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PLANNING FOR A PROFITABLE FUTURE

A Whitepaper by:

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Planning for a Profitable Future

In the 1970s significant consolidation took place in the beef feeding industry and the industry grew in the southwestern plain states and decreased in the Midwest Corn Belt. This was due to better weather and more competitive feed costs in the southwestern plain states.

That trend is being reversed by a feed cost advantage that currently exists in the Midwest due to the availability of ethanol plant byproducts and other feed stuffs. Feedlot nutritionists have made remarkable advances in developing high quality rations from a variety of feed sources.

Weather in the Midwest has not improved and during recent decades has become wetter. Dr Elywin Taylor, Iowa State University climatologist, has tracked river and stream flows in Iowa and over the past three decades the water volume has increased significantly. This makes it even more difficult to feed cattle in outside pens.

Additionally, State departments of environmental quality regulations will make it more costly to continue to feed cattle in open outside lots where water runoff cannot be contained.

These factors have resulted in an increased level of interest in feeding cattle in deep bedded covered lots or deep pit confinement buildings. Following are guidelines and considerations to assist you as you research and analyze opportunities to build beef feeding facilities.

Tremendous Opportunities in the years ahead

- **Increasing demand**
- **More middle class consumers**
- **Ingenuity, Innovation and Appetite**
- **New Fortunes made in Heartland**
- **Entrepreneurs will emerge worldwide**

As indicated above we feel there are tremendous opportunities in the years ahead in production agriculture, in both grain and animal protein production. The most significant opportunities in beef production will be found in areas where there are lower feed costs and where there are efficient and effective feeding facilities.

Cycles in Production Agriculture

- **Have been cycles for the last 100 years.**
- **Will continue to be due to greed and fear.**
- **Strategy is to bulletproof your balance sheet during good time.**
- **So you can catapult ahead of your competition in bad times.**
- **If you get greedy during good times you will likely be on your knees in bad times.**

Your Plan

The key to having a successful and profitable business plan for your farming operation is recognizing the impact of cycles, having a strong financial position to weather the cycles and understanding the role diversification plays in sound business management. As I indicated above cycles have occurred in production agriculture for the last 100 years and as long as the basic human emotions of greed and fear are present there will always be cycles. Cycles are a result of a free enterprise economy. The key to your planning process is recognizing that there will be cycles and manage your business to capitalize on them rather than being a victim of them.

To manage cycles you need to "bulletproof" your balance sheet during good times so you will be in a position to take advantage of opportunities when tough times occur. If you do not follow that strategy you will be struggling during the low parts of the cycle and not be able to capitalize on opportunities that may present themselves or be out of business.

Below are guidelines for bulletproofing your balance sheet. The first "shock absorber" to get you through tough spots in the financial road ahead is working capital. I recommend having your working capital equal to or greater than 50% of your annual gross revenue.

The second most important concept is managing margins. Taking a profit when available will allow you to reach your goals.

Bulletproof Your Balance Sheet

- **Working Capital**
- **50% of revenue**
- **Overall equity > 60%**
- **Keep fixed costs low**
- **Take a profit when it presents itself and meets your goals**

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Diversification

Another way to build a successful and sustainable farming operation is to recognize the benefits of diversification. As outlined below if you invested in a business that earned you seven percent you would essentially double your money in ten years. However, if you followed a diversification strategy and invested in five different businesses, that return 20%, 15%, 7%, 0% on the first four and if you even lost all of you original investment in the fifth business, you would still have a third more money by following a diversification strategy.

That is why having a crop production business and adding or expanding a livestock production business makes good business sense.

