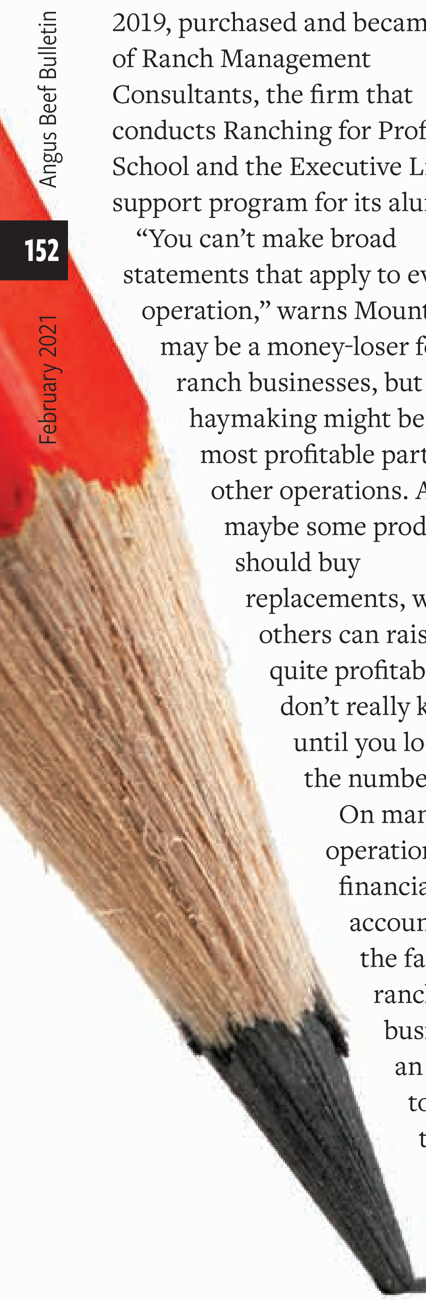
# Above the Bottom Line

## Find the weakest link with enterprise analysis.

*by Troy Smith, field editor*

The faulty generalizations make Dallas Mount wince. Perhaps most common is the one about the Ranching for Profit School teaching cattle folk that harvesting homegrown hay is not profitable. Also, some people claim the course tries to convince cow-calf producers to purchase replacement females instead of retaining home-raised heifers.



Neither is accurate, according to Mount, a grazier from Wheatland, Wyo., and a former University of Wyoming Extension educator. Mount is a longtime Ranching for Profit School instructor who, in 2019, purchased and became CEO of Ranch Management Consultants, the firm that conducts Ranching for Profit School and the Executive Link support program for its alumni.

"You can't make broad statements that apply to every operation," warns Mount. "It may be a money-loser for some ranch businesses, but haymaking might be the most profitable part of other operations. And maybe some producers should buy replacements, while others can raise them quite profitably. You don't really know until you look at the numbers."

On many operations, financial accounting for the farm or ranch business is an effort to satisfy the Internal Revenue Service (IRS). That's as far as it goes. However, that's not the same thing as an economic analysis that breaks the business down by enterprises. Mount urges producers to consider the parts as well as the parcel.

Typically, each farm or ranch has multiple parts. Each business is a combination of several activities or enterprises, with each devoted to a single crop or livestock commodity that actually produces a marketable product. To fully understand and effectively manage the business, the decision-maker must assess each part of the business. An enterprise analysis is one component of that assessment process.

"In my experience, few cattle producers do a thorough job of enterprise analysis," offers Mount. "I'd estimate that fewer than 25% of producers use it in a meaningful way. They think about it, and they might even talk about it, but they often don't follow through."

### Gross margin

Mount recommends evaluating each enterprise on the basis of gross margin, calling it a relatively simple way to determine where enterprises incur costs and where they create value. He says it "shines a bright spotlight" on the winners and the losers.

Additionally, the calculation of gross margins can be the starting point for construction of cash flow budgets and assessment of the whole business's profitability.

They can also be used to help evaluate opportunities to expand existing enterprises or develop new ones. After all, a key task for good managers is making informed choices between alternatives.

**TOOLS TO SUCCEED**
**ENTERPRISE ANALYSIS**

To determine gross margin, figure the difference between the annual gross product (the value of production) and the direct costs associated with a particular enterprise. Fixed (overhead) costs are ignored when figuring gross margins of individual enterprises. It's not that overhead costs don't matter, because they definitely are important to the profitability of the whole business.

"Overheads are the costs to keep the doors open, so to speak," explains Mount. "They include things like land taxes, utilities, basic repairs and maintenance, plus other costs that are shared by all enterprises."

### Enterprise exchange

On a good many farm and ranch operations, the product of one enterprise becomes an input to another. Examples include home-raised hay fed to a cow herd, or calves produced by the cows becoming inputs to a stocker or replacement heifer enterprise.

Mount reminds producers new to enterprise analysis that an enterprise receiving inputs from another must pay for them at the price someone else would pay for them and not at the cost of producing them.

So the cow-calf enterprise pays the haying enterprise for harvested feed. A stocker enterprise pays the cow-calf enterprise for calves at weaning. The cow-calf enterprise also receives payment for heifer calves sold into the replacement female development enterprise.

The recommended practice is to use the market value of the commodity being transferred from one enterprise to the next. Sure, such transactions may occur on paper only, but they reveal whether the first enterprise would generate a profit if the commodity were sold rather than used, and whether the second enterprise would be profitable if its inputs were purchased at market value.

