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"Key factors in growing a business"

A 1997 Irish Nuffield farm scholarship report

by Peter Baker.

Introduction:

I run a dairy farm business in partnership with my wife Sarah in County Tipperary which is in the in the heart of Ireland.
As a teenager, I spent a year working on farms in Australia and New Zealand before returning home to the family farm business in 1980. We inherited the business in 1994 and run a profitable dairy operation of 140 cows in a seasonal herd with a focus on grazed grass.
My Nuffield journey took me to the United States, Argentina, New Zealand and Great Britain and was without doubt, a wonderful opportunity to meet interesting, successful and motivated people. The opportunity to “stand back” from ones own situation is one of the under stated advantages of being honoured with a Nuffield scholarship and one which I know has been of great benefit to me.

Reasons for looking at this topic:

1. The regulated environment that farm businesses find themselves operating in within Europe is leading to total industry stagnation. Business growth has begun to elude many and the challenge must be to identify pathways to growth for those interested.

2. A belief that change can be effected politically over the long term but that in the short term, **individuals farming for the present cannot effect political change** and therefore must accept the challenge to grow **within and around** the present climate.

3. A feeling that too few farm businesses measure their efficiency in a structured and meaningful way. A conviction that “partial measures” such as gross margins are inadequate and that many farm business benchmarking analysis are superficial and do not address the real issue which is **profit.**

4. A wonderful opportunity to meet some of the most successful farmers in the world alongside top class corporate managers in an attempt to discover **“Common pathways to The Promised Land!”**

Summary of Objectives:

Main goal: To identify and quantify "The key factors in growing a business".
I will attempt to achieve this in 3 sections of the report:

1. Conclusions: At the outset I want to present the reader with the conclusions of my study: I want the reader to stay with me!
2. European Agriculture: Very briefly outline the predicted outlook for European agricultural policy into the future.
3. Key factors in Growing a business: Outline the key factors that combine to grow a sustainable and profitable business.

I have attempted to construct a composite of all the thoughts expressed by individuals rather than personalise or attempt a country by country analysis. It is also written with the general farming community in mind and with my dairy farming background, may at times, have a "dairy" slant. I hope the messages and observations detailed can be applied to any business.

Conclusions:

The pivotal message of this study is very simple.

It concludes very clearly that sustainable business growth will come from:

A very clearly thought out and written down plan:__STRATEGY (page 6)
Excellent management who understand it:________CAPABILITY (page 14)
The assets and finance to drive it:_______________CAPITAL (page 20)

The bottom line is that each of these factors is vital and that the speed of growth will be limited by the weakest element of this formula.

Of the 3 factors, I believe that the process of **clearly planning a strategy** as to how to grow the business is the **absolute key**.

For example: How can a farm business get from £30,000 profit today to £60,000 in 5 years?
This is 15% compounded growth per year.
This is the rate of growth being consistently achieved by many businesses outside of farming.
The reality is that few farm businesses worldwide achieve this level of growth.

I am clearly suggesting in this conclusion that achieving this level of growth will only be achieved within the frame work of a clear and realistic **plan**.
Farm businesses have, for too long, paid lip service to planning growth.
It is clear that EU policy will keep many inefficient farm businesses, viable and neck and neck with inflation into the future.
But it is strangling those farm businesses keen to grow significant businesses. This is reality!
The conclusion of this study is that only those businesses that clearly identify the realities, think positively and accept the challenge of planning will achieve growth out of this mediocrity.
The conclusion is that the reality of the environment demands “lateral” thinking, which may well drive farm business growth away from their core business. A positive attitude, which is the fuel that drives successful people, will look on this as a real opportunity!

I suggest that planning is definitely a skill that has to be learned and strongly recommend searching out help from those with experience in this area. Large businesses and corporates expend substantial resources in this area.

The report clearly identifies the importance and inextricable link between STRATEGY and the CAPABILITY to formulate and implement it.
All the managers I met had exceptional capability.
Their exceptional capability allowed them to clearly see the bigger picture, to plan a strategy. So one very definitely compliments the other. You need capability and vision to plan a strategy. You need a realistic strategy on which capable management can operate!

This capability not only encompassed a person's ability to plan a clear strategy but also enabled a clear understanding and focus on CAPITAL and its uses.
It suggests:
'**A focus on understanding the present business and constant fine tuning of it'**

This focus should lead to increasing cash surpluses and an understanding of the need to invest these funds into high return areas that have the ability to compound.

The conclusion is that growing a business entails an ability to take risk but that this risk is **<u>calculated</u>**.
But to many of the entrepreneurs that I met, the biggest risk of all was <u>not</u> taking a risk. Growth to all of the people I met had come through aggressive leveraging of "other people's money" which fuelled the business. "Sitting" on assets and surpluses that were not being used to secure money which could be channelled into higher return areas was considered wasteful in the extreme.
The strong conclusion is that growing a business requires a deeper understanding of capital and requires innovation in its uses.

The final analogy in this conclusion is to imagine the 3 factors: STRATEGY, CAPABILITY AND CAPITAL as a see-saw.

<u>Capability</u> is the fulcrum in the middle that attempts to balance a very clear **<u>strategy</u>** with sensible use of **<u>capital,</u>** invested in high return areas.

Within these parameters of a drive for business growth, my final observation in the conclusion is the necessity to keep a balance between growing a business and growing with family or the people most important in your life.

"Obstacles are what you see when you take your eyes off the goals"

European Agricultural policy:

My main interest in this report is **not** EU policy but I feel that a brief reference to it is necessary to lay the foundations for the report.
Briefly, the main developments within the EU into the new millennium would appear to be:

1. The planned accession of the Central European Countries to the EU bringing with them massive population increase (30%) with over 20% of their workforce involved in agriculture. The sheer scale of the extra support needed, even at present 1998 levels, is clearly not sustainable particularly in the light of GATT commitments.

2. Support in the future will be directed more toward social and environmental areas. So we have an attempt to mix agri and social policy which by its nature is anti growth.

