Reading the farm's dashboard: Business skills producers often lack

Progressive Forage Editor **Lynn Jaynes**

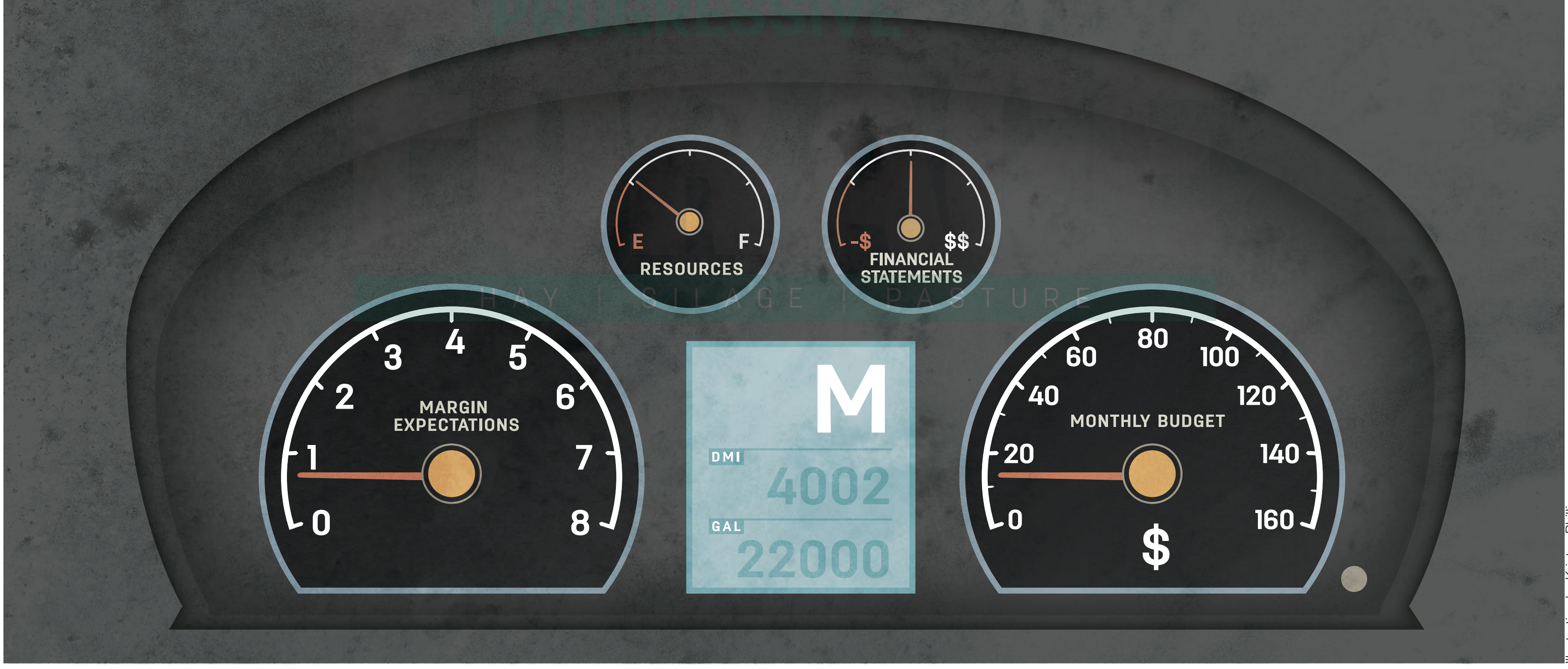

Illustration by Kristen Phillips.

Some years you make money; some years you don't – that's the nature of agriculture, right? Not so, says Nate Riggan, certified public accountant and owner of Pointguard Financial.

Riggan's firm serves as outsourced chief financial officers for businesses. He says while there are challenges common to all businessmen, with the same set of challenges one farm will show consistent growth and profit, while another farm in the same market will lose money. Why is that? Riggan says farms that struggle show common symptoms, which include:

- Not being sure how to impact profits other than by increasing revenues or decreasing expenses
- Financial reporting is an afterthought with limited or no interpretation
- There is cyclical performance, and the owner isn't sure what to do to change it
- The business doesn't operate from a forecasted monthly budget, where resources can be planned for maximization

Identifying the deficits

Riggan says deficits of businesses that struggle often include these common factors:

- *Businesses that struggle leave money on the table.* Small businesses often do not capitalize on revenue opportunities because they lack the understanding that impacts the bottom line. In this day and age, working harder or longer hours doesn't necessarily equate to increased earnings.
- *Businesses that struggle don't know how to interpret financial statements.* While many understand income statements, two other statements are important: the balance sheet and cash-flow statement. These tell you things about your business the income statement doesn't. Interpreting these and knowing how to use them can impact your business.
- *Businesses that struggle don't link company goals to employee performance.* Riggan says it's like coaching a basketball team: If you put kids onto the court and tell them to try and beat the other team but don't tell them what the specific goals are (expected rebounds, assignments for who brings the ball down the court, defensive roles, field goal percentages, etc.), then the results will not meet expectations. Employees need specific goals and accountability.
- *Businesses that struggle do not project financial plans.* All businesses need to ask, "What do we want to accomplish next year?" When entering a new crop year, a return-on-equity goal should be identified (more on that later). A financial plan should include a monthly forecast of what you intend to have happen, how much revenue will be generated, what margins will be and how much revenue each employee needs to produce. Without these indicators, a business becomes reactive.