Diversification

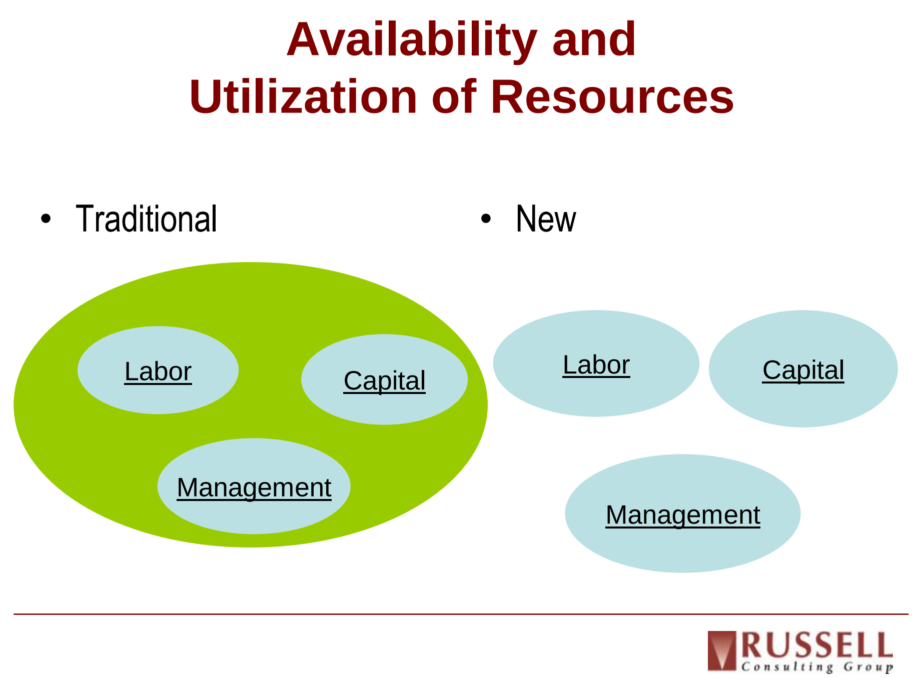
- $100,000 invested @ 7% for 10 years = $196,968

Diversification

- $20,000 @ 20% for 10 years = $123,834
- $20,000 @ 15% for 10 years = $80,914
- $20,000 @ 7% for 10 years = $39,343
- $20,000 @ 0% for 10 years = $20,000
- $20,000 lose it all = $0
- Total $264,715
- 34% more than $196,968

Three Key Resources

Diversification alone will not ensure a successful faming business. You will need to maximize expertise in three key areas of labor, capital and management. As indicated in the slide below, traditionally we used to think that we had to supply all three resources in expanding our farming business. A better approach is to think outside the box and look for maximum talent, quality and expertise in each area of labor, capital and management. Then your job is then to provide the synergy to get the best and most sustainable results over the long run.



An example is our family farm that I own with my five brothers. We wanted to expand and built two 7200-head, wean-to-finish hog production sites. We provided the capital, our nephew, Jason, provides the labor and Maschhoff Farms provide the management expertise. The businesses are very successful, but by doing it all ourselves we would have likely failed.

Labor

You do not have to do provide all of the labor to have a successful farming and cattle feeding business, and efficiency and effectiveness are much more important than what you pay for labor. Following is an example of the labor and overhead costs of Wamart's Sam Club and Costco, which are remarkably different, but the more talented labor and lower turnover of Costco results in better efficiency with nearly half the cost of labor and overhead per dollar of sales.

Costco Beats Sam's Club (Walmart)

	Costco	Sam's Clubs
Average hourly wage	$15.97	$11.52
Annual health cost/employee	$5,735	$3,500
Covered by health plan	82%	47%
Annual retirement costs/employee	$1,330	$747
Covered by retirement plans	91%	64%

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Costco Beats Sam's Club (Walmart)

	Costco	Sam's Clubs
Employee turnover	6% a year	21% a year
Labor & Overhead costs percentage of sales	9.8%	17%
Sales per square foot	$795	$516
Profits per employee	$13,647	$11,039
Yearly operating income growth	10.1%	9.8%

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Another effective tool I have found is the use of independent contractors. My nephew, Jason, is an independent contractor for our swine facilities. As outlined in the attached article "Contract Labor Relationships" this management technique often attracts higher quality and more entrepreneurial talent.

Management

Management is the most critical resource and to have a successful feedlot business you need top quality animal care, animal health, nutrition, and facilities. If you do not have these, then hire it done. Outlined below are the four critical tasks that need to be done to make a farming business successful. Most of us are best at being the plant and production manager, but even some of those tasks in a feedlot need to be sourced from outside the business. The other three financial manager, marketing manager and human resources manager are equally critical. I have seldom seen any one person excel at all four areas. The key to having a successful business is knowing what you are best at, spend more time at getting better at that and knowing what you don’t know and hiring that done. That makes farming and cattle feeding more profitable and more fun.