3. There will be a reduction in price supports. For example, there is a proposed 30% cut in the beef sector, 20% in the cereals sector and 15% in the dairy sector. This will be "balanced" by a form of direct income support, sub divided into a community wide basic payment with an extra payment according to national priorities. So a clear shift in policy from price supports to direct payments.

4. There is a clear insistence on retaining the milk quota regime at least to the year 2006.

The reason for briefly alluding to the proposed changes as set out in Agenda 2000, is that the individual entrepreneur who aspires to grow a business within this environment should recognise the realities facing the industry. Particularly within Ireland at present, there is a definite policy toward penalising increased scale in favour of sustaining the viability of the smaller scale producers. The rights and wrongs of this policy are not to be debated here. The challenge is to grow in the face of these perceived obstacles.

“Growing the business”

I took the opportunity in my study to meet not only world class farm owners and managers but also with managers of successful corporate businesses where the equity investor’s demand for growth must be reflected in increased share price, higher earnings per share etc.
Many of these companies will target growth of 15% per annum, which effectively means a doubling of the business every 5 years.
First impressions might be that growth in the corporate sector has little relevance to the small, owner operator business. Not so!

One of the companies I visited was the Kerry Group who, in the space of 20 years has grown from being solely an Irish milk processing co operative to become a world player in the manufacture of specialist food ingredients. Their other major activity is the manufacture of consumer foods in the UK and Ireland. The broad “formula” as to how this was achieved makes up the basis of this section on “growing a business”.

The Kerry Group focus has been on the formula that states:
Strategy × Capability × Capital = **<u>Sustained Profitable Growth</u>**

I propose to individually address these three elements of sustained profitable growth.
It was pointed out to me that businesses fail for many reasons but nearly always because one of these three main components has been particularly weak.
Equally, the <u>speed</u> of growth will be determined by the weakest link in this “formula”.
I strongly believe that this type of formula or if you like, this way of addressing how one might grow a business has very clear lessons for most businesses. Farm business is no exception!

Strategy:

Strategy has been described as:
1: recognising where you are today,
2: knowing where you want to be in a certain period of time and
3: deciding how to get there.

1: Recognise where you are today:

In 1979 the Kerry Group lost 20% of its milk pool because of a disease eradication programme. This crisis forced a major re think of how Kerry Co-op was going to survive and grow. Kerry's chief executive, Denis Brosnan remembers saying at that time that "they would never again be as dependant on milk and that there must be an easier way of doing things". He clearly identified that growth, in the Kerry situation, was not going to come from a dependency on a regulated commodity.

Corporate businesses grow either organically or through acquisition or a combination of both.
The Kerry Group recognised initially that growth had typically been organic, benefiting from what either God, the Government or the EU dictated! The change in attitude by Kerry was that a reliance on one or all of these three factors was foolhardy and shortsighted and required a fundamental shift in their **objectives and planning**.

If this is the case, then Denis Brosnan's initial recognition of the unsustainability of their present position was, in effect, **the first element** of a broad strategic plan. He "**recognised** where the company was today"

So why plan for growth in European farm business? :

Bearing in mind the necessity to **"recognise where we are today"** concept:

Stagnation is widespread within European agriculture and very few have managed to significantly grow their businesses under the politically regulated environment in which they operate. If business profits stagnate, the reality is that inflation will gobble up these static businesses.
The choice as to whether an individual is prepared to accept this status quo is obviously personal. If the decision is to accept it then it is in itself a "recognition of where you are today". The decision to accept a continuance into the future of a certain present state might be associated with a desire to keep a balance between business and lifestyle or family commitments.
Even where an individual is not a growth driven animal, it would seem just as important to have a clear picture as to whether the present "balanced" lifestyle is sustainable into the future. Is it possible to continually satisfy basic financial

demands or “critical mass”, by a static business? Is a fine-tuning of input costs in the present business enough to continually satisfy inflation and increased lifestyle demands?

It must follow then that the onus on farm business managers is to plan a strategy that initially recognises the realities. If the reality recognises that the present profit of a farm business at £30,000 needs to double by 5 years time to £60,000, then this certainly <u>will not happen</u> without a very planned approach.
The successful farm business people that I met, irrespective of their environment, were all very clear in their plan. They had an ability to clearly assess where they stood at a given point and were very focussed on what they needed or wanted to achieve and <u>how</u> they would achieve it.

2: Knowing where you want to be in a certain period of time:

The 80 / 20 rule:

This “attitude” toward future growth has been a cornerstone of the Kerry Group philosophy. It is basically saying that 20% of the growth of a business might be because you run excellent technical operations. The true driver in sustained growth will be a very clear strategy on which to operate. 80% of the growth will be because of the clarity of the plan.

80% strategic planning
20% operational performance.

It is not for a minute suggesting that the day to day operational performance of a business is not important. Kerry has a relentless focus on quality and operational performance. Rather, it is an attempt to illustrate that in attempting to achieve significant growth into the future that the greatest emphasis should be on importance of looking at the bigger picture or “knowing where you want to be in a certain period of time”.

In general, farm businesses are terribly guilty of the reverse: **“heads down, a… up”** syndrome.

The challenge to farm businesses is to at least address the imbalance, or as one person said: “don’t sweat the small stuff”.
The challenge is to pull back from the coalface and focus on a plan for the future. It should be cognisant of good technical performance, accepts it as a fundamental of growth but recognises that the bigger focus **must** go into a sensible and realistic plan for the overall growth of the business.

Within an overall goal of being a “major international food ingredients company and a significant food supplier in Europe” the Kerry group set very clear parameters as to where they wanted to be in a certain period. These parameters included a specific targeted yearly earnings increase.

That they have consistently achieved their targets, which have produced compounded mid teen growth, can be directly traced to exceptional management with a very clear strategic focus.
As Denis Brosnan said: **"We have seldom had to operate on bad strategic decisions"** or more bluntly**: "If you have made the wrong strategic decision at the outset then you're dead!"**

Identifying where you want to be in a certain period of time or setting an objective, which might be as straight -forward as stating: "We want to double profitability within 5 years and compound that profit in sensible high return investments". Then there must be a very clear and realistic thought process in place to plan that objective. Once a clear objective is in place, then the strategy to implement it has to be developed.

