

ANDERSONS

# Arable Outlook

June 2011

Converting  
Higher Prices  
into Profit

ANDERSONS

the  
FARM business  
CONSULTANTS

## INTRODUCTION

Last year at this time we wrote that any stability in markets might be short-lived, and that cereals businesses should prepare themselves for further volatility. This certainly proved to be the case with markets taking-off soon after Cereals 2010. Although output prices are much higher compared to a year ago, the challenge for the sector now is to translate this into higher profitability.

## PRICES

The bull run in global grain prices began in earnest with the early summer drought in Russia and the subsequent grain export ban. The countries of the Former Soviet Union have established themselves as one of the main sources of cheap wheat on global markets over the past decade. Once it became clear that this would not be available, markets surged. However, data suggests that there is no fundamental shortage of wheat from the 2010 harvest, and it looks unlikely that there will be one from harvest 2011 either. So why are grain prices where they are?

The answer lies in the 'coarse grains' markets. These are basically the feed grains, and the category is dominated by maize ('corn' in the US) which comprises two-thirds of all coarse grains. Indeed, maize is the most important cereal grown globally, with a tonnage produced almost 20% greater than wheat. This means that maize sets the global grain pricing agenda.

The 'safe' level for global coarse grain year-end stocks is widely held to be around 15% of annual consumption. Below this level grain users start to become concerned about securing supplies, and prices react. Stock levels at the end of the 2010/11 marketing year (2010 harvest) look set to be below 14% of usage, and are forecast to be even lower at the end of the 2011/12 marketing year. This indicates that, unless we get a surprisingly good global harvest, cereals values should be underpinned for harvest 2011.

One major uncertainty is that a large proportion of the global grain stocks are held in China - and nobody really knows what is there. If China is shorter of grain than is being assumed, and comes to the global market in 2011, this could cause another surge in prices.

Currency remains an important factor in setting the price on the UK market. In recent times the Pound has been relatively stable against both the Euro and Dollar. Any major realignment (possibly due to wider economic issues) could trigger a proportionate change in prices.

Also in the domestic market we have rising demand for wheat due to the new bioethanol industry. However, this new sector is experiencing some teething problems. The existing plant will shut down for up to four months in the run-up to harvest 2011 due to unfavourable market conditions. The second major UK wheat-to-bioethanol plant is unlikely to be operational before 2012 due to construction problems. Fortunately, the tight global market should provide plenty of alternative homes for UK grain.

Turning to inputs, the cost of fertiliser and fuel show no signs of reducing significantly from their current levels over the next 12 months. This will offset some of the rises in output prices seen over the past year.

## POLICY

The discussions on the next reform of the CAP continue at EU level. Negotiations may well continue for two more years, and it is clear that a reformed CAP will be introduced for the 2014 Single Payment Scheme at the earliest. This will mean a roll-over of the current system for an extra year.

Of course things may change, but the indications so far are that this will *not* be a radical reform of the CAP - the Single Payment (SP) will continue in some form after 2013. However, there will be 'tweaks' to the current direct payment system requiring farmers to undertake more environmental work to receive their SP. Funding is likely to fall and Andersons' believe that its value could be halved by 2020, 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 risk-free bedrock in many farm accounts for almost two decades. As payments reduce, the effect of volatile markets will become more pronounced on cereals businesses.

The other main stream of public support is through agri-environmental payments. A new set of Rural Development programmes will be required for 2014 onwards. It is not yet clear whether any of the UK administrations will use this opportunity to radically alter their agri-environment schemes. Those already with agreements will be safe from any changes until they come up for renewal.

In England, the Campaign for the Farmed Environment is currently falling some way short of its targets. There is still the threat that this will see the introduction of a compulsory

set-aside replacement scheme. However, Andersons' believe that it is unlikely that anything will be enacted whilst the CAP reform discussions are still continuing.

## PROFITABILITY

The table shows the latest profitability figures from Andersons' Loam Farm model. This is a notional business which has been running since 1991 and tracks the fortunes of combinable cropping farms. It comprises 600 hectares in a simple rotation of milling wheat, oilseed rape, feed wheat and spring beans, and is based on real-life data.

<b>LOAM FARM BUDGETS - £ per Ha</b>	<b>2010 Result</b>	<b>2011 Budget</b>	<b>2012 Budget</b>
Gross Margin	677	735	743
Overhead Costs	342	352	367
Rent and Finance	143	173	185
Drawings	110	113	113
Margin from Production	83	97	78
Single Payment and ELS	259	254	251
<b>Business Margin</b>	<b>342</b>	<b>351</b>	<b>329</b>

The good news is the positive margin from production foreseen for all three years. This comes after a negative result for 2009 (and a good number of the years that preceded it). This positive margin before support payments should be the long-term goal for all cereals businesses. Of course, it is far easier to achieve with high output prices.

The more concerning issue is the rise in costs. Although not shown in the table, variable costs are forecast to rise for 2012, resulting in a lower gross margin than would otherwise be the case. A big increase in costs has come about because some of the rented land on Loam Farm has come up for renewal. Rents have been agreed at much higher levels - in line with market realities. This illustrates how a profitable season or two can build cost into an arable business, which it then has to live with for a number of years (the 3-years life of the FBTs in this case).

Loam Farm calculates a cost of production (COP) per tonne in order to highlight areas for improvement and as a marketing aid. For this reasonably well-managed business the COP for feed wheat is budgeted at £122 per tonne for harvest 2011. This figure is very sensitive to final yields however. Although Loam Farm's budgeted yield has been cut slightly as a result of the drought, the final impact may be

more severe. For 2012, the cost increases previously outlined mean the forecast COP rises to £124 per tonne.

## PERFORMANCE

There is not much that the growers on the ground can do about world markets, but the management of a cereals business is the primary factor affecting its profitability. There is a vast range of performance between the best and worst farms in the UK arable sector.

Some of the common features of the better cereals businesses that Andersons advise are;

- a focus on target crop yield and specification
- knowing which farm areas and crops contribute to profit
- timeliness of operations
- not chasing scale without considering the bottom line
- having a long-term business strategy
- procuring machinery and labour efficiently, often in collaboration with other businesses

The current price highs should not mean that investment appraisal is any less thorough - machinery purchases have long term consequences for a business. Business restructuring can also enable costs to be reduced which lessens exposure to market fluctuations. Andersons have been implementing and managing joint venture arrangements since the 1970's. These continue to develop and many businesses are finding success by working together under a well-structured and mutually beneficial agreement.

## HELPING YOUR BUSINESS

Faced with better output prices and profits it will be tempting for many UK cereals businesses to make little or no change - simply because they don't have to. But this would be to miss many of the opportunities that are currently available to secure very good profits. Rapidly changing marketplaces and production cost movements mean that farm business objectives and financial performance need frequent assessment. Finding time to focus on the current and potential future health of your business remains vitally important.

*Please contact us for an initial visit without charge or obligation to discuss the cost effective assistance that we can provide.*

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