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UW Growing
Beginning Farmers & Ranchers

Getting Started in Ag: Six Factors Affecting Profit

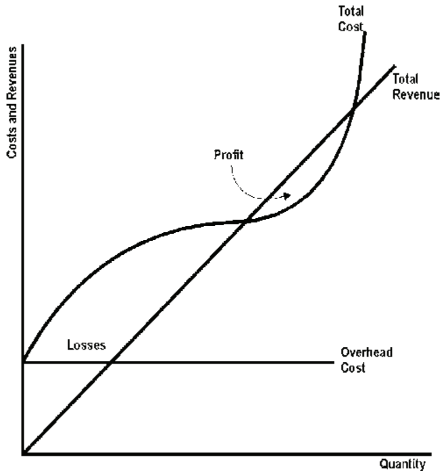

Figure 1. Profit: bounded by total revenue and total costs.

Making a Profit is Not So Simple

Profit—defined as revenue left after covering all expenses—is the goal of every successful farm and ranch business. It may seem like a simple concept. However, many factors go into making a profit. If you are new to farming or ranching, you are probably learning that much more goes into building a profitable business than simply making more than you spend.

Many managers make the mistake of not realizing the difference between positive cash flow and profit. A positive cash flow means more cash was generated than spent, but fails to account for where the cash came from. A positive cash flow could come from selling assets versus products produced; profit also includes non-cash expenses like depreciation.

Profit is defined as the positive return left after accounting for all expenses, both cash and non-cash. In order to run a successful business, it is essential to have a solid understanding of your financial status based on up-to-date financial statements and analysis. This analysis should include detailed insight into what contributes to the profitability of your business—and what may take away from that profitability.

Strategic Goals and Planning

Before you assess the profitability of your operation, it is important to draft a set of strategic or long-term goals for the business. In setting these goals, take the time to carefully evaluate your financial status and plan accordingly. Think of it in terms of using GPS on a road trip; it doesn't matter how good a driver you are if you don't know where you are going.

The first goal is to maintain ownership of the farm or ranch for most managers getting started in agriculture. From there, production goals, such as number of bushels per acre or calf weaning weights, are often set as part of operational planning; the plan should also include cash flow projections and other financial performance benchmarks. With these operational goals in mind, you can focus on the profit objectives. At this level, planning should be broad enough to consider potential revenue shortfalls that could occur if the business is unable to meet your goals. An example might include the need for off-farm income to meet personal financial needs.

Six key factors affect business profitability: production (number of units produced), production per unit, direct costs, value per unit, enterprise mix and overhead costs. Once you've set strategic goals, these six key factors can be used to assess profitability.

Number of Units

The number of units, or total production generated, refers to the crops or livestock produced. In general, profit can be increased by adding more production units. However, it is important to remember that maximum output does not necessarily mean maximum profitability. Keep in mind the concept of diminishing marginal returns—simply producing more, without accounting for the increased costs associated with greater production, may not be profitable.

For example, a producer earns a profit of $500 per acre from raised corn. Simply raising more corn by leasing more acres may not be profitable; a careful evaluation of the overall impact of the costs associated with the increased acreage, including additional inputs, labor and equipment required, must be completed. It is important to include all costs associated with potential increases in production when estimating expected profits.

Figure 2. Chopping corn for silage. J.P. Hewlett

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Figure 3. Layer with eggs, units of production. J.P. Hewlett.

Production per Unit

Another angle on increasing total production may be through increased production per unit. Examples could include seeking to increase yields per acre, weaning weights per cow or other increases at the production-unit level.

It is important to be realistic with your expectations. For instance, if your current average corn yield is 150 bushels per acre, setting a yield goal of 220 bushels per acre is not realistic and will not be achievable without considerable increases in operating costs and other costs, such as fertilizer, equipment and labor. In many cases, small adjustments can improve profit per unit. Examples include changing crop varieties, buying improved livestock genetics or modifying calving dates to improve death losses and weaning rates.

Direct Costs

Direct costs, also known as variable costs, are those that are tied directly to production levels. Many managers look to these costs first when considering how to improve profitability. It is important to carefully consider the impact of these potential cuts before implementing any changes. If cut too deeply, the reduction in variable costs may be offset by even larger reductions in revenue, resulting in reduced profits.

For example, the increase in fertilizer prices in recent years has caused many growers to consider drastically reducing the amount of fertilizer they use in order to cut costs. The flip side of that change is potential yield reduction.

Make sure that any reduction in costs is sustainable from a long-term perspective. Also consider taking steps to reduce cost variability as much as possible by taking bids, forward contracting and using other strategies to lock in costs wherever possible.

Value per Unit

Increasing the value per unit is another way to improve profitability. Remember, even small adjustments can make a big difference when it comes to adding value. These changes can range from carefully evaluating market timing to looking at alternative sale points (direct, online and others), forward selling, using futures markets and more. No single approach will work for everyone.

Be sure to develop a marketing plan as part of your overall financial plan. From a profitability perspective, it is too risky to simply haul bushels or livestock to town at harvest and accept the going price that day.

Enterprise Mix

Another important aspect of profitability is how the various enterprises in the business work (or don't work) together. An evaluation of your enterprise mix can reveal the profitability of your overall operation, as well as identify potential areas for improvement. Following this strategy can help identify areas to monitor closely in order to avoid costly mistakes that may affect profit over the long term.

For example, it might cost a ranch more to produce hay than to purchase it off site. Without periodic enterprise analysis and awareness that corrections may be needed, a manager may simply repeat past production strategies, resulting in a long-term decline in profitability with potentially disastrous results.

Overhead Costs

Overhead costs, also referred to as fixed costs, are often a tricky area to address. The farm or ranch may generate returns that cover cash costs, but are too low to cover all fixed costs.

A common example is the cost of new equipment or machinery. Careful, consistent analysis is required to make sure equipment costs are not excessively shrinking profit margins. For example, a producer may be better off hiring a custom harvester rather than purchasing the machinery due to high ownership or maintenance costs. While new technology may complete the job more quickly, that speed comes at a price—and sometimes that price may be too high to be profitable over the long haul.

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