

2010

## *Making Profits in Uncertain Times*

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**ANDERSONS**

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CONSULTANTS

### **INTRODUCTION**

Over the past four years commentaries on the prospects for cereal farming have found ample exciting and dramatic price movements to discuss. Just at present, markets appear quieter, but the current period of relative stability may be short-lived as the following article sets out. Businesses should reassess their arable enterprises to prepare them for the more turbulent times that could lie ahead.

### **PRICES**

The large price movements of the last four years can be partly attributed to strategic decisions made in several countries (for example China and the EU) to sell grain stocks as storage costs and complacency over food security both rose. This stock liquidation, which started in the early 2000's, created an oversupplied market so prices and consequently production fell. As this liquidation ended it left a supply shortage, contributing to the price surge seen in 2007-08. Farmers responded to higher prices as economic theory would suggest, and output increased. This has led to the well-supplied markets currently seen, and, in-turn, the lacklustre grain prices.

World wheat stocks as a percentage of usage fell below 20% at the end of the 2007 harvest year: the 'danger' level at which grain buyers become concerned about supplies. Stocks are now above 30% - leaving purchasers relaxed and prices less erratic. Wheat prices have remained within a £20 range for the past 12 months, and traders do not currently foresee supply and demand imbalances altering this dramatically. This is reflected by little change in forward values through to May 2012.

However, it should be noted that a £20 price movement is still a 20% change: not something that many industries would regard as stability. A £20 difference in the selling price would have a massive effect on the bottom line of cereal farms. Forecasts of 'continued volatility' are based on less intervention in future (therefore no price safety net), and greater, more open world market access for agricultural goods. Lower market support and more open markets expose UK farmers to global price fluctuations.

Turning to inputs, fertiliser values have stabilised from their own period of massive price shifts, albeit at a higher level. There is continued volatility in fuel prices, and other costs such as sprays and machinery have moved upwards as a result of the weakening of Sterling.

Currency remains a key variable. Shifts in the value of the Pound against both the Euro and the Dollar are responsible for probably 60% of movements in arable profits in the last decade. With the current economic turbulence in the UK and Europe uncertainty continues as to the future direction of exchange rates.

At the time of writing there are signs of a strengthening of Sterling. On a conservative estimate, the devaluation of the Pound over the last two years might well have added £20 per tonne to UK wheat prices. UK arable producers would begin to lose this considerable benefit if the Pound strengthens.

### **POLICY**

There is much talk of a new 'age of austerity' in the UK, as the new administration grapples with the massive budget deficit. All aspects of Government spending will come under review. This may see a culling of the many agencies agriculture deals with.

In terms of direct support to farming, the sector will probably get off relatively lightly, at least in the short term. Most aid is prescribed by the EU under the Common Agricultural Policy (CAP). This includes not only the Single Payment (SP), but also the Rural Development money that funds programmes such as agri-environment schemes and diversification grants.

Again, stability may not last. The current EU support structure is due for another reform, to be implemented for the 2013 SP year. With money tight across Europe, the budget for the next 7-year period to 2020 may well reduce. There could also be a redistribution of aid: between countries, policies, and individual farm businesses.

The last major change to the agricultural support system was the implementation of the SP in 2005. Although the mechanisms for paying aid changed radically, the actual funds being distributed stayed much the same. Many arable farms were barely affected financially. The next policy change, to be implemented in only 3 years time, is likely to be the reverse; little change to the system, but a considerable alteration in the payment levels. The signs are that the SP will be retained through to 2020, but Andersons' believe that, by then, its value could be halved, with all UK countries having moved to a flat rate per hectare system similar to England's. Could you remain profitable at today's grain prices with half of your current SP? This should be seen as a key indicator of long-term business sustainability.

The SP (and AAPS before that) has provided a reliable and relatively constant payment to arable farmers for over 15 years. This has not reduced market volatility but has had a big effect in offsetting the farm business exposure to it. A guaranteed, relatively fixed subsidy income has made businesses far less vulnerable to price fluctuations.

More immediately, many arable farmers will be considering whether to renew their Entry Level Stewardship (ELS) agreements this year. Despite changes to the scheme rules since it was launched in 2005, it is still financially worthwhile for many producers if implemented correctly. Although the payments look low in comparison to business turnover, like the SP, the income is regular, certain, and guaranteed. As the Loam Farm figures below show, ELS payments can be an important element in farm profit. It should also be remembered that participation in the ELS contributes towards the Campaign for the Farmed Environment (CFE) targets, and so reduces the threat of a compulsory set-aside replacement.

### PROFITABILITY

The table below shows the latest profitability figures from Andersons' Loam Farm Model. This is a notional 600 hectare combinable crop farm with a simple rotation of milling wheat, OSR, feed wheat, and spring beans. It has now been running for 20 years, charting changing arable profitability.

<b>LOAM FARM BUDGETS - £ per Ha</b>	<b>2009 Result</b>	<b>2010 Budget</b>	<b>2011 Budget</b>
Gross Margin	418	556	561
Overhead Costs	332	338	347
Rent and Finance	142	143	142
Drawings and Tax	110	110	110
Margin from Production	(167)	(34)	(38)
Single Payment and ELS	283	267	265
<b>Business Margin</b>	<b>116</b>	<b>233</b>	<b>227</b>

What the table does not show is that the margin from production was positive in both the previous 2007 and 2008 harvest years – the aim for all cereals businesses. However, as input prices rose and output prices fell, the 2009 harvest result was dramatically poorer.

Since then, whilst output prices have moved relatively little (either for 2010 harvest or indeed for 2011 harvest), input costs have dropped back considerably. So whilst Loam Farm still requires the SP to make a profit, it is far less dependant. In fact the Loam Farm margin from production plus ELS would almost break even in 2010. On current forecasts, the budget figures for the 2011 harvest are similar to those of 2010.

The memory of recent price gyrations is fresh in our notional farmer's mind. Loam Farm has therefore already sold some of its 2011 crop. Grain marketing will remain important in the coming years, and a vital part of this is knowing the cost of production of each crop. As an illustration, the cost of producing feed wheat on Loam Farm has fallen from £121 per tonne in 2009, to a budgeted £107 per tonne in 2010, then rising slightly to £109 in 2011. It is perhaps instructive to look back to 2006 – before the upheavals of the recent past. The feed wheat cost of production for that harvest on Loam Farm was then £84 per tonne – indicating that costs appear to have moved to a fundamentally different level.

Although wheat is the main crop on most British cereals farms, it can be argued that there is perhaps too much focus on this crop. Rents are often tendered on the basis of first wheat costings, but the profitability of the whole rotation, including breaks, is the important factor.

### CONCLUSION

Volatility in the cereals sector is probably just resting rather than dead. The last five years have taught us that management time (which is a scarce resource), should be devoted to both reducing the risks where possible, and improving the productivity of the farming operation. In essence, concentrating on the things that are under a business's own control.

Every farm is different, and strategies need to fit in with the aspirations and objectives of the proprietors of the business. Andersons have vast experience of helping people make the right strategic decisions, and then assisting clients in taking action to make those plans a success. In the future, whatever it may hold, we look forward to helping all those in the cereals sector, whether farmers or those in supporting industries.

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