

July 2007 – Where to from here?

David Sackett

Holmes, Sackett & Associates, PO Box 5757, Wagga Wagga, NSW 2650. Email david@hs-a.com.au

Abstract

In looking at recent droughts and learning from them, one clear lesson is that the focus on managing during the drought has sometimes been at the expense of planning for the period of drought recovery. Analyses presented in this paper indicate that this period can be longer and more severe than the drought itself, especially on livestock-only properties. This paper suggests some solutions and approaches for cashflow management after drought. It also emphasises that despite the need to cope better with a more variable climate, we should not forget the basics of good farm business management.

Key words

Drought, recovery, cashflow, gross margin, profitability, farm management.

Introduction

The future is never certain, so it would take a braver person than me to predict what the next one, five or twenty years might bring. That does not mean we cannot look critically at what we have been doing in the past and learn from it.

The impact of the last few years on farm businesses has been substantial and, with hindsight, many decisions that have been made in agriculture in that time would have been quite different. The challenges we face from here are, however, primarily about making the best decisions for the years ahead. These need to be informed, but not dictated by what we have learnt from what has gone before. The challenges and some suggested solutions are presented.

Drought recovery

It is quite natural that going into and during any drought there is a focus on the best strategy to manage the immediate issues – stock sales, fodder purchases, water issues. However this appears to come at the expense of planning for drought recovery. Analysis of data from the 2002-03 drought shows:

The recovery period from droughts can be longer and more severe than the effect of the drought year.

The average cost of the drought was \$520,000 for the sample of farms in the Holmes Sackett benchmarking program. These are not representative of the industry in that they are large and more profitable over the short and longer term. Of the \$520,000 cost, 40% was incurred during the year of the drought while the remaining 60% was incurred in the recovery phase.

The average grazing-only farm took until 2006 for its profitability to be returned to the same level as those farms that were not affected by drought (Figure 1). Unfortunately, the recovery coincided with the onset of the next failed spring.

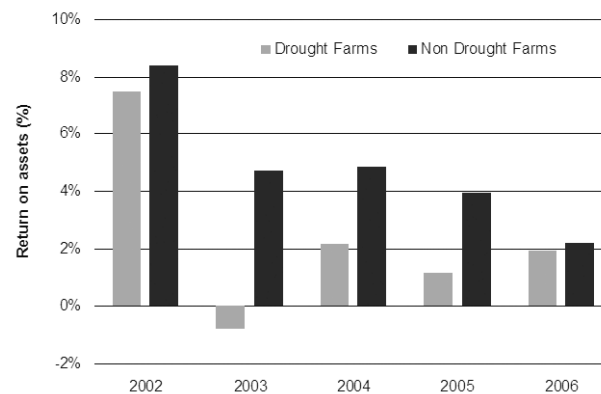


Figure 1. It is not until the third year after the drought that drought-affected farms have regained performance comparable with farms not affected by drought.

In comparison, mixed farms recovered much quicker, principally due to their ability to increase crop area to compensate for the reduction in livestock numbers.

The principal reason for the slow recovery was the time taken for the farm to get back to its pre-drought stocking rate. It is apparent that more time and effort needs to be put into post-drought strategies to overcome the risks associated with slow recovery.

Whilst profits have been severely damaged by the drought, balance sheets have not suffered the same fate.

The contradiction of the doubling of land values

since 2002 and during a period of below-average profitability has been noteworthy. Frequently, we had farmers lamenting these increases but, for many, their wealth has doubled without effort. All too often we hear that farmers have ‘lazy’ balance sheets, and they have the opportunity to borrow against that increase in equity to expand either on- or off-farm. Such advice should be considered with caution. The simple reason is that the cashflow from the farm business has not kept pace with the change in land values. The ability to service debt has therefore not changed. Any additional investment, unless cashflow positive, will increase the risk to the business in the short to medium term

Those who bemoan the current high land values and the corresponding low return to capital invested (typically 3-4% in good farm businesses over the longer term, excluding capital gain) need to consider the wealth they have reaped from the changes. We need to remember that agriculture is a low-risk investment (risk is different to volatility), and that the main reason for this is that the majority of farm business assets are tied up in the land component of the business. How do we overcome the low returns to capital invested?

