

## The Business Of Farming: Making A Business Work – Finance

*By S. D. Parsons*

In the first article I indicated that economics and finance are different subjects. To recap briefly economics concerns profitability, which can only be increased by either improving the gross margin per unit, increasing the number of units (i.e. increased turnover), or decreasing overheads. Finance on the other hand, is the fuel that makes the business run. In this article I will touch briefly on just one aspect of finance, viz. where limited funds should be invested.

Money invested in the business is used for only one of two broad categories:

1. To acquire the fixed assets needed in the business. Think of fixed assets as things we mean to keep, for example, land, buildings, machinery, and if you are a livestock producer, breeding stock.
2. As working capital. This is the money used to acquire the raw material and labour needed to pay for the things we mean to sell, and also to pay for the overheads associated with running the business viz. salaries, fuel, rent, repairs and so on.

Investing a large portion of the business capital in fixed assets (things we mean to keep) means that little is left over to pay for the things we mean to sell. It's that simple. Yet that is precisely what we do in agriculture, and I suspect in many start-up businesses. It is an easy trap to fall into. While discussing a potential subsidiary business an engineer friend, who heads a substantial business enterprise, virtually rejected an excellent opportunity because, as he said, so much machinery would need to be purchased. Like so many business people he considered it essential to own rather than hire the fixed assets.

As we all know, but tend to forget, businesses make money on the things they sell and not on the things they keep. Yet, we put most of our money into things we mean to keep – yes land, buildings, machinery, vehicles, breeding stock, and then have to go to the market to borrow money to pay for things we mean to sell despite the fact that the return on fixed assets is generally very low.

It amazes me to see executives driving extraordinarily expensive vehicles in Zimbabwe today. I'm sure this does much for their egos while doing little for the improvement of the bank balance. In opportunity interest alone, with current rates topping 60 percent, a \$6 million car costs \$10 000 a day – every day of the year. As Robert Kiyosaki<sup>1</sup> says the supposedly affluent middle classes surround themselves with non income earning assets like cars, swimming pools, expensive houses, four wheel drive pickups and the other toys. By his definition those items are not assets but *liabilities*. Of course in conventional thinking we would define them as assets, but I prefer Kiyosaki's definition that assets *are items that earn an income*. By contrast the truly wealthy invest in things that earn an income.

Kiyosaki writes of course about conditions in the first world where inflation is controlled at less than two percent, interest rates rarely exceed ten percent and real

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<sup>1</sup> Rich Dad Poor Dad – what the rich teach their kids about money that the poor and middle class do not! Robert T. Kiyosaki and Sharon L. Lechter

wealth is counted in millions and billions – of real money. His simple rules are ever so much more important in this third world country where inflation and interest have reached banana republican levels.

A simple rule of thumb known as the *Rule of 72* indicates just how dangerous it is to be borrowing working capital in today's market. Dividing the interest rate into 72 provides a surprisingly accurate measure of how long it takes for a given sum to double in value. For instance, if you were to invest \$1000 at a compound rate of 8 percent you would have \$2000 in nine years. Stretching the truth by only a little, in the current market that means \$1 million borrowed today would require a repayment of \$2 million in a bit over a year. There are not many businesses that can withstand that kind of debt repayment. So what's the alternative?

The business with limited capital is well advised to have as little invested in fixed assets as possible. This is true not only from a financial perspective but also because the things we mean to keep add to the overheads and therefore adversely affect profits. The more vehicles, equipment and buildings we own the more the overheads go up. And the greater the overheads the lower the profit.

The upshot of all this that we ask our clients to present the *business* balance sheet (as distinct from that prepared for tax purposes) in a different form. We divide the things we own into three main headings each with its own sub-headings, These are:

1. Things we mean to keep subdivided into income earning and non-income earning.
2. Things we mean to sell which in turn we categorise as slow turn over and fast turn over and finally,
3. Reserves, i.e. cash and investments.

It may be a funny looking balance sheet but it can be very revealing when looking for the opportunities and weaknesses in the business.

If the business' finances look a bit tight perhaps this leads to an examination of all those fixed assets and to ask what contribution they really make to profit. We know they add to overheads and we know that one way to improve profit is to slash overheads. Perhaps a hard look at those things you were planning to acquire, and things you already own but never meant to sell, might reveal that they aren't really as useful as you thought they were. That is a tough call for anyone, but it may make the difference between surviving and going to the wall.

A common, and not unnatural reaction is that no one is buying on a down market and therefore it is better to delay the sale of fixed assets till the market improves. But wait a minute, the converse to the rule of 72 is how long it takes for the value of money to half in an inflationary environment. Dividing the inflation rate into 72 yields the number of years that the buying power of the dollar halves. Thus, if the inflation rate is 12 percent the value of the dollar halves on six years. If the authorities are to be believed Zimbabwe's inflation rate is 60 percent so that means the purchasing power of the dollar halves in about 14 months. Thus, from a practical standpoint one would be better off to accept an offer of \$600,000 for a machine today rather than hold out for a \$1,000,000 in a year's time. I know that my clients are frequently shocked when they realise that selling at a fraction of the price today may be the wisest course of action.

All of this of course may be a gross over-simplification of the world of finance but it does serve to start us on the right track when examining the question of financial risk.

This is especially so at times like this when the business world is turned upside down and businesses are so involved in the day to day running of the business that no time is devoted to working on the business. As my Australian colleagues put it, Head down, bum up going like hell and getting no where.” There is an alternative and that is to take time out to work ON the business rather than merely IN it. In a future article that is a subject that I would like to address in more depth.

It is not the situation but what you do about it that determines the future.

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