3: How to get there:

"It involves isolating what may be the best mix between the opportunities out there and the capabilities of the individual or business to implement the plan"

- The concept of a 5-year strategic plan backed up by a 1-year operational plan seems to be a model used by many corporations. Most of the people I talked to felt that planning was difficult to envisage any further than this 5 year window.

- It has been said that you cannot simply sit down one day and decide: "we'll all take the day off for planning". There is however, evidence to suggest that there is a strong connection between **writing down** a broad 5-year plan and turning it into reality. A study of business school graduates from Stanford in 1970 revealed that just 3% had written down a long-term strategic plan at graduation or soon after. By 1990, that 3% had a net worth equal to the combined wealth of the remaining 97%!

- "**Planning is very definitely an on going process** that gets formalised once or twice a year". Denis Brosnan referred to it as: "Updating the Book itself" or another proposed the concept of "mini e.g.m's" during the year. The point was also made that **you cannot repeat often enough** the business objectives and the plans to achieve them because it is very easy to drift back into day to day chores and lose sight of the bigger picture.

Denis Brosnan talked of the concept of: **"the Photograph and the Text".** This referred to the idea of the business manager looking at the overall picture of the present business or proposed acquisition of a business, taking a **"photograph"** of the bigger picture, talking to management, "developing pictures" of what synergies were possible, what efficiencies could be implemented. All the while he would be keeping an eye on **identifying opportunities**. At the same time the **"Text"** was that part of the business devoted to looking at the figures past, present and future. In the larger corporate business, there are numerous people employed constantly working on

“the Text”, even for businesses that may be acquired 2 to 3 years down the line. Quality planning now will tell Kerry what broad profits and capital spend the company will have 2 to 3 years out. The broad plan might tell them that they need to be operating within a particular country in 2 years and already they will know all the potential companies within that country that may be suitable acquisitions. Thoroughness, patience and incredibly extensive research are the hallmarks of this company.
<u>There are lessons in this for all businesses.</u>

- There must be a very clear focus on, and understanding on the way in which this growth is going to be achieved. This may be organically, through acquiring similar “bolt on” type businesses or perhaps through passive “outside investment”.

If growth is going to be achieved through other people, there must again be a very clear understanding by those people of exactly what the business goals are and they must have the ability to implement that plan. **So: quality people to replicate the skills and strategies of the manager and business.**

At farm level, Michael Murphy in Ireland stands out as an example of achieving this through top quality managers who are very clear on the business objectives and the principles of “how to get there”. There is an understanding by the managers of the need to get a very high (20%+) return on these operations and equally there is an understanding that this will only be achieved through a low cost, high grazed grass system. There is undoubtedly a natural climatic advantage in this country, which many in other countries will argue is not available to them. The secret is in recognising the advantages thrown by any given environment and harnessing those advantages with top quality management, tight cost control allied to optimal production.

<u>Use a facilitator</u>:
Planning “how to get there” is not an easy task. Strategic planning has been described as a skill that has to be learned. Corporate business often uses **outside expertise** in helping address the processes in planning strategy. America, not surprisingly, has invented the notion of a “life coach” who is employed to guide and help the individual in fulfilling his or her goals. I don’t suggest the need for us all to suddenly rush out and employ a “shrink”. The reason I allude to this is that I feel most of us are simply not educated in strategic planning skills.
Very few have written down where they want to be and actually shy away from doing it. Denis Brosnan rightly observed that “You have to teach yourself to stop and think but not everyone wants to do this” Getting outside expertise to help in this area may well be a very good investment.
The strong recommendation for the average farm businessperson is to sit down with a consultant, advisor or someone with experience to talk through a realistic set of objectives and who can help formulate and write down a realistic strategy.

How to get there must include <u>realism</u> in strategic planning:

- Planning may be easier in a bigger organisation where many skills can be married to produce and implement a plan for growth. It will always be easier in a bigger organisation because the great thinkers may not necessarily be the great operators and vice versa. Realism in planning within a farm business may well be in acknowledging that few <u>individual</u> managers have **absolute skills.** This **may** then beg the question: "Do I have to create all my own wealth or do I invest surplus cash wisely in a company which has a proven track record of superb management achieving consistently high returns?"

- Realism in planning is identifying what you are not prepared to do or where you are not prepared to go. Some have travelled to other countries and made clear strategic decisions that, rightly or wrongly, they wanted to grow from their home country <u>base.</u>

- Realism is a plan that is just that…realistic. Also it must be desirable by everyone in the business. Planning the future of a business **must** encompass the personal strengths and goals of the individuals. This includes financial ambitions but also family commitments, lifestyle, community involvement, personal development…. any other area that may influence the implementation of the plan. This was one factor that some people had overlooked in achieving such growth. Some questioned the "sacrifice" they had made in terms of family and certainly my lasting impression would be that a **"balanced outlook"** is vitally important.

- Realism, particularly in the agricultural sector is in recognising the limitations of the sector we work in. There are basically two types of business: **a commodity and a franchise**. Farm production is a **commodity** business where, since the product is generally no different from anyone else's, competition is only on the basis of price which means cutting into profit margins.

A **franchise** business can be described as a product that is needed or desired, has no close substitute and is not regulated. The real strength in a franchise is the ability to freely raise prices and earn high returns on capital invested. Realism in planning is taking such factors into account.

One corporate manager of a food distribution business felt that his particular business would prosper through "bolt on" type acquisitions, which brought his business as "close to the consumer as possible". This clear focus was on the basis of an already 30%+ return business. He had the understanding that being as close to the consumer market as possible gave him a relatively strong franchise selling top quality and desirable products for a very high return.

Those focussed on growth within the farming sector must ask: Does creating a 5 year plan that drives one further in the direction of pursuing a commodity business particularly one that is severely regulated and anti growth in its policy, make sense? There **will be some** that may achieve growth in this environment; the realistic planner has to decide if he or she has that capability. There must be **rationale for the decision.**

Planning for 5 years down the line can revolve around such areas as:

1. A certain target annual net worth improvement or % growth or ROC.

2. Simply targeting inflation linked true surplus cash figure / year to invest.

3. Moving to a larger scale business within a certain time frame.

4. Targets related to family goals, education of children.

5. Targeting increased sales, increased price, and higher margin in added value products or reducing costs to a certain percentage of sales.