The majority of the profits are made in the minority of years.

Those years are characterised by either the season or the prices being above average or, less commonly, a combination of good prices and good seasons. The challenge is that we cannot predict the good years in advance due to the unpredictable nature of both prices and seasons. Farm businesses must be in a position to capitalise on the good ones when they come along – failing to do so will mean a substantial reduction in long-term profitability of the business (Figure 2). Unless every opportunity is taken in the average and the good years, long-term profitability will suffer.

Traditionally, we look at gross margins to compare enterprises but, when recovering from drought, where cashflow is critical, gross margins are too simplistic. The key issue not accounted for in gross margins is the time taken for the return to be made and, often, the amount of capital invested. The use of internal rate of return helps indicate the impact of timing and capital requirements on future returns. For those who are passionate about cattle, the results are not favourable, due to the long period between stock purchase and income received (Table 1).

Future strategies

So what strategies should we consider to ensure we have resilient and robust farm businesses in the future?

Continue to strive for high levels of pasture utilisation.

However, this needs to be done with more flexible systems than we have had to date. The typical self-replacing beef herd or sheep flock suffers from increasing autumn/winter stocking rates as feed utilisation increases. Often the increases in spring associated with lactation are greater, but they are also easier to manage because of their closer match to feed availability (except in 2006). Increasingly, we need to monitor and manage the ratio between spring and autumn stocking rates (Figure 3).

For many businesses this may mean inclusion of one or more of strategies including:

- a) Opportunistic trading
- b) Inclusion of cropping where it can be done. This lowers summer/autumn stocking rates on the area of the farm under pasture. Grazing crops are a good option, but it is important that the system is not built around the regular availability of grazing crops. Their track record has shown extremely high dry matter production when sown early, but the frequency of early sowings is too low for the production system to be built around them.
- c) Treating fodder conservation as an enterprise in its own right

Table 1. Changing into beef is still the most capital-intensive livestock enterprise and has the lowest internal rate of return.

	Capital invested (\$/DSE)	Internal rate of return	
		2004/05 Prices	Median Prices
Self-replacing beef	\$53	34%	26%
Wool	\$37	101%	167%
Dual purpose	\$30	230%	180%
Prime Lamb	\$37	278%	71%

