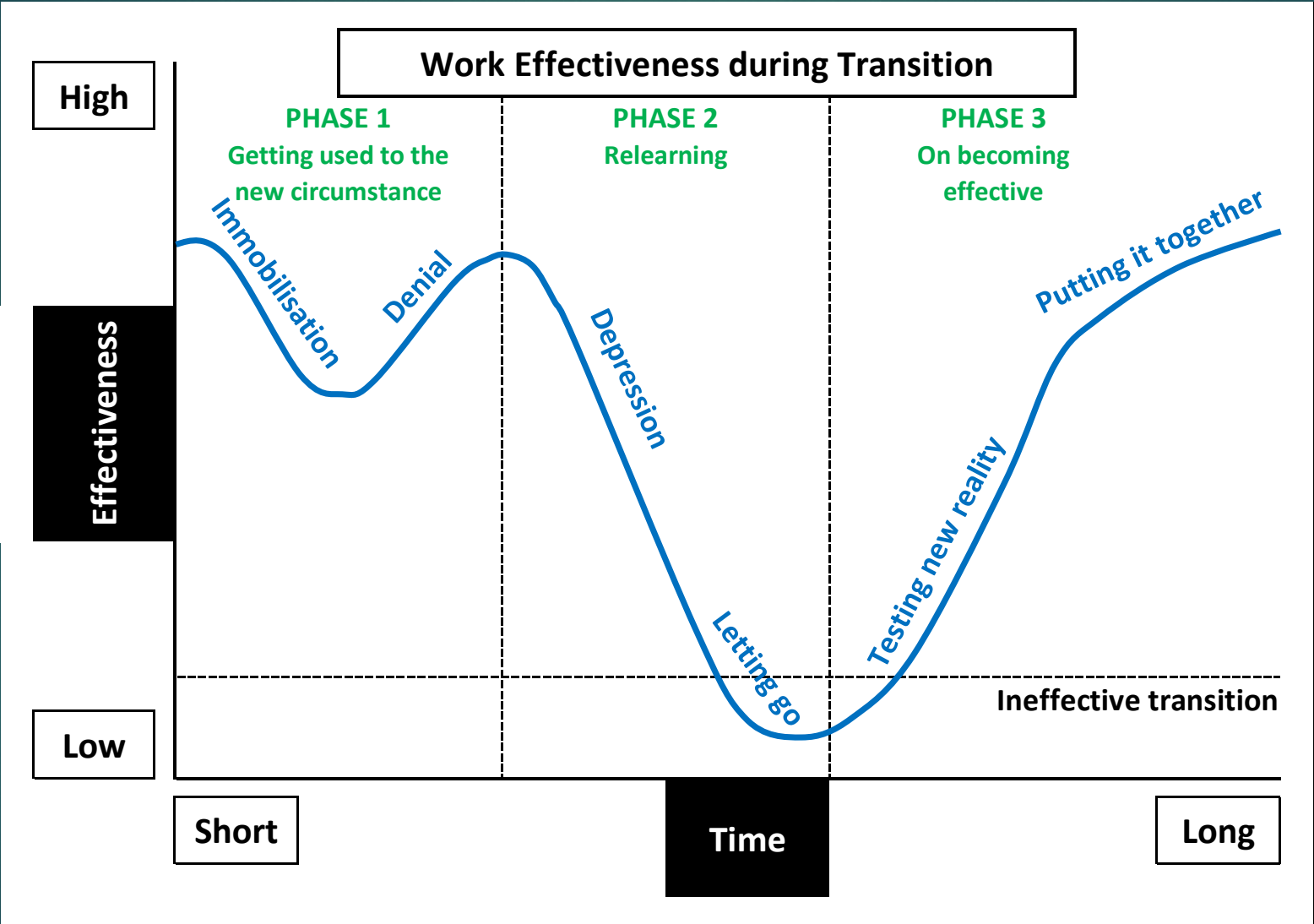
Growth of a business comes with increasing complexity, higher returns and increased volatility of returns

The need for good management increases, and the consequences of poor management increases

Growth involves reorganisation which involves three things:

1. Incorporating new technology in an expanded system, often including investment and a new set of fixed resources and higher total fixed costs
2. Increased output from the fixed resources resulting in a lower average total cost per unit of output. Profit and return to total capital is maintained, even though price per unit of output is lower than previously.
3. Time for learning before the reorganised system is operating efficiently

Work effectiveness during transition



They reject unsound advice based on average technical ratios

The best farmers seek out other views/advisors as 'sounding boards'...but they do not suspend disbelief or become beholden to evangelical-types who 'just know' what is best