The Operational Plan might include (in a dairy situation) such areas as:

1. A clearly targeted calving date that optimises grass growth and utilisation.

2. Strategies planned at the start of the year to reduce dependence on the dreaded "heavy metal", which means focussing on systems that avoid conservation of feed.

3. A clear breeding policy that is cost effective, producing a well-grown and sustainable animal that will produce at **optimal** efficiency.

4. Clear focus on improving labour productivity through sensible investment in key areas. Also a well thought out plan for staff motivation.

5. Targeting key areas within the overall budget to focus on.

Many of the farmers that I met admitted to a lack of planning in the initial stages of their growth and probably initially prospered on a combination of hard work, tight cost control and focus on debt reduction. Along with the growth in their businesses have come a larger focus on planning and the ability to "stand back" to critically plan future growth. A clear plan coupled with a determination to see it through which leads to the motto of one individual who said:

"Obstacles are what you see when you take your eyes off the goals"

The importance of strategy is absolutely pivotal to the future growth of farm businesses. It is a fundamental into which all larger businesses and corporates channel huge time and resources. Farm business must wake up to this and not rely on the old reliables: God, Government and the EU for help!

History might look back at this generation of European farmers and likely identify that most people accepted the “cheque in the post” with it’s accompanying set of rules and conditions. Hopefully it will also identify some that had the foresight to plan and make things happen and not blame others for perceived injustices.
This is analogous to the story I read in, of all places, an accountant’s newsletter:

“You need glasses,” growled the dismissed batsman as he passed the man in the white coat as he moved to the clubhouse.
“So do you mate,” answered the man, “I’m selling the ice cream!”

Capability:

This is the second component in the “formula” for growth used by the Kerry Group which Denis Brosnan described as: “the ability to run that part of the organisation (irrespective of how big or small the part is) to 100% of its efficiency”. Whether it is the chief executive of the big corporate or the farm / owner manager, capability is a vital ingredient to growth.

The most important point about capability is that it is inextricably linked to strategy.
What separates the very best managers in business from the rest?
Firstly, they will generally have had more training and experience.
However the nearer you are to the top, the ability to think and plan strategically becomes the most important skill.
At this level, **you cannot afford to get it wrong**.
Capability within a bigger organisation is all about picking the right people in the first place.
It is the ability of a manager to plan a strategy that finds a balance between the level of risk and safety.

The over riding fact is that the capability in any manager is this gift for strategic thinking, this gift to look at the bigger picture. I observed many other differing traits, which combine to separate the truly great managers apart from the rest:

1. **Always highly motivated and flexible.**
   Very clearly within farming, there was a pattern of the real achievers having “jumped in” at an early age. They were highly motivated with a burning desire to be “better than the rest”. They either did not have the “parental resources” in terms of financial support behind them or if they did they simply were not prepared to hang around waiting to drift into an inheritance. Many farm family structures have been spectacularly successful in avoiding this issue. Again, New Zealand has long since tackled this via the sharemilking / profit route, which has been the main force in enabling young, dynamic people enter and drive the industry.

- One manager referred to the need for a realisation of what he termed the “flexibility years”. This points to the stages in ones life where there is the flexibility to be **mobile** and go where the opportunities are. Flexibility can also mean being allowed the freedom to work to ones own agenda within the present business structure. There is a suggestion that the mid 20s to mid 30s are a critical period in ones life in terms of implementing growth or as one person described it “that time between leaving school and getting married!” As the years go by, other, often family issues cloud the picture and large changes can impose other human stresses.

2: Excellent technical performance with very good financial skills.

Many, particularly in the farming sector, were award winners. The ability to fine tune the core business gets back to the original description of the capability of the manager being able to run the business at 100% of its efficiency. The successful people were <u>all</u> technically very good. The question in the farm situation is the ongoing chasing of this “100%”. This gets back to the concept of “absolute skills” and the realisation that in small farm businesses, **nobody** has this infallible touch. Perhaps maintaining a 90% efficiency and focussing energy into other areas of high return growth may be more sensible than the return on time and effort in getting that last 10% in the present business.
However, **scale** makes the return on chasing this last 10% much more worthwhile. As one person said: “I have now built myself to a **scale** with turnover of £500,000. Surely 10% increase efficiency on this is achievable and worthwhile chasing?”

Excellent technical performance was more often than not achieved because of a focus on simple, low capital intensive and easily understandable systems.
All of the successful people I met had achieved growth through a marrying of technical performance with very good financial control or skills. In many farm situations these financial skills had been honed from taking on large debt at an early stage with the consequent, insistence of the lending institutions on paying some of it back!
Many felt that starting with no “free lunch” from parents or wherever, was the real starting point to success because “fiscal constraint” in low return areas was an absolutely vital ingredient to initial survival and consequent growth.
The poorer performers often have good physical performance from their business but lack the financial skills and discipline to capitalise this and increase net wealth.

3: Identifying opportunities.

The most important task for the entrepreneur is to **identify** opportunities. Opportunities will not come running at you but "getting your face out there" helps. One famous quote was "If you wait for opportunities to turn up, your toes will do it first".
Again it is argued that identifying opportunities will become a lot easier if it revolves around a clear focus and strategy.

If there are messages in this for the smaller business intent on growth they are:

- Clear role identification. Many businesses would benefit greatly from a session of talking through what each person's key strengths are. Many farm situations still do not acknowledge the massive capability and potential benefits to the business of the female partner for example. Of the people I visited, I would generalise by saying that the male member of a successful team seemed to be strong in the "Photographic department" or identifying opportunities. The females were often exceptionally talented in the "Text" or financial control side of the business. Quote: **"The fastest way to increase profits is to define what the individual or organisation is good at and increase the effort in that area".**
- The term: "leveraging your core competencies" is often used and really does focus on reminding us that everyone has skills that perhaps are not "levered" effectively enough.