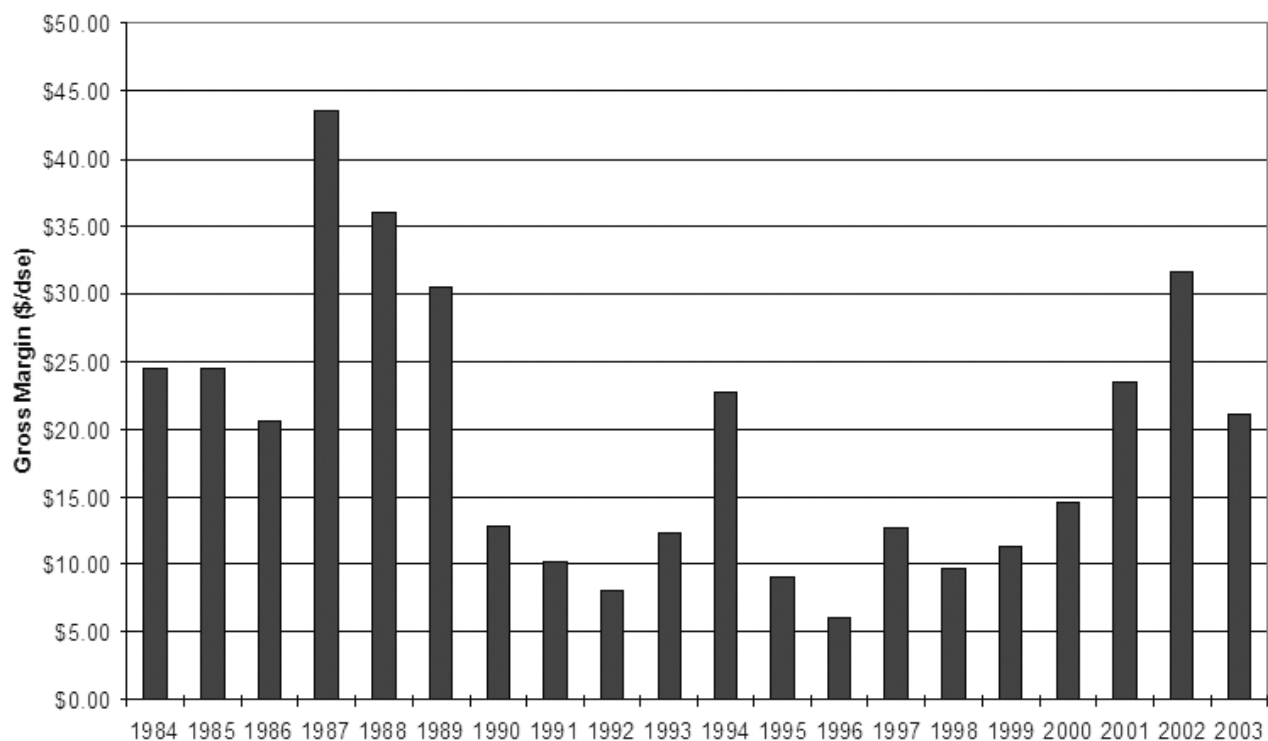


Figure 2. Historical real gross margin per dse (1984 – 2003). (Source: Herbert 2005)

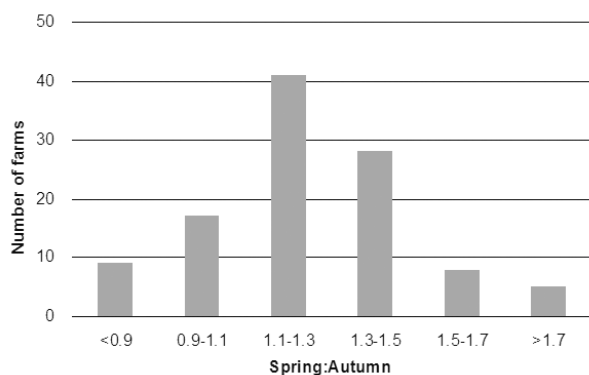


Figure 3. Spring:Autumn stocking rates vary widely between farms

The more frequent the droughts, the greater the benefit from investment in fodder conservation, provided the fodder is produced cheaply. That excludes the use of fancy mixes specifically for silage production – to be cheap, silage must be made from pasture that would otherwise go to waste. That means late lockups and use of existing pasture resources. If the combination of low opportunity cost and low production cost are achieved, fodder conservation becomes more favourable for many businesses when we see fodder prices at least double or triple during droughts.

d) Ensure the pasture you do sow provides the highest chance of persistence, even if it means foregoing some dry matter production.

The era of fancy varieties and high-cost pastures

that are no more than show ponies (because they also drain the bank balance like show ponies) should be well and truly over. In fact it should never have arrived (Table 2).

Conclusions

Whilst we may need to adapt our production systems to better cope with a more variable climate, we should be careful not to forget the basics of good farm business management:

Focus more on how well you run the enterprise rather than what enterprise you choose to run

This provides much greater scope for improving returns than being mediocre at the enterprise that might be slightly above average in profitability over the long term.

Ensure you have adequate scale

Also ensure that there is a clear plan to increase that scale over time to help negate the declining terms of trade. Scale can be increased within the existing business (intensification) or by expansion of the land area. Leasing has often been touted as the salvation for less capital-intensive expansion but, unfortunately, opportunities are still limited and way overpriced in the last few years.

Ensure you have a sound plan for genetic gain

This is probably one of the few free lunches that agriculture has to offer. Both the sheep (particularly wool sheep) and cattle industries still have plenty of opportunity in this area.

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Table 2. Difference in NPV between a highly persistent pasture (30 years) and a less-persistent pasture.

Additional DM production	Years of persistence					
	2	4	6	8	10	12
10%	-\$1,346	-\$679	-\$297	-\$132	-\$22	\$9
20%	-\$1,224	-\$528	-\$131	\$40	\$154	\$186
30%	-\$1,103	-\$376	\$35	\$213	\$330	\$363
40%	-\$982	-\$224	\$202	\$385	\$506	\$539
50%	-\$861	-\$72	\$368	\$557	\$682	\$716
60%	-\$740	\$79	\$534	\$730	\$858	\$892

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