### Per unit

According to Mount, subtracting total direct costs associated with an enterprise from its total value produced and dividing the remainder by the number of units in that enterprise reveals its gross margin per unit. Calculating gross margin per animal unit is an effective way to compare the economic efficiency of various cattle enterprises. Calculating gross margin per acre would be a useful way to compare different cropping enterprises, or the economic efficiency of a grazing enterprise compared to that of a haying enterprise.

Mount urges profit-minded producers to seek ways to improve gross margin per unit, rather than focusing narrowly on increasing production. High production levels won't guarantee

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profitability. Operations with the highest gross margins per unit and low overhead costs are most likely to be profitable.

## Practical example

Offering a practical example, Mount relates the story of a Colorado operation whose hay-making enterprise was a money-loser. Projections showed the haying cost for the coming year would be $20,000 higher than the cost of purchasing a like amount of hay.

The ranch's cow-calf enterprise had a gross margin of $375 per animal unit. If this operation eliminated the haying enterprise, used the hay ground for grazing and purchased hay elsewhere, the cow herd could be expanded by 150 head.

"That would create an additional $56,000 in margin with no increase in overheads. In addition, eliminating the hay-making business would liberate approximately $300,000 in capital and free up a month a year of the family's time," Mount explains.

"This is a perfect example of focusing on the things that are working," he continues. "This isn't to suggest that your hay business isn't working. Maybe it is the most profitable enterprise on your ranch, and your cows are the money-loser. The point is to identify those enterprises with a strong gross margin that fit your passions, then do them well and at scale."

## Crunching the numbers

Angus seedstock producer and Ranching for Profit School alumnus Bart Carmichael agrees that enterprise analysis helps find an operation's weakest links. About six years ago, Carmichael began implementing the process for his family's operation near Faith, S.D. The analysis did not result in abandonment of any particular enterprises, but the careful scrutiny showed where attention was needed.

"Our bull enterprise was the most profitable, but the gross margin for the cow herd wasn't as good as we had guessed — and guessing is what you're doing until you crunch numbers for each enterprise," offers Carmichael, explaining that the cow herd's gross margin was improved through better marketing of cows exiting the herd.

Previously, Carmichael's cow marketings consisted of cows with infirmities and any that preg-tested open. They sold as weigh-ups. A good many were teenage cows, which speaks well of Carmichael's selection for longevity. However, it didn't make the cows bring more money when trotted across the scale at the sale barn.

"We started marketing cows at a little younger age, selling them 'bred' at private treaty," explains Carmichael, noting how pregnant purebred cows with a few years left in them often capture a premium on the bred-cow market. That has increased income for the cow enterprise, whittled down cow depreciation cost and boosted gross margin.

Carmichael says individual analysis showed his replacement heifer development enterprise had the lowest gross margin. He admits that it does yet.

"Improved conception rates would help. That may take more supplemental feed, which increases direct costs, so it might not improve gross margin," says Carmichael. "That balancing act is pretty tricky. We're still working on it."

Lemoyne Dailey grazes purebred Angus cattle, too, but enterprise analysis helped convince him to get out of the bull business. The Thedford, Neb., cattleman and Ranching for Profit Executive Link member found the gross margin for his seedstock enterprise was lower than it ought to be. That discovery, plus a shift in personal interest, convinced Dailey that the "commercial side" of the cattle business offered more opportunity to increase the overall profitability of his family's ranch. One enterprise was dropped, and new ones were launched.

In the past, Dailey had sold his spring-born calves in the fall, except bull and heifer calves saved for seedstock development. Now he has more steers, which, along with the heifers, are kept longer and shifted to postweaning enterprises that add value to the calves. He's also changed the way he markets cull cows, targeting a premium rather than salvage price.

"When we sold calves at weaning, somebody else was buying them and making money by adding weight to them. We figured that we could do that economically ourselves, so we started backgrounding the steers and shipping them in late January," says Dailey, adding that heifers are held over as yearlings.

"We keep nearly all of our heifer calves and, come spring, we expose them to bulls. Bred heifers we don't keep for replacements are sold," says Dailey. "Open heifers are sold as feeders, or we might send them to a feedlot, retaining ownership to finish. It depends on the market," he explains.

Dailey also started sending cull cows to the feedlot, finished on grain for the "Premium White" market. It's another way to add value and increase income.

"And we were able to add these enterprises without increasing the overhead costs of the ranch," Dailey adds. That's important.

## Beware creature comforts

Overhead costs still have to be paid out of the combined income from various enterprises. Mount reminds producers that it's possible for farm and ranch businesses to struggle financially, even though gross margins are good, because overhead costs are too high. He believes a leading cause of unprofitable farm and ranch businesses is the expansion of overhead costs over time. Often, it's the accumulation of more equipment or people than the business can support.

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According to Mount, producers often fall into the trap of buying bigger and better tools that are supposed to make their lives easier. It's difficult to deny themselves the creature comforts; however, Mount urges producers to consider whether acquisition of another piece of equipment will generate more gross margin to cover the purchase and associated costs in depreciation and maintenance.

Have you identified the profit drivers in your business? Are some enterprises not working? Are some enterprises a distraction that ought to be eliminated? With existing overhead, could you do more with what does work? Mount says producers need to consider those questions. Finding answers starts with enterprise analysis.

"If you run cattle as a hobby, or you have access to an unlimited trust fund, it might not matter. However, if your operation is a business, you absolutely ought to do this," states Mount. "It's how you develop financial literacy."

Editor's note: Troy Smith is a freelance writer and cattleman from Sargent, Neb.