Ranching for Profit

Putting Profit into Agriculture

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There are three issues when it comes to money: economics, finance and taxes. In economics we ask the question "Is it profitable?" Economics involves the application of the three secrets: reducing overheads, improving gross margin/unit and increasing turnover. In finance we ask different, but related questions: How do I pay for it? How does the cash flow? If economics is our business's engine, finance is the gas that makes it go. We can have the engine in perfect working order, but if we are short of fuel (cash) we won't get very far. This newsletter will help you assess the financial health of your business.

Fixed Assets & Working Capital

We put money in one of two places in our business: 1. Things we mean to keep; and 2. Things we mean to sell. Things we mean to keep are called ***fixed assets***. Fixed assets include things like land, buildings, machinery and breeding stock. Things we mean to sell are called ***working capital***. Working capital also includes those things we consume in order to make these sales, like feed, fuel, rent and salaries.

If we tie up all of our money in fixed assets there will be nothing left over to pay for the things we intend to sell. It is that simple. Yet that is precisely what we do in agriculture. We put most of our own money into land, buildings, machinery, breeding stock, and then we borrow working capital to pay for the things we mean to sell.

A person with limited capital is well advised to have as little invested in fixed assets as possible. This is wise financially and economically. Fixed assets add to our overhead costs (e.g. fixed assets depreciate, require repairs, etc.).

In a recent article to Zimbabwe farmers (where the interest rate is 64%) Stan challenged farmers to take a hard look at their fixed assets and ask what contribution they really make to profit. That's good advice for North American farmers and ranchers as well.

What Do The Numbers Mean

It's a big step to know your numbers. It is a quantum leap beyond that to know what your numbers mean. Just as a doctor checks your temperature, pulse and blood pressure to evaluate your health, we can use economic & financial ratios, calculated from information in your balance sheet, to determine the financial health of your business.

There are two types of ratios. *Economic ratios* measure the *efficiency* with which a business uses its resources. *Financial ratios* measure the *creditworthiness* of a business and its ability to withstand risk. The ratios on the following pages can help you check the vital signs of your business. I've included a brief description of what each ratio indicates and generally accepted benchmarks for each ratio. However, there are no hard and fast rules. "Safe" benchmarks for your business depend on:

- How accurately the assets have been valued
- How much risk is inherent in the business
- The economic outlook for your business (what's the phase of the cattle cycle?)
- Attitude about risk (both yours and your lenders)

ECONOMIC RATIOS

Return on Equity

Return on equity (ROE) is an economic benchmark showing the profit produced by the owners investment in the business. It is calculated by dividing profit by equity (net worth):

$$\text{Return on Equity} = \frac{\text{Profit}}{\text{Equity}}$$

At the Ranching for Profit School we use a ROE benchmark of 10% (≥ 0.10) of the beginning inventory value of the herd. In other words, after the rent, wages and all of the other cash and non-cash costs are paid, our target for a livestock business is a profit equal to, or greater than, 10% of the value of the herd. However, return on equity and other profitability ratios will reflect the current business environment (e.g. are we at the peak of the cattle cycle or in the trough?). For that reason the business, political and economic climate should be considered when looking at economic ratios.

Inventory Turnover Ratio

The inventory turnover ratio indicates the economic efficiency of production. It is calculated by dividing the gross margin by the inventory valuation of livestock:

$$\text{Inventory Turnover Ratio} = \frac{\text{Gross Margin}}{\text{Inventory Valuation}}$$

The gross margin is calculated by subtracting all direct costs (feed, health, trucking, marketing expenses, interest on livestock) from gross product (livestock sales minus livestock purchases, plus changes in the value of livestock inventory). A ratio below 30% (≤ 0.3) indicates that the economic efficiency of production is poor.

FINANCIAL RATIOS

There are two basic kinds of financial ratios: ***liquidity ratios*** and ***solvency ratios***.

Liquidity Ratios

Liquidity ratios (also called *current* ratios) measure the ability of the business to meet its current obligations. They show the relationship between current liabilities and current assets. Current liabilities are things that have to be paid within the next twelve months. Current assets are those things that can be readily converted into cash (e.g. cash, accounts receivable, livestock and crops intended for sale, as well as feed, fuel and fertilizer which will be converted into things we mean to sell.

Many lenders use current ratios to evaluate liquidity. However, because income on most farms and ranches is seasonal, the current ratio can vary a lot from month to month and therefore may not tell you all that much about the ability of the business to pay its bills. A good cash flow budget, updated monthly to show the actual expenditures is a better test of liquidity for most agricultural businesses.

Solvency Ratios

Solvency ratios are used to evaluate the financial structure of the business. They show the degree to which a business is leveraged and indicate the business's ability to withstand risk and remain solvent.

At the Ranching for Profit School you learned that the greater the percentage of borrowed capital (leverage), the greater the return, as long as the business is profitable. When the business suffers a loss, a highly leveraged business is in big trouble.

Net Capital Ratio

The net capital ratio measures the overall solvency of a business. It is calculated by dividing the total assets of a business by its total liabilities:

$$\text{Net Capital Ratio} = \frac{\text{Total Assets}}{\text{Total Liabilities}}$$

The net capital ratio of a healthy business generally exceeds 2 :1 ($\geq$2).

Debt to Equity Ratio

Some debt may be prudent, but too much is dangerous. The debt to equity ratio shows the extent to which a business is leveraged. It is used as a measure of the financial risk carried by a borrower. The debt to equity ratio is calculated by dividing total debt by the equity (net worth):

$$\text{Debt to Equity Ratio} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

A debt to equity ratio of less than 1 : 2 ($\leq$0.5) is usually considered safe.

Equity Ratio

The equity ratio shows the proportion of assets that are actually owned by the business. It is of particular concern to lenders considering long-term loans. The equity ratio is the owner's equity (net worth) in the business divided by total assets:

$$\text{Equity Ratio} = \frac{\text{Equity}}{\text{Total Assets}}$$

An equity ratio of $\geq$ 2 : 3 ($\geq$0.67) is generally considered safe.

Debt Ratio

The debt ratio is another measure of liquidity. It is the current liabilities divided by the total liabilities:

$$\text{Debt Ratio} = \frac{\text{Current Liabilities}}{\text{Total Liabilities}}$$

The ratio of current liabilities to total liabilities should be less than 1:5 (<0.2). This ratio tends to get out of whack (> 20%) when fixed assets are financed with current liabilities.

Red Flags

Missing a benchmark for one or more of these ratios does not necessarily spell doom. However, it should raise a red flag. Participants in the Grad Link meetings this fall will learn more about using these ratios and will develop strategies to improve the health of their businesses and reduce their exposure to risk.

WHAT'S GOING ON IN ZIMBABWE?

Due to the unstable political situation, the international meeting that we were planning for Zimbabwe has been cancelled.

We've received many calls asking about Stan and Hazel. They are well and safe though obviously concerned about the situation. Stan has been conducting workshops to capacity crowds with the theme *"It's not the situation but what you do about it that determines the future."* I'll be in Zimbabwe in July and August to help him teach two schools for the people who have enrolled in the Executive Link program he is starting there.