Four Critical Tasks

- Plant and Production Manager
- Financial Manager
- Marketing Manager
- Human Resource Manager

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Few Managers Can Do It All

- Determine what you like doing and are good at
- Get better at that
- Know what you don't know
- Hire it done

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Capital

Few of us have all the capital it takes to farm and feed cattle so it is very important that you have a top quality lender with adequate resources and knowledge of your industry. It is also important that you have a back up lender relationship as things can change with your current lender.

See the attached article on that subject, "Have a Backup Lender."

The following financial analysis, "Sample Plan Grain & Cattle Feeding 2011," is software we have developed to assist producers in the planning process to assure a higher degree of success. If there are red light areas in the analysis you need to mitigate or manage those issues.

Financial Analysis
Sample 2011

Expenses

Payments	$353,000	Principal	$220,398		
Expenses	$1,656,000				
Living & Tax	$100,000				
Livestock	$2,772,315	3385 hd @650# @$1.30			
Profit	$560,000			$780,398	Net Worth Increase
Depreciation	$137,000			$365	per acre profit
Total	**$5,578,315**				

Income

Source	**Gross $**	**Sale/Acres**	**Feed/Acres**	**Yield/Acre**	**Price/Unit**
Corn	$426,436	589	935	181	$4.00
Soybeans	$801,350	1,550	0	47	$11.00
Livestock	$4,270,638	3,317	$1,250	1.03	
Govt Payt	$75,000				
Other Income	$5,400				
Total	**$5,578,824**				

Goals	**Gross Dollars per Acre**
Corn	**$724**
Soybeans	**$517**
	$0

		GO INDICATOR	
Total Assets	$7,657,000		
Net Worth (Equity)	$4,268,957		
Operating Interest	$53,598		
Working Capital	$387,000		**Guidelines**
Working Capital/Annual Expenses	**18.3%**	RED	>20%
Owners Equity	**55.8%**	YELLOW	>60%
Return On Assets	**12.6%**	GREEN	>6%
Return On Equity	**18.3%**	GREEN	>16%
Expense/Revenue	**80.2%**	RED	< 65%
Debt Coverage Ratio	**2.97**	GREEN	>1.50
Withdrawals/Revenue	**1.8%**	GREEN	<10%

A key to building a business plan is to project all payments, expenses, living, depreciation and a **profit** (we feel strongly that profit should be viewed as a cost, the cost of staying in business and capitalizing your growth) The total of all five then determines the gross dollars per head and per acre you need, which is also your marketing goal for the year.

This system is simple yet effective in developing a risk management plan unique to your operation. At the bottom of the business plan is “financial health checkup” that reflects red, yellow or green lights based on the numbers for your farm business.

Also following is a sample feasibility analysis we did for a client considering a deep bedded cattle feeding facility expansion. This is a very feasible project as it projects a $280,532 Net Present Value (NPV) and a 15.66% Modified Internal Rate of Return (MIRR). The model projects out 15 years but only the results are shown below to conserve space.

The traditional yardage charge for outside lots is about $.28 per head per day however our data shows a .6 # per head per day increase in rate of gain and a 10 % increase in Dry Matter Feed Efficiency, so that would equate to $.385 per head per day which is what I used in this example.

Please note the $70,000 figure above “other project effects.” This is where we put the annual manure value from the facility. It adds value to your grain operation or can be sold and makes these types of projects much more valuable. This will continue to be a factor in profitability of cattle barns and likely increase in value over the years.

Net Present Value is the discounted cash flow of the project at a 10% discount rate, in this case, minus the down payment. A negative NPV means the project will not return enough cash flow to pay all costs and return the down payment. A positive value means the project is feasible based on the assumption in the model. A positive NPV also means your wealth increases in today’s dollars by this amount over the life of the project.

Internal Rate of Return is the most widely used project analysis figure. Oversimplified it is the compounded rate of return on the down payment of the project.

Modified Internal Rate of Return (MIRR) assumes the cash flows from the project are reinvested at the firm’s cost of capital, 10% in this case. IRR assumes cash flows are reinvested at the projects own IRR. MIRR is a better indicator.

In this model we assumed that the client will custom feed the cattle, however if the client wants to own some or all of the cattle in the barn he or she would just "charge" himself or herself the yardage in calculating the potential profit in feeding a pen of cattle.

What discount rate do you want to imply?	**10**	percent
How many years would you like to review? (max. 20)	**15**	
What is the total investment?	**$650,000**	960 hd
Financing		
amount financed	**$400,000**	
term of loan in years, max. 20	**10**	
APR interest (express number with 2 decimals like 9.25)	**7.00**	percent
What is the estimated sales price per unit?	**$130.90**	340 days @
How many units are estimated to be sold per year?	**1,400**	$.385/day
If units are not applicable, what is the estimated gross revenue per year?		
If units are not applicable, what are the estimated operating costs and COGS?		
What fixed cost is associated with the project?	**$2,000**	RE taxes
What is the variable cost per unit?	**$83.950**	Var cost /hd
What is the salvage value at the end?	**$200,000**	
Remaining amount to be depreciated(after line 20 &21)	**$650,000**	
How many years to depreciate? maximum 20	**10**	$65,000
What are the effects of this project on other projects?	**$70,000**	
Total Amount to be depreciated	**$650,000**	
Section 179 depreciation		
Accelerated depreciation (bonus dedpreciation-50% of remainder)		**Year 1**
Tax rate	**25**	**%**
Gross Revenue		$183,260
Less Fixed Cost		$2,000
Less Operating Costs and COGS		$117,530
Equals Operating Income (EBITDA)		$63,730
Less Interest		$28,000
Less Depreciation		$65,000
Plus (minus) Other Project Effects		$70,000
Equals Earnings Before Tax (EBT)		$40,730
Less Taxes		$10,183
Equals Net Income		$30,548
Plus Depreciation		$65,000
Net Operating Cash Flow before Principal Payment		$95,548
Less Principal Payment		$28,951
Net Operating Cash Flow		$66,596
	Results	
Plus Salvage Value	$200,000	
Less Tax on Salvage Value	$40,000	
Project Net Cash Flow (Equity)	($250,000)	$66,596
Net Present Value (NPV)	**$280,532**	
Internal Rate of Return (IRR)	25.34%	
Modified IRR (MIRR)	**15.66%**	

Recent closeout we have seen have shown profit per head of $96 to $346 per head profit but that changes constantly with the price of feeder cattle and feed stuffs so you would need to "run the numbers" on each individual decision to own or not own the cattle.

The projected operating expenses for this barn were as follows

Labor	$40,000
Equipment depreciation, opportunity cost on invested capital and repairs-	$10,000
Bedding, repairs and maintenance, utilities and fuel	$30,000
Total	$80,000

$80,000/ 365days/ 960 head =$.23 per head per day.

Please note the cell C18 figure of "other project effects." This is where we put the annual manure value from the facility. It adds value to your grain operation or can be sold and makes these types of projects much more valuable. This will continue to be a factor in profitability of cattle barns and likely increase in value over the years.

Russell Consulting Group can run all these numbers for you. We will help you answer two critical questions;

1.) Is this a good investment?
2.) Can I afford it without putting my operation under more than normal risk? Please call Bill Haupts at 712-579-9964 and visit our website at www.russellconsultinggroup.net

Collaborating with Key Experts

It is important that you use your trusted advisors in helping you make these decisions, including but not limited to your legal and tax counsel, your lender and financial advisors. Ask them their advice and have them evaluate the prudence of this investment. Often times they have great suggestions for ways to mitigate potential problems and manage the risks.

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BY MOE RUSSELL

WHY USE INDEPENDENT CONTRACTORS?

In monitoring the top guns in production agriculture, it's been my observation they are so good they can get all the money they need, all the land they need and all the equipment they need. However, getting the right people in the right place at the right time, doing the right things with the right set of skills is becoming increasingly difficult.

If at times you feel like you're trying to "push a log chain" when attracting, training and keeping top-quality people, you might research the possibilities of contract labor.

We have used it successfully in three of our businesses for over 10 years and feel the advantages outweigh the disadvantages. All Russell Consulting Associates are independent contractors, including my nephew who manages our pork production facilities.

There are definite criteria that must be met in order to qualify as an independent contractor.

