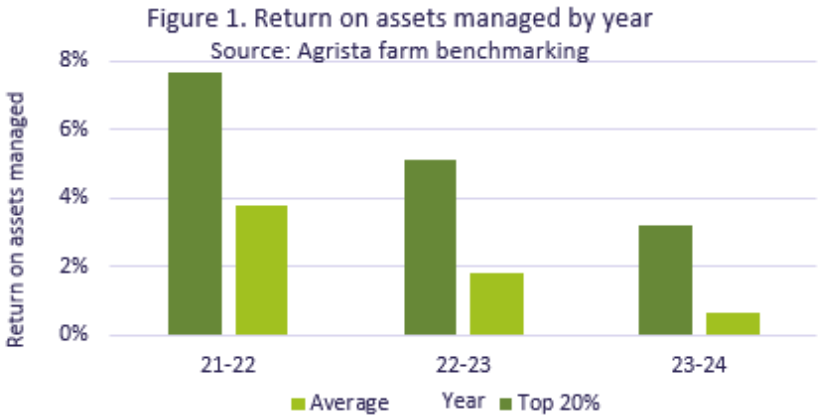
Written by
John Francis
Director Agrista

IT'S A GOOD TIME TO REALLY UNDERSTAND YOUR COST OF PRODUCTION

The changes in commodity prices over the last 24 months have had a major impact on broadacre farming businesses deriving earnings from commodity agricultural production. Agrista farm benchmarking data (Figure 1) shows that year on year relative reductions in return on assets managed (ROAM) have been approximately 35% for the top 20% and closer to 60% for the average.

Return on assets managed, otherwise known as operating return, is a financial resource efficiency measure. It is calculated by dividing operating profit by the total value of farm assets managed. It is used to assess the efficiency of conversion of the capital value of assets to earnings. In other words, how well did management convert the use of capital that was tied up in farming assets into earnings.

The power of this number is that, as a ratio, it can be compared with operating returns of alternative asset classes to establish the relative operating performance of the capital invested. In other words, if the value of the assets in land and infrastructure, livestock and plant and equipment was invested elsewhere would it have earned you the same profit, more profit or less profit than farming.



The importance of asking this question is that it applies an economic rationale rather than an emotional rationale to the ownership of farm assets

While much of the decline in operating return is related to commodity price decreases and land value increases, some of it is related to a lack of business discipline when prices were good. When the good times roll there can be a tendency to increase cost without consideration to the value created. The higher prices deliver higher margins which can mask the impact of these costs.

The low commodity prices received in the 23-24 year appear to have stimulated an interest in managers looking to take control of their business to lower their cost of production. Farm management reporting and farm benchmarking are a useful starting point in identifying the opportunities for reducing cost of production.

Cost of production is a different metric to the value of operating costs. Cost of production is a ratio of cost relative to the production achieved with that cost structure. To that extent it is a measure of the efficiency of expenditure in the business.

Operating costs are an absolute dollar figure and a component (the numerator) of the cost of production ratio. Operating costs include enterprise costs and overhead costs but exclude financing, capital, tax and personal expenditure.

Production is the other component (the denominator) of cost of production. Production is calculated as sales kilograms less purchase kilograms plus kilograms of inventory change.

Table 1 shows a business with the same operating cost but different levels of production from business A relative to business B. Business B has a higher cost of production not because costs are different relative to business A but because it hasn't converted the cost to the same level of production as business A.

This may be due to any number of reasons but typically this outcome relates to suboptimal feed utilisation due to inefficient livestock systems design or a mismatch in the costs in the business.

As costs increase, the tendency for managers is to want to cut back to maintain margins.

Intuitively, this seems sensible, but if the cost reduced has a negative impact on production (for example lowering fertiliser cost with already suboptimal soil fertility) then the cost of production will increase. This means the cost cutting delivered the opposite effect of the aim.

Table 1. At the same operating cost, as production decreases cost of production increases.

	A	B
Operating cost ($)	$300,000	$300,000
Production (kg lwt)	200,000	150,000
Cost of production ($/kg lwt)	$1.50	$2.00

The key message here is rather than looking at ways to cut costs, spend the time finding ways to increase production. Then investigate the extent of the investment to achieve the additional production.

Adding more cost seems counter intuitive at times like this but where the cost is relatively small and it results in a large increase in production then cost of production decreases. The key message here is rather than looking at ways to cut cost spend the time finding ways to increase production then investigate the extent of the investment to achieve the additional production.

Agrista benchmarking data in 23-24 (Figure 2) shows that the top 20% of producers (ranked on net profit per DSE) generated a cost of production around 40 to 50% lower than the average. This suggests that the vast majority of producers have opportunities within their businesses to lower their cost of production.

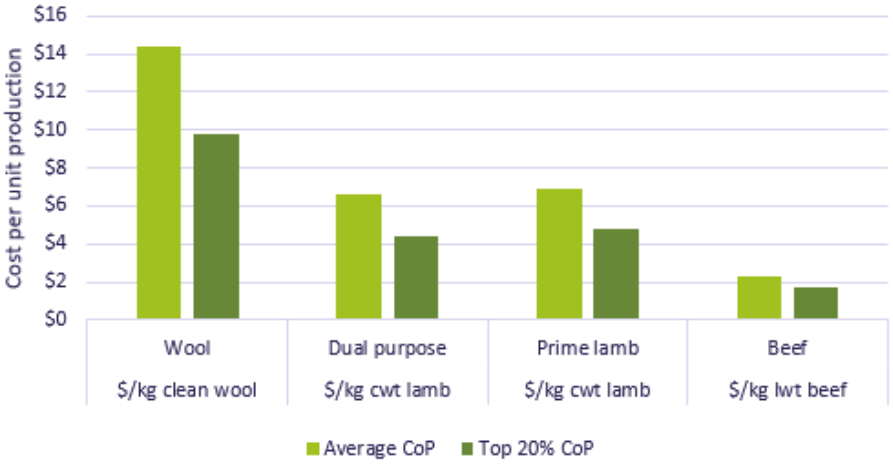
What this means to you

Cost of production is an important performance measure in livestock businesses.

Recent surveys suggest that less than 20% of producers know their cost of production. Production and cost of production are just two of a suite of key performance measures delivered to those who benchmark their business annually.

Given the effect of commodity prices curfarm business performance currently, now is a good time to take control of these important metrics.

Figure 2. Average versus top 20% cost of production



Given the effect of commodity prices on performance of farm assets now is a good time to take control of these important metrics.