The Business Of Farming: Business Analysis 2

By S. D. Parsons

In the last article I looked at two economic items that are no-nos in business analysis namely, past records and the allocation of overheads. On the other hand there is one aspect which really must be included when budgeting under inflationary conditions and that is the impact of interest on enterprise selection and decision making. What applied in the past is not necessarily valid today.

The concept discussed in this article can have a fundamental impact on which enterprises to produce and on subsequent profitability and indeed business survival, so set it aside till you have uninterrupted time to concentrate. I suggest that read this article again before your next budgeting session.

In the past, with low interest rates, there was little point in including interest on direct costs in the budget. When interest rates are lower than 10 percent the impact on which enterprise to produce is negligible. However, when we're talking about 60 and 70 percent the impact can be significant and may well cause an otherwise sound enterprise to be economically suspect.

Of course some producers borrow very little, or nothing at all, to produce a crop. Nevertheless interest still has a bearing on which crop they produce and that is the interest that could have been earned had the money been invested in another venture. We call this *opportunity interest*. Opportunity interest is used when assessing the value of alternative strategies – regardless of whether the business is financed by equity capital or by borrowing. It is especially important in inflationary times.

An Example

Enterprises like beef cows or tobacco, which have a slow turnover, will incur interest on direct costs for a longer period than say a vegetable crop with a quick turnover. Even if the gross margin per hectare, before charging opportunity interest, is greater for the slow turnover enterprise the situation may well be reversed after taking interest on direct costs into account.

Consider the following hypothetical example:

	Fast Turnover	Slow Turnover
Months to sale	3	12
Gross Income	6 000	7 000
Direct Costs	4 500	4 500
Margin b4 interest	**1 500**	**2 500**
Interest @ 60%	675	2700
Margin after interest	**825**	**(200)**

It is obvious that charging interest changes the decision as to which enterprise to produce.

<u>What if the gross margin is negative as a result of charging opportunity interest? Should one proceed with this enterprise or abandon it?</u>

The answer lies in the cashflow. Assume for example, that we have a business with overheads of $3 000 000 and two enterprises with the following gross margins:

	Enterprise A	Enterprise B
Gross Income	6 000 000	4 000 000
Direct Costs	4 500 000	1 500 000
Gross Margin b4 interest	**1 500 000**	**2 500 000**
Interest @ 60% for 9 months	2 025 000	675 000
Gross margin with interest	**(525 000)**	**1 825 000**
Profit no interest	1 000 000	
Profit after interest charges	(1 700 000)	

From an economic perspective the business is not viable i.e. it makes a loss of $1 700 000. For the self-financed business person that means the owners are subsidising the business to the tune of $1 700 000. However, the business does have a cash surplus of $1 000 000 (the profit before charging opportunity interest). That sum represents the return to equity and is also the amount available to pay off any debts including interest. If loan repayments are less than $1 000 000 it may pay to produce Enterprise A because the enterprise does make a (subsidised) contribution to overheads. Without it the before interest loss would be $500 000.

As a rule of thumb (something I dislike because each situation varies so much) we can say:

1) that under inflationary circumstances go for crops that have fast turnover
2) even if a crop has negative gross margin after charging opportunity interest it might still pay to produce that crop if it makes a *financial* contribution to the business.

Remember, if the business makes an economic loss the only three alternatives are to:

- Increase per unit gross margins.
- Increase number of units produced and/or sold, or
- Reduce overheads.

Do your budgets if you want to stay in business.

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