Independent contractors are often described as people engaged in occupations who contract to perform work according to their own methods, without being subject to control of the employer except for the result.

The basic tenet of an independent contractor relationship is that the contractor has an independent occupation and is only responsible for the finished product.

THESE FACTORS ARE guides to the primary question of whether a worker is in fact independent, or subject to the control of the employer:

- The extent of control that the employer may exercise over the details of the work.
- Whether the person employed is engaged in a distinct occupation or business.
- The kind of work to be performed, compared to whether the work is usually done under the direction of the employer or by a specialist without supervision.
- The skill required for the work.
- Whether the employer supplies the instrumentalities, tools and location for the person doing the work.
- The length of time the person is employed.
- The method of payment – hourly or by the job.
- Whether the work is a regular part of the employer's business.
- The intent of the parties.
- The opportunity for profit or loss.
- Whether the employer is in a distinct business.

Checking with a labor law attorney is a good practice to assure you meet the National Labor Relations Acts and the Fair Labor Relations Act criteria and expectations for independent contractor status. CSD

PHOTO: SUSAN WINSOR

BIG PLUSES WITH CONTRACT LABOR

One of the benefits of contract labor we have identified is independent contractors generally have entrepreneurial characteristics. They are goal-oriented and many times have written goals.

Second, they are risk takers. Not taking undue risk, but more like a mountain climber who takes calculated risks and uses tools and techniques to manage the risk.

Third, they are accountable to themselves. When things go wrong, entrepreneurs look in the mirror for the problem rather than looking to blame someone.

Last, they are innovators. Each day when they wake, they ask, "How can I do more with less, thereby being more productive and innovative?"

Try a contract labor relationship and see how it works for you. It may prove to be a riskwise decision.

Moe Russell is president of Russell Consulting Group, Panora, IA. Russell provides risk management advice to clients in 34 states and Canada. For more risk management tips, check his Web site (*www.russellconsulting group.net*) or call toll-free 877-333-6135.

BY MOE RUSSELL

HAVE A BACKUP LENDER

Farming is a business that requires large amounts of capital, and few of us can run a farming operation without the help of a lender to provide part of that capital.

I've had an increasing number of clients this past year who have had problems getting their line of credit renewed. Most are involved in cattle, hog or dairy businesses that have been "financially field dressed" the past 24 months.

I have seen some great business plans derailed because of regulatory requirements, changed personnel, changed credit standards and a whole litany of other reasons.

That's sad since livestock and dairy operations are businesses that require greater and more intensive management than crop operations. You'd think they should be rewarded for their efforts, but as we all know, life is not fair and cycles exist in every business. As long as we have the two basic human emotions of greed and fear, we'll continue to have cycles.

Long ago when I was with Farm Credit Services (FCS), I had a director who had all of his credit with FCS but paid a $20,000 commitment fee for a $5 million line of credit with a large commercial bank. When I quizzed him about it, he said he used that as a backup line. If something would happen to his relationship with FCS he could have his current lender completely paid off by the end of any day.

He said his father taught him that and he would never be hostage to a one-lender relationship. Good strategy.

I think it's good risk management to establish another lender relationship as backup if you need it. There are many potential changes in the ownership, credit standards, procedures, personnel and regulators of your current lender that leads to the conclusion that things could change quickly at any time. You need credit and commitments to carry on business and reach your goals. That means you need a reliable lender – if not on board, then on the bench.

How do you get a reliable lender on the bench? The first step is inviting them to review your financial statements including balance sheets and profit-and-loss statements, past and projected.

THE NEXT STEP is to get them involved with your management team so they can become familiar with your entire operation.

Allow them to drill down to the heart of your operation including your vision, mission, strategies, goals and tactics. Let them interview your employees, management and owners.

Share with them your competitive strengths, unique challenges, opportunities, threats and weaknesses. Transparency is a key to establishing long-term symbiotic relationships with lenders.

Lastly, obtain a commitment in writing if they would finance your operation and under what terms. If they could not finance it, have the lender put in writing what you would need to do for them to finance your operation.

You will likely learn a lot about your operation from a third party objective look. That alone might be worth the effort.

If the bench lender requires a commitment fee, consider paying it. It may be a smart risk-wise decision if things change when you least expect it. CSD

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