In terms of identifying opportunity, one manager said: "Be prepared to move outside your own patch. If you don't all you will ever see is how things are done in your own patch and that's not a broad enough experience". Another said that he always looked forward to the chance to get in his car and drive a few hundred miles to another farm. This was because there was always the chance along the way, of coming across another idea or opportunity either through meeting someone or seeing something in over the ditch!

- Obviously the identification of opportunities must fit in with the general strategic plan and to that end they may be governed by certain parameters. One entrepreneur said he had 4 main criteria in looking at a new venture:
  1: It must positively increase cash flow
  2: It must positively increase the balance sheet.
  3: It must take up no more than 50% of my "spare" time in its first year.
  4: It must take up minimal time after that.

- One company was very focussed on setting up structures that were capable of finding opportunities. In this instance they had taken the decision to install 4 area managers whose brief it was to actively seek farm purchase opportunities alongside the business of supervising existing operations. There was a strategy in place to grow this business through acquiring farms; converting them to efficient dairying operations and management that fully understood the goals and were constantly seeking to achieve them fuelled this strategy.

- The same company had concluded, "90% of their success had been timing" in terms of identifying opportunities and responding to them.

Another said, "One of the great business strengths is the ability to say No". The message here was that many opportunities might jump up once you start actively pursuing them but few will be the right fit. Once the "right one" has been identified through thorough research, the message would seem to be to never look back but focus totally on making things work.

4: Very good advisors.

This may include your accountant, solicitor, banker and people in your field. Everyone stressed the need for these advisors not to be too conservative. This was typified in one situation with the statement: "I want a bank manager with heaps of scrotal capacity!"
I was struck by the intolerance shown to inefficient and poor quality professional advisors. Not only in farming but also in all other sectors, there are varying degrees of capability. Traditional "family loyalty" does not enter the vocabulary of successful entrepreneurs. Loyalty can come at a cost.

- The strong message is to become ruthless in demanding quality professional services. If this is not forthcoming…. Move elsewhere! You are paying for a service, be it accountancy, legal, banking or whatever. You will only gain respect if you are seen to be serious about your own business.

5: "Connexity".

Lots of friends with brains who have heaps of wisdom and experience. Everyone I met suffered from "infectious positivism" and avoided negative whiners like the plague! One couple I met could look back and pin point a particular year when they made a strategic decision to avoid any negative people!

- Mixing with positive thinkers has an infectious effect that is very much a two-way flow. The wonderful aspect of positive thinkers is that **they** are going to be extremely interested in what **you** have to say because it will **always be positive**!

If you are a negative they will not want to hear you so it will not be a two-way flow. One person stressed the need to develop **listening skills** where he suggested "breathing before you speak!" This was an observation on many conversations where many of us simply are waiting for our chance to speak. We're not really listening to the other person but simply waiting for an opening to express our view. Avoiding these negative situations was a recurring theme and one, which frees up an enormous amount of time and energy to channel into productive areas.

I liked the story of the farmer whose expectant wife was entering the maternity ward for the fifth time having previously produced 4 daughters. His pleading request to the attending midwife was for a son and a farmer! Returning 2 hours later to the anxious farmer, the midwife announced the arrival of a son. She added quickly that it looked very much like this newborn son would also be a farmer. "And tell me nurse, how can you be so sure?" asked the farmer. "Sure he's whinging already!" came the reply.

- Talking to people outside your area of expertise was another recommendation. Farmers, as I presume other professions also, are guilty of mixing in close knit circles where the conversation can often be narrowly focussed and repetitive. (Ask my wife!) Meeting and talking to positive people from other professions can lead to new ideas and a broadening of horizons.

- I was particularly struck in the United States by the social isolation factor suffered by farm families. Very clearly, many farmers that I met had seldom travelled outside their own patch partly because of the incredibly labour demanding businesses they had developed. Lack of quality and well-organised extension services, which might have, at a minimum, co-ordinated discussion groups, was sadly lacking.

6: Develop leadership and people skills

Growing a business and working via other people demands that you develop leadership skills and that you must have a much clearer picture of what you as the owner/manager are trying to achieve.

In the overall context, this comes back to the clearly thought out, realistic plan that is "owned" by all the staff. As one manager said **"My job in the organisation is to get it strategically right. There are others in the organisation who have the skills to go ahead and implement it"**
At a more basic level, this entails having a clearly thought out picture of the ongoing operational side of the business who's simplicity and clarity is easily understandable and executable by the staff. Some of the North American dairy farming systems were complex in the extreme and attracting people into that particular environment was proving difficult and costly.
It was interesting to note that some managers of very large- scale businesses had opted to distance themselves from the "coal face". That is not to suggest that they did not have an intimate knowledge of their businesses. Rather they recognised the advantage of being able to make more rational, business like decisions from a relative distance.
As one businessman said: **"The excellence of the director is not proportionate to the amount of time you spend at the job".**

However, many would admit to struggling with their "people skills". One corporate farm business manager felt that a mistake was failing to recognise earlier than they did the need to delegate and use people skills. The concept of scale for growth was not an issue but rather the <u>management</u> of that scale had given rise to problems. Another felt that the biggest limiting factor to his business growth was the relationship between himself and his staff.
As one accountant said: **"The bigger you get, the more ruthless you need to be with money and the more gracious you need to be with people".**

"Listen, recognise and reward".
This can be exemplified in one situation where the manager took the opportunity once a month to sit down with each staff member and review the past months performance. Both manager and employee together "scored" different areas of performance using a spreadsheet system developed by the Macdonald's food company. This "score" was then related to a bonus on top of the basic salary. The concept here was the opportunity to **listen** to the employee, **recognise** problems or mistakes but also **recognise** in terms of praise for a job well done and lastly **reward** this performance with a bonus on top of basic.
"Recognising" mistakes or excellence was described by someone who used the analogy of telling a friend that you love them and then punching them in the face rather than punching them first and then telling them you love them!
The second option would appear to be the better approach!

