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Vegetable Industry Development Program

Business Management: Thinking Through the Numbers

Farming businesses make many decisions every day. Some of these decisions have a direct impact on how much money is made or lost. This fact sheet gives you some simple tools and methods to help you make better decisions. The following tools will be helpful, but they do not replace the need for a good business plan and detailed financial analysis for the big decisions and investments.

A previous VIDP fact sheet titled 'Business Decision Making' describes the key factors that need to be considered for making good business decisions. This fact sheet can be accessed by going to http://ausveg.com.au/rnd/fact_sheets.htm. There are also people and companies who can help with these decisions. It is important to plan well and make informed decisions as:

'failing to plan is planning to fail'.

Some decisions will also have credit and taxation implications and professional advice should be obtained.

Money is nice, but there is much more to life than a bank account! While a decision might make the most money, it may result in less family time and more stress; it is important to consider impacts on people and resources when making financial decisions.

Key Messages

- 'Good decisions are made with good information'. Budget, plan and assess the financial data to make confident decisions.
- Know and manage your 'variable' and 'overhead' costs. Where possible benchmark costs with other producers.
- Improve 'profit' by maximising revenue from your crop. Create plans and 'cash flow budgets'.
- Capital (either cash or borrowings) needs to be used efficiently. Think about the real cost of owning and operating infrastructure and machinery and the appropriate scale of area farmed.
- Carefully plan for expansion and ensure that there is sufficient operating profit to meet debt repayments. Also consider the risks of increased debt versus the opportunities to expand and improve efficiency.

Overhead and variable costs

Costs or expenses on a farm fall into two categories. They are either an overhead (fixed) or a variable cost.

Overhead costs do not change significantly by planting a different crop. Some examples are: insurance, fixed water charges and permanent salaries. These overhead costs continue to occur regardless of the crop planted, or even if no crop is planted at all!

Overhead costs can significantly impact on the risk profile of a business and should be identified so that they can be managed. In understanding overhead costs, decisions can be made about managing crop risk and whether to even plant a crop. If a business has high overhead costs, then more crop area may need to be planted to cover the overhead costs. When a business is struggling financially one of the first areas to check is the overhead cost structure.

Variable costs change dramatically. If there was no crop planted then there would be no variable costs, but when a crop is planted the costs of seed, fertiliser, pumping costs and casual labour are incurred and hence are the variable costs i.e. they

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vary with the level of activity or production activity.

Variable costs need to be identified so that an activity (or crop choice) can be assessed and answer questions such as:

- Is this the best crop for my water allocation?
- How much area of a particular crop should I plant this year?
- What happens if I use a contractor for planting or harvesting?
- What happens if I lease out my land for a year and don't grow a crop?
- What is the impact of leasing another paddock?

See more about variable costs in the 'Gross margins: Using VegTool' fact sheet.

Australian agriculture and horticulture has a historical trend of farms becoming larger to increase scale. The old saying is 'get big or get out' and to some extent this is true. The reason this is true is that we have some ability to keep our overhead costs modest, and with the same amount of value in pumps, tractors and people (overhead costs) we have been able to run larger areas of land (variable costs) therefore increasing efficiency and profit. As we think about running larger areas of land we need to be sure that we are using the capital (money, bank debt, machinery) in the most efficient way possible.

Consider management profit, not tax profit

To answer the profit question it is tempting to look at your tax return. However it is much more useful to consider management profit rather than tax profit. Management profit is the income earned less the total expenses incurred for an activity or business for a given period of time (such as a season). Focus on the management profit for your situation and let the accountant work out how to manage any tax implications. It is important not to get the two confused or focus solely on tax deductions.

The basic profit equation

Profit = Total Income – Total Expenses

Looking at the profit equation there are two ways we can think about increasing profit. One is by increasing income and the other by decreasing expenses. While there may be benefit in obtaining three quotes for the supply of fertiliser for the season and this will improve profit, if the same amount of time and energy was spent on actively developing new markets for the crop then this may have a better impact on profit. An additional 3% on the sale price per tonne will yield a much better profit than a 3% decrease in the cost of fertiliser.

It is worth considering where you spend your time in the business and what return you can achieve from the time you spend on each activity. Focus on areas in your business that make the most management profit especially marketing, developing new sales avenues and increasing the value of income on the crop that you sell. Develop a profit budget and use it to determine the key drivers of profit for your particular enterprise; this process will help you focus on the aspects of your business that will generate the greatest profit.

Benchmarking

Benchmarking can be very useful to see how your costs compare against other producers. If the large multi national corporate companies benchmark their costs then surely small to medium sized businesses should as well!

Formal benchmarking studies occur from time to time in each industry, they require participation and honesty to help everyone understand the costs of production. Informal benchmarking can be as simple as talking to a neighbour, a grower in a different state or travelling to another region in the world to see how their production costs compare.

It is important to consider your competitors either locally, interstate or overseas and know what it costs them to produce the same crop.

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Cash flow budgeting

Cash flow is crucially important and should be planned out and regularly managed with a cash flow budget. A cash flow budget looks at the timing of when crop payments come in and when expenses have to go out. They are particularly helpful when thinking about increasing production or taking on additional debt and debt repayments.