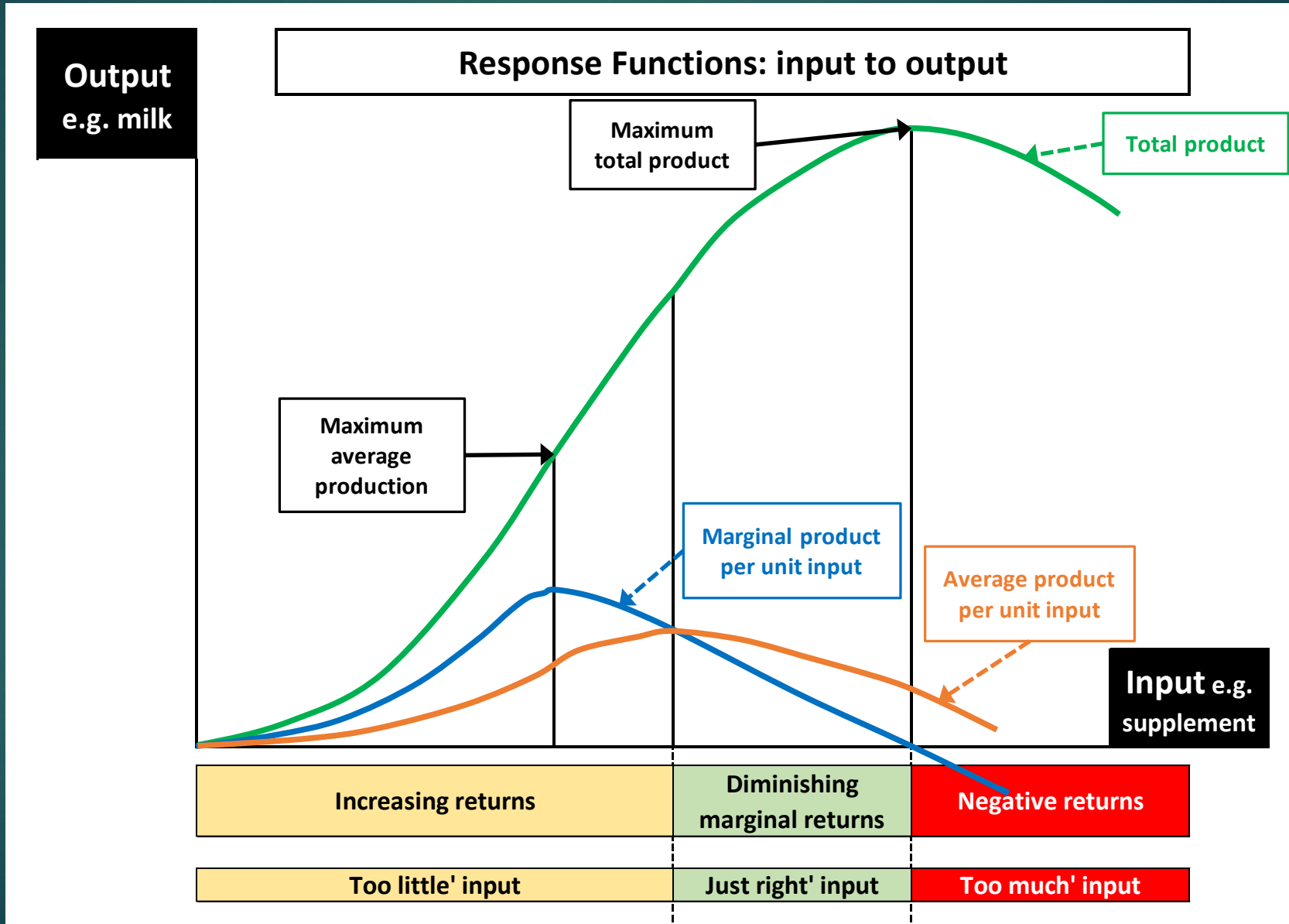
Advisors cannot know what is good for you better than you do yourself!

The "Technologist's Dilemma" arises because the technologists' information about technical efficiency, which is physical output divided by physical input, is insufficient information on which to formulate sound advice

Indeed, advice based on increasing or maximizing technical efficiency ratios, such as production per cow or per hectare, or say feed conversion efficiency, will, if followed by the farmer, lead to making the farmer worse off economically than can be achieved using advice based on sound farm economic methods and analysis

They reject unsound advice based on average technical ratios

Law of diminishing returns...



They compare themselves with themselves

Benchmarking is less useful where the production system is influenced by factors outside of the control of management e.g. weather, soil type, etc

If there are too many uncontrolled variables, it will be impossible (certainly unscientific) to make valid comparisons between partial productivity indicators

In the farm sector, it is even more complicated due to a mixture of business and family goals, and attitudes to risk, etc

The only benchmarks which make sense in these cases are the general whole financial/welfare indicators e.g. farm cash income, business profit, ratio of profits to earnings, equity, debt serviceability

...though they do compare themselves externally

They maintain contact with other top farmers

They benchmark externally to see what they can learn from other top farmers:

- ❑ They look at total farm performance and not individual parameters
- ❑ They compare their performance by utilising parameters that correlate with high performance on the basis of causation
- ❑ They look at benchmarks from the top farmers and not the average
- ❑ They review how changing a potential parameter might impact on their whole farm budget before implementation

They make good decisions

Good decision-makers make their good decisions by doing the following things:

- They use as much information as can be obtained at the time the decision is made
- They use information, experience, intuition, judgement to develop rules of thumb that work (quick, efficient decision making)
- They use marginal thinking...a bit more of this, a bit less of that
- They ask the right questions (the question is the answer)
- They face the brutal facts
- They understand systems (whole farm approach)
- They know there are only 2 or 3 key factors
- They use experience, keen observation, and have a comprehensive 'world view'

They make good decisions continued...

- ❑ They listen to 'experts' but know experts only ever see part of the big picture
- ❑ They do not over-analyse but act quickly, decisively...as good options 'disappear'
- ❑ They can say no to an opportunity...there will be another one the next day
- ❑ They know it takes longer than planned to reach potential
- ❑ They know knowledge is incomplete...some things just aren't knowable and unexpected things happen all the time
- ❑ They know nature varies unpredictably, and they recognise uncertainty
- ❑ They know people misunderstand one another and make mistakes
- ❑ They know we cannot predict the future accurately so we have to imagine it instead

They keep their business afloat

Sustainable long-term management means managing so the business is profitable, has cash, builds wealth...which gives choices, which enables farm owners to achieve their goals, despite all the risk and uncertainty. The key is profitable change!

To stay in business over a medium or long time it is necessary to:

- preserve and improve the productive capacity of the resources of land, labour and capital; and
- have returns to capital that are equal to or better than alternative uses of the resources involved

In the modern farming game, the match goes to the fittest and the games are getting harder!

And finally, it helps a lot to have more good luck than bad luck!



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MUCHAS GRACIAS !

