# David M. Kohl

**Professor, Virginia Tech**
**Agricultural Finance and Small Business Management**

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## Widening Gap of Profitability

By: Dr. David M. Kohl

In agriculture today, there appears to be a widening gap in profitability. The current economic reset is intensified by the recent high prices of the great commodity super cycle. This is specifically true for businesses with over $500,000 in farm revenue. However, in assessing a potential trend, it is always best to start with an examination of the data. University of Minnesota's FINBIN data illustrates the concept.

The FINBIN data segments financial information of larger farm businesses into high and low 20 percent ranges of median net farm income. This analysis is conducted according to farm size and dollar amount of gross farm revenue. Interestingly, as the size of the farm increases, the gap of profitability widens. For example, while the top 20 percent earned a median of $570,000 in net farm income in 2015, the bottom 20 percent lost $330,000. This calculates to a $900,000 difference in profitability for farms with over $2 million in revenue.

In a recent conference, we asked producers and experienced agricultural lenders to assign expected management practices to each group of profitability, both high and low. The producers and lenders came up with some interesting points that may help explain the growing profitability gap.

One of the practices commonly assigned to businesses in the lower 20 percent of profitability was lack of knowledge or awareness of costs. This group was also thought to be comprised of wishful thinkers concerning projected revenue. This inflated inaccuracy is harmful whether in production, marketing, or expectations for new markets. Another practice indicated for this group was set cash rents. Some businesses agreed to long-term agreements anticipating that high prices and strong markets would continue. Of course, those businesses are losing money today.

Another practice assigned to the lower 20 percent was emotional decision-making. Disregarding the logical, objective approach can be quite costly. For example, the plan for $4.00 per bushel corn is not executed because of the hope for $5.00 per bushel corn, which turned into a reality of $3.00 per bushel. Others relied on weather issues or market disruptions in other production areas to boost demand. Many of the farms with lower (or negative) profit margins simply got caught unprepared and without a back-up plan to implement when various factors did not go as expected.

Occasionally, times of adversity tempt perspectives towards the negative. Some farms in the lower 20 percent wanted to play the blame game instead of accepting responsibility and making adjustments. Further, many farms decided to make adjustments by looking for one magic silver bullet rather than incremental, managed changes. Sometimes the most costly expenses come from denial or pride.

Next, the businesses in the top 20 percent were also assigned some distinct practices. The producers and lenders at the session saw the more profitable businesses as organized. Businesses in this group commonly have accurate record systems in production, marketing and finance. Unlike the lower percentage, these businesses know their cost of production for each enterprise, if multiple enterprises exist. In fact, these more profitable farms shift resources according to net margins and changing market conditions.

The more profitable group of farms also invests in productive assets as dictated by the bottom line. Noticeably, this group continues to make cuts in family living and personal withdrawals from the business. In other cases, some are willing to engage in side projects that provide needed and temporary cash flow to bridge the losses.

The key attribute amongst more profitable businesses is their proactive nature. These businesses make time to plan, and strategize, but also execute and monitor. Managers of profitable businesses do not wait until December to review the year's finances. Finally, financial tools such as, the balance sheet, and projected cash flow with various scenarios are completed and recorded in the most profitable businesses.

Managers at the top level also maintain open communication with lenders, partners, the younger generation of management, and other stakeholders. They also realize that the only bad mistake is one from which they do not learn. Profitable businesses are forward-thinking and position themselves for the next generation. In addition, they prepare the younger generation with proactive management practices in order to strengthen the chances of continued success.

While certainly not a complete list of management practices from either end of the spectrum, these practices can provoke thought and serve as a basic measurement of business performance. As the data tells us, management is the premium that differentiates the top from the bottom in financial performance during these days of challenging margins. Measuring your business against the mean can lead to failure within a five year period. Remember the saying that "average does not reside in the future."