Cash flow is different in that while a crop or season may be highly profitable, if there are lots of expenses and the payment for the crop is delayed then it will be very difficult to manage with no cash. A profit will never materialise if the cash flow is wrong and there isn't enough money to put food on the table or all the profit is soaked up in finance costs.

There is some good information on cash flows available at:

http://www.sa.gov.au/subject/Business%2C+industry+and+trade/Starting+and+managing+a+business/Running+a+business/Financial+control/Cash-flow+and+budgeting/Cash-flow+budget

One of the old rules of business is 'If you look after the cash flow, the profits will look after themselves'. While this philosophy may not be completely correct, there is a very good principle in understanding that cash flow is crucial to business success.

Equity and debt

Farming has always been a mix of both capital and cash returns. The value of land increases over time, so its great to own some land so that we get that benefit and we can also make money by growing a crop on a piece of land regardless of whether we own it or not. It is important to get the mix of capital growth (equity) and cash income right.

Equity is simply 'the real value' any business has in land and equipment, so if everything is sold and all debt paid to the bank, whatever is left is the equity of the business.

Equity, land and growth

A large debt can be a great opportunity for growth but it also comes with a larger risk; be very careful if your debt position increases every year due to the fact that you cannot pay the interest costs back to the bank or are hanging on for the 'one good year' that may come too late.

The formula for growth in equity is:

Growth in Equity = Operating Profit – Interest Costs – Tax – Consumption (or distributions)

The formula clearly shows the risk of high interest costs to equity. If you need to borrow significantly to purchase an expensive block of land and end up spending all of your available cash on interest payments then you may be reducing your equity.

Alternatively if you can borrow to purchase some more land and comfortably pay the interest costs and any consumption or distribution each year then borrowing can be a good strategy to grow equity.

While there has been significant capital growth of land in recent times, it is important not to base purchasing decisions solely on capital gains; land does fluctuate in value and over commitment to land based on expected capital gain is a risky business. If the land can make a profit, pay the interest, tax and consumption, then any capital gains (above inflation) are bonuses.

Equity, infrastructure and equipment

If you purchase an item such as a tractor or packing shed and don't use it to full capacity then it may be the case that you are better off renting, borrowing, sharing or getting a contractor in to do the work. It is a similar equation to the one above regarding equity and land but more dangerous.

The additional trouble with borrowing heavily for equipment is that unlike land, which usually appreciates in value, infrastructure and equipment depreciates in value. This means that although you might be meeting all the cash payments for the equipment, your business can be losing equity if you are inefficiently using equipment and it is depreciating rapidly.

Thinking about the impact your decisions make on equity and the 'real value' in your business, can help determine if decisions are good or bad. Different situations will require a different approach to using, generating and borrowing money.

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Case Study - Thinking about expansion?

Andrew and Mary have a vegetable farm growing Brassica and lettuce crops, a young family and a small sized farm with some debt.

A block of land has become available to purchase on a nearby property. If they conduct the same crop rotations what should they pay for the land?

The following text outlines some of the key questions Andrew and Mary need to answer so that they can make a good decision about purchasing the additional property.

- **What are the Overhead and Variable Costs?** Efficiencies can be gained or lost on additional land. For example if the same machinery is used across a larger area, then a better profit per hectare can be made across the entire farm, as it is more efficient. Planning, budgeting and reviewing overhead and variable costs will be useful to make the best decision.
- **Managing Profit and Cash Flow**. Is the parcel of land good enough to generate a profit? If so; how much? Is a different production system required? What will it cost? Are there opportunities to grow different crops and spread production risk or are there opportunities to grow a larger crop and maximise revenue through different marketing techniques, such as year round supply to one retailer? Will the additional block have a positive or negative impact on cash flow at different times in the year?
- **Debt and Risk**. There is an increased risk with more debt. For example if the whole crop fails for one or two years on the new or both farms; more debt means higher interest repayments and hence risk. Is the increased debt load able to be serviced with the crop rotation risk profile being used?
- **Growth in Equity**. If the profit on the new block of land can pay:
  - the interest on the new block,
  - tax bill and
  - consumption or distribution,

  then growth in equity can occur. There may a good opportunity to grow equity and perhaps participate in some capital gain.
- **Buy, Lease or Share Farm**. If there is an opportunity where the land can be leased or share farmed under a suitable arrangement then it may give a better average cash result to Andrew and Mary and a lower level of risk. Land does not always have to be owned for it to be profitable.

In addition to thinking about all the numbers and financial outcomes it is crucial to consider all the people in the decision making process and what impact these decisions will have on families, work loads and the management challenges and skills required to run a larger business. Refer to the 'Business Decision Making' fact sheet available at http://ausveg.com.au/rnd/fact_sheets.htm to find further guidance on making these types of decisions.

Further Information

These tools are not designed to be a complete solution to the financial management of your business, only to stimulate thinking about the best way of analysing and solving a particular situation or problem. Often is it helpful to get another opinion from an experienced consultant or accountant so that you can make the best decision possible for your situation.

A useful tool, including some benchmark information is available at:

http://www.pir.sa.gov.au/pirsa/drought/irrigation__and__water_management/business_decision_making_tool

Further financial information is available at:

http://ausveg.com.au/resources/statistics/financials.htm

If you would like some assistance to work through the numbers or talk about some financial training in a small group then please contact Kristen Stirling from the InnoVeg program on 03 9882 2670 or at kristens@rmcg.com.au.

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