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• *Businesses that struggle don't understand profitability for multiple products or service lines.* If a business has more than one product or service line (alfalfa hay versus timothy hay versus custom planting, or weaned calves versus replacement heifer costs, for instance) and doesn't know what each of those lines is making separately, then the business is too blurred, and it's difficult to see how to maximize profits or improve.

• *Businesses that struggle have limited ability to predict cash flow in the short term.* At some point in most businesses, there is a short-term cash-flow problem. As a business owner, you need some understanding of how to manage cash flow in the short term and know what the tools are to help with that.

• *Businesses that struggle lack the ability to implement change.* This limitation is common because most business owners spend their time working "in the business, rather than on it." The reason most entrepreneurs leave the employment of another (where one receives only partial value for one's work) and starts a personal business (where one will receive full value for one's work) is because the individual is good at his trade, and he believes those trade skills are the only ones required. The problem is: The skills of a trade don't automatically translate into good business skills – where managing people, marketing, finances and other skills are needed. Not being able to step out of operations to work "on" the business sets up an entrepreneur for failure.

• *Businesses that struggle often have no plan for leadership or ownership transition.* Riggan says too many businesses fail to plan for ownership and leadership transition – and often reach retirement with no available options. An important part of realizing the value for the business is planning on how you will sell or transition your role to the next generation or to a new owner. Failing to plan for transition often reduces the amount you can realize for your business.

Where do we go from here?

Riggan says the following skills must be mastered by businesses for maximum profitability.

Understanding the required return on sales

Return on sales is the income generated at the end of the year as a percentage of total sales. Do you know what that percentage should be? Riggan says a 5 percent return is needed just to survive in any business. At that percentage, you won't be receiving much, if any, return on your equity, as these profits will be used for payments for machinery and taxes, and generating some working capital to run the operations of the company. But this is simply survival. It's equivalent to buying yourself a job.

At a return of 10 to 15 percent, a production business can build equity and begin receiving payment for the higher risk taken by owning a privately held business. It would be rare for a production business to receive higher than 20 percent return on sales because these businesses produce a physical product with a "ceiling" imposed by the customer on what they are willing to pay for a tangible product.

Often, however, a hay producer may say, "I can't sell my hay any higher because my competitors are selling their hay lower." Riggan asks, "Is that where you really want to be?" Relying only on price for increased profitability is limiting, and there are many ways to increase return without increasing price – including increased yield, quality, productivity and managing the size of your infrastructure. Too many businesses have underperforming assets that drive down profitability, placing too much pressure on having to achieve the highest available prices from the market.

Understanding return on equity

Typically in agriculture, equity is invested back into the business instead of, for instance, investing it in the stock market. Just as an exercise, if you did put that money into the stock market, your return over time might average between 8 and 10 percent. The reason it isn't higher is that a normal investment portfolio is diversified, and you have the benefit of taking your money out of the market in a short period of time, which limits your risk.

Riggan says, "As you re-invest your earnings back into your own business, you should plan for a return between 20 and 25 percent on equity. If a buyer comes to buy your company, that is the range of return they will expect to receive for the cash-flow stream your business creates and will determine the price they are willing to pay." Therefore, if you want a higher value, you will need to create higher cash flow through profitability. So when you look at the 20 to 25 percent return on equity, it forces you to also know the return on sales you need to reach your equity return goal.

Understanding productivity

Productivity is about maximizing the utilization of your assets. Common measurements for productivity in agriculture would be calculated on tons per acre or yield per acre. In the case of employees, percentage of productive hours (hours producing revenue divided by total hours) is used. Riggan cautions that gauging the "busy-ness" of an employee is not the same as how productive the individual is in terms of producing revenue. This metric can be used in relation to other assets, as well, like machinery or land; how many hours a machine is used versus sitting idle or how many acres are producing revenue are some common measurements. The key is understanding how to maximize the utilization of the asset to achieve high productivity.

Understanding realization

This metric is about maximizing the profitability of your product or service. Metrics in this area serve to increase profits without solely relying on price. This can often be achieved by changing the mix of products you sell or reducing the cost of producing your product through labor or machinery efficiency.

Understanding leverage

This operational metric measures the return you achieve on your employees' labor, your machinery or your land. There are two kinds of leverage – revenue leverage and cost leverage. Revenue leverage is often illustrated as "upselling" or offering a product or service that is complementary to your primary product – like going into a restaurant and having dessert and hors d'oeuvres offered in addition to the meal. Cost leverage, on the other hand, is often illustrated as placing the right people in the right positions in your company to ensure you have the right level of competency for the job. It doesn't make sense to have your most expensive employee performing a job that someone with less skill, on a significantly lower pay scale, can perform. In essence, for every dollar paid an employee in wages and benefits, the business should see a return of $2.50 to $2.80. Putting the right people in the right roles is essential to maximizing leverage.

Drivers versus mechanics

If managing the business financials seems overwhelming, Riggan offers a car analogy to break it down. A mechanic gets under the hood and knows how pistons, carburetors, transmissions and engine parts all relate to and affect one another – which is great; everyone needs a mechanic. But a driver doesn't have to know all of that; the driver just needs to know how to read four basic dashboard gauges: how fast the car is going, how much fuel is available, the temperature of the engine and how fast the engine is turning.

Likewise, a business owner doesn't need to know every item of information in the business to be a great manager, but he needs to be able to read the farm's "dashboard" and interpret what it means. This includes the development of a monthly budget to allocate resources, accrual-based financial statements, margin expectations and resources (employees, land, machinery) needed to support sales levels.

Nate Riggan presented at National Hay Association's 2016 convention. Pointguard Financial is based in Spokane Valley, Washington. Nate can be reached at nriggan@pointguardfinancial.com