Interestingly, the "reward" does not always have to be in monetary form. Issues such as more time off, better working conditions, a feeling of sharing and being part of growing a business are all-important and need to be addressed.

Monetary reward in corporate business seems to be driven more by bonus related to target percentage growth. One company had the broad concept of a basic salary with a **50%** bonus if a certain targeted increase, say 15%, in earnings per share (EPS) was achieved. The cut off point was 10% increase in EPS with 35% bonus. Below this 10%, **no** bonus was awarded! Certainly a great driving force!

Particularly in the bigger corporations, recruitment of top quality people is on going. The problem then arises if you have, as one person said: **“the inlet valve open and the exhaust valve shut”**. Dealing with employees that do not fit with the business is a problem in all companies and off loading them can be difficult but essential for the long-term well being of the business!
Because of this, thoroughness in initial selection and training is vital. “Employ people who motivate people.” This may sound idealistic particularly in an industry that is now struggling to attract new entrants. However, many efficient farm businesses that I visited were very focussed on attempting to recruit the right type of person and then training and motivating them on an ongoing basis. At commencement of employment, they sometimes used a typed “job description” outlining all the relevant details for the position which was signed by both parties.
So recognising the <u>positive</u> relationship between youth and responsibility is vital as long as it is tied in with quality training and motivation.

One of the biggest issues facing the industry is human resources and we will ignore the problem at our peril.

7: On going education, seminars and reading.

Corporate businesses channel huge resources into recruitment, training and development of employees. Every individual receives on going education and training within many of these organisations.
For the successful individual, on going up dating would seem to be a common trait. One quote was that “Knowledge is power and my work involves a great deal of research generally gleaned from reading material”. Two of the outstandingly successful people I met were avaricious readers and seemed to create enough space in their lives to enable them to pursue this constant desire for up dating and educating.
Others in the farming sector had taken time to get involved in “wealth creation” type courses covering a wide range of financial skills whilst also encouraging a socially enjoyable atmosphere among like minded individuals.

“You should never let your schooling get in the way of education”.
Interestingly, few of the people I talked to had progressed through third level/university education. The positive, and in some cases driving force of this, was a determination to prove themselves as good or better than those who had received formal education. This is not for one minute to suggest that this report frowns on third level education! Rather it is a recognition that the successful entrepreneurs have capabilities that transcend specific formal education.

There was also a distinction alluded to, that the highly qualified academics did not always turn out to be the real entrepreneurs where somehow formal education had a tendency to funnel individuals into a conservative, “institutional imperative” type mentality. I point out that this is a generalisation!
I again point to the trend observed that responsibility given or assumed at an early age seems to be a massive influence in the development of an entrepreneur.
Being “released” from the protected nature of a formal education in the mid 20s age bracket can be disadvantageous to some.

At farm level, it is essential to foster a very strong and **relevant** education base for young entrants to the sector. The present agricultural college system in Ireland seems to be failing to educate students with the financial and business skills needed to survive and grow in the industry.
More importantly there is a lack of coaching in **planning** skills.
The message here would seem to be that on going education is vital but that much of this must be self motivated either in the form of reading, seminars, group discussion or self organised courses. There will be little real help jumping up at those who are content to sit and wait for it!

9: Believe in how good you are.

One key “mistake” suggested by a top chief executive was that it took the company too long to recognise how good they were!
On an individual basis, I also found a tremendous self-belief, which to the outsider may have appeared to border on arrogance: “we have made more correct decisions than anyone else”
Of course the age-old issue of begrudgery to success is alive and well but not an issue that bothers the achievers. The interesting thing here is the “localisation” of begrudgery in that it seems to be particularly pointed closer to the home base. Once the entrepreneur moves away from the local patch, it doesn’t seem to be an issue.

The story goes of the American tourist in a Dublin fish restaurant where he observed to the waiter that there was one particular lobster clambering to get out over the top of the fish tank. On drawing the attention of the waiter to this exceptional lobster, the waiter observed, “Not to worry Sir. Once he gets a certain way up, all the rest of the lobsters will jump up and drag him back down again!”

The other sure-fire way to verbally knock is to comment that someone was “lucky” in his or her success. As one person said: “If the concept of luck is given credence then it must follow that one is equally susceptible to bad luck as well as good luck”. An extremely effective silencer!
All of the people I met had very definitely “made their own luck”.

10: Avoid lemming like behaviour and go against the flow, which is **the ability to think outside the square.**

Warren Buffett, one of the world's wealthiest investors, terms this "the institutional imperative" where, in the world of money managers and stock markets, the general trend is to conform to generally accepted portfolio management practises.
He says, "Most managers have little incentive to make the intelligent- but- with- some- chance- of- looking- like- an- idiot decision".

He distinguishes between the speculator (who is effectively a gambler) and the investor who is interested in investing in all or part of a business for business like reasons. Calling a gambler or speculator an investor is like calling a person who engages in one night stands, romantic. His point is that real success comes from standing back from the "mindless imitation of one's peers" and suggests taking the attitude of being dealt 20 "cards" for your business life. With each investment made you have one "card" less to play so each play better be well thought out!
Buffett relies on the vagaries of human nature to throw up opportunities: "The fact that people will be full of greed, fear or folly is predictable. The sequence is not predictable!"

George Soros, the currency speculator also takes the radical view: "The prevailing wisdom is that the markets are always right. I assume that the markets are always wrong and even if my assumption is occasionally wrong, I use it as a working hypothesis"
Interestingly, he admits to making as many mistakes as the next guy but observes: "One of the secrets to my success is in recognising my mistakes. The key insight I have reached is recognition of the inherent fallibility of human thought."

Farm businesses are no exception when it comes to the tendency to go with the flow. The example in Ireland and the UK might be the incredible prices being paid for relatively small amounts of milk quota where the going market rate is paid because every one else is paying it!
Everything points back to the fact that the exceptional person is going to be the one who has a **clear plan, which sees beyond the square and focuses on the bigger picture.**
As that great Irishman, George Bernard Shaw wrote:
"The reasonable man adapts himself to the world. The unreasonable man persists in trying to adapt the world to himself. Therefore all progress depends on the unreasonable man"

Capital:

Capital is the third key factor in growing a business.

Capital is a commodity that should never be in short supply given the right business proposition and strategy.

Many of the individuals I met had grown large-scale businesses through aggressive use of debt. As one said, “In an ideal world, my idea of risk and reward is for me to get the reward while others take the risk!” Realistically, risk taking is part and parcel of developing a business. The difference between success and failure is the ability to take calculated risk and it comes back to the cash generating ability of a business to service that risk.
Another said that “**the biggest risk of all is not taking a risk**” and this really sums up the attitude needed if sustained growth is to be achieved.

A common “key” regret of many of the entrepreneurs was their failure to borrow enough, early enough!

However smaller scale initially, may have not enabled them to push the boat as much as they would have liked.

Banking relations:

Conservatism among bankers was a universal complaint amongst all the entrepreneurs that I met, particularly in the early stages of growth. One entrepreneur described it as: “Look for £100,000 and they do not want to know you. Look for £10 million and they are all over you”.
One might argue that this is a situation peculiar to the agricultural sector because of the generally low return nature of the business. However it seems to be an “across the board” experience.
Again, scale brings with it a lessening of this problem.

Observations in this area were:

- Making a greater effort in terms of keeping your bankers up to date with the financial state of your business. This is equally important in a “no borrowings situation”. Building a relationship that shows a capability and understanding of your business is important for future growth. This includes quality presentation of proposals and projections for proposed new ventures.

- Building a reputation of honesty with a record of ability to re-pay debt aggressively means banks want to know you.

- Banks are perceived as having a poor record in the area of customer relations (though they will argue differently!) Historically there has been a "Yes Sir, Thank you Sir" atmosphere permeating from the managers office. This attitude is changing, as competition amongst the financial institutions becomes greater. Electronic banking will put even greater pressure on this "human" side of banking. However I feel that banks still can take a lead in setting up systems that bring them closer to the client. New Zealand agri banking again seems to be a leader in this area of regular communication; simple systems of information gathering and actual farm visits.

Innovation in the use of capital:

- Many businesses availed of "interest only" type payments particularly in the early stages of a project, which eased the demand on repayment. Some appeared to ease themselves into the situation of on going "interest only" payments, repaying principal only when it seemed prudent or practical. As one individual said: "It took me a long time to realise that banks didn't always want their money back (the principal element that is)

- In another situation, a couple had raised funding in their early stages of growth through rearing a large number of dairy calves, "selling" them to a livestock agency, with the livestock agency "lending back" the calves back into a company newly created by the couple. So money was raised from the "sale", admittedly at a 3% excess to normal rates, which was used to grow the business. The lesson here was that in this situation, the banks were not prepared to back them but innovation and a belief in themselves led them to find a way around the obstacle.

- Once into a large scale, a small difference in interest rates equated to large sums of money. So the question: What price for loyalty?

One individual put his price at .2%. This effectively meant that, if after tendering all his business to the various institutions, he would remain with his present banker as long as no other quote came in lower than .2% off his present interest rate.
An emphasis on total disclosure was very important to this man. The ability to demonstrate you really know your business and a history of growing and repaying debt rapidly was seen as vital to nurturing a "Win Win" philosophy with bankers.

Equity partnerships:

Basically, this involves the pooling of resources both financial and human. I came across a number of these examples in my study.
This may involve an involvement of preferably 3 or 5 investors (certainly not an even number) with one of the equity partners also being the manager of the operation. This effectively means that everyone's investment is being managed or protected by a top class manager who has a keen interest in ensuring the success of the venture. As one investor highlighted: "I have $1 million invested, which is a 20% stake, and that investment is only costing me $12,000 in management charges . (i.e. the manager, who also had a 20% stake, was being paid a $60,000 salary.)

Equity investors can bring differing human skills alongside their leveraging of present assets to raise more funds. A pool of investors at a farm related investment might include a consultant prepared to input ongoing advice, an accountant providing financial services and a top class farmer with technical skill and perhaps an ability to look at the bigger picture.

The other factor in this area is the "psychological security" aspect of equity partnerships. If we accept the aforementioned fact of nobody possessing "absolute skills" then it seems that an equity partnership offers the opportunity to grow under the
security of operating with partners that bring differing human skills to a large scale venture with a sharing of the risk.
Many individuals never move outside their own area partly because of the fear of tackling a new venture on their own. **Equity partnership <u>may</u> be the route that offers security in tackling a new venture with a larger asset pool with a stronger human skills base.**
In so doing, the unleveraged capital assets tied up in many farm businesses might be unleashed into exciting growth areas.
Part of the success of the larger corporate is the pooling of vast human resources into a **team** effort that is totally focussed on utilising capital to implement a strategic plan for growth. This should be contrasted that with the sole trading farm business struggling to be master of his empire.

Two other vital ingredients in equity partnerships are friendship and trust. Entering into a partnership that has potential downsides (as most will) will require trust among like-minded individuals. These human qualities, along with honesty and integrity, were regularly referred to by the people I met and form the basis of any business.

To complete this section on capital I outline some key financial practises and measures. As was outlined earlier, all the managers I met were very clear thinkers with finely honed financial skills.

If it is accepted that strategy involves "recognising where you are", then understanding the on going financial situation is part and parcel of that knowledge.

One accountant preached the concept of **"Profit first and <u>then</u> choices".** This sums up the need for all businesses to initially concentrate on high net margins from their core business or cash cow <u>before</u> attempting to look at other areas.

If we accept this concept, then there is a need for measuring this profit and using this measurement to:

1. Improve present performance and efficiency.

2. Get a handle on the returns the business is giving on its capital employed.

3. Use the measurement data to make informed decisions as to future opportunities. This <u>includes</u> educating ourselves in how to put a value on a business.

Critical mass:

It is vital for all businesses, in particular smaller ones, to understand their critical mass which is the basic sum of money needed to cover living expenses / taxation and <u>necessary</u> reinvestment. This starting block in measurement is so important because it gives the foundation on which to build. Identifying it and deciding whether it is at an **optimal** level is crucial. In many farm situations, **personal spending is way out of line** with the ability of the farm business to effectively service them.

As scale develops, the percentage of profits devoted to critical mass become lower. Obviously all of the people I met on my study had grown their businesses to an **efficient scale** where critical mass was a minuscule percentage of their overall turnover. However **for the average sized farm business, there is a distinct pressure to scale up or become more efficient simply to satisfy critical mass.**

One common thread among the real wealth creators is an **absolute determination in the early stages of growth to cut personal spending to the core,** which delivers the maximum amount of cash to service growth and taxation.

Necessary re investment is another element of critical mass that carries differing interpretations depending on the focus of the individual. Generally **the most profitable farm businesses worldwide are those that necessitate minimal on going capital re investment.** There are few better examples of this than dairy cow harvesting grazed grass without the need for elaborate buildings and machinery.

Budgeted cash flow:

Because of the highly geared nature of their businesses, I found that **all** businesses visited had prepared budgeted cash flows based partly on previous years performance and partly on realistic predicted changes for the future. These people were very clear in their minds as to **the absolute necessity to create and monitor annual budgeted cash flows.**
The fact that they had financed their growth, almost exclusively with someone else's money meant that it was vital for them to be in total control of their business and hence monitoring cash flows becomes so important. To this end, I found a **culture of openness with bankers** where sometimes even monthly communication existed to monitor progress.
One couple I met had admitted that budgets for a large scale venture had been way out of line four or five times mainly due to unforeseen development costs. Regular monitoring of their budgets allowed time for early re action and a restructuring of borrowings.
Having sorted out that problem, the same couple had calculated that on the basis of next years predicted budgets that he would have the ability to service the debt on an extra £10 million investment! Many referred to the principal of a setting a target cash surplus before sitting down to create a budget so that you dictate what you want out of the business and you make the budget work to that end.

Many people also referred to the hidden costs of new ventures and the need to allow a 10 to 15% margin on top of original budget for contingencies. That said, one ruthless individual had a rule of: "$5000 **means** $5000 **not** $5001!

Fine tuning the business cash flow was described as a 10 rung ladder on which getting up the first 8 steps is relatively straightforward. The last 2 steps are made possible by the **capability** of the manager. The message here was that **"you are never finished with the fine tuning process".** There is always new thinking, new technology or machinery that can make the business more efficient. At farm level in Ireland over the past 5 years, adoption of new thinking and technology in the area of grass measurement and utilisation has dramatically enabled fine-tuning of those businesses interested in survival and growth.

Creating a budgeted cash flow and the use of computers:

With one notable exception, all of the people I talked to have embraced the personal computer as an aid to business management, particularly in the creation and monitoring of budgeted cash flows.

Some points to stress in relation to PCs:

1. In terms of on going measurement, the ability to have fast, accurate and up to date information is vital to any business. Too many businesses rely on historical information, presented 6 months after the end of the financial period and prepared mainly by "distanced" accountants.

2. I saw many instances of simple spreadsheet facilities being used to develop systems for assessing new opportunities. One very successful manager felt he was definitely a few years too late in adopting computer aids to monitor the business.

3. The development of electronic mail, which will enable communication, technology transfer, electronic banking, are all areas that 5 years ago were areas for the techno-nerds only. They will be an integral, invaluable and unavoidable part of business sooner rather than later.

Cost control:

Complacency in feeling that nothing can be done about certain costs is disastrous and one farmer I met asked the question: "How many can say, with hand on heart, that they have seriously scrutinised **every single cost** in their business?"
It is absolutely vital to critically examine every single item of both income and expenditure in preparing a cash flow.
Managers of high cost operations tend to continually find ways to add to overheads, whereas managers of low cost operations are always finding ways to cut costs.

It was pointed out on a number of occasions that one common trait amongst all successful businesses was the **ability of the manager to control costs irrespective of whether profits are at record levels or when they are under pressure**.
One quote was that: "The really good manager does not wake up in the morning and say, 'This is the day I'm going to cut costs,' any more than he decides to wake up and practise breathing!"
Equally with income, a low commodity price generally demands low cost of production. Pay a high commodity price and human nature appears to naturally gear up and follow with spending in all sorts of wasteful areas.

Management of cash flow:

One of the striking features of most of the businesses I visited was a discipline in settling accounts promptly. Most were stunned at the culture that seems to have developed, particularly in Ireland, of “extended credit”. The cost of collecting these monies is one of the “invisibles” built into the product price. A well-structured and disciplined payment system should be reflected in discounted prices and a more accurate handle on the up to date strength of the business. The seasonal nature of some farm enterprises may make this difficult but still worth addressing.

5 Messages:

1. Make a serious effort to create a budget for the coming financial period.

2. Be realistic, constantly monitor and fine-tune and question every item … **nobody’s net profit is as important as yours is.** Develop the discipline of prompt payment with negotiated discounts.

3. Make sure it fits in with the personal goals for growth and lifestyle requirements.

4. Be extremely focussed on using this budgeted cash flow to know what your **critical mass** is and to **aggressively set a target for true surplus cash.**

5. It was strongly suggested that one should set a target of true cash surplus first and foremost and **then** create a budgeted cash flow to fit… in other words **you** dictate.

Balance sheet and net worth:

One comment was that: “The accountancy profession are masters in the art of **“keeping the mystery in it”** when it comes to presenting balance sheets!”
It is surprising how many fail to really understand the importance of reading a balance sheet and focussing on net worth improvement. All of the people I talked to had a deep understanding of their net worth and were very focussed on growing it.

5 points on Balance sheets:

1. Total or gross assets are “balanced” by liabilities and owners original money invested plus the sum of retained earnings.

2. Assets are shown at their original costs **not** their current value.

3. Retained earnings are not a pool of cash but accumulated profits that have been reinvested into the business.

4. The bottom line figure of a balance sheet is the surest way of indicating the direction of the business….**it must be increasing from year to year …net worth must be upward bound!**

5. A balance sheet does not reflect any capital gain in the business i.e. increased market realisable value of the assets employed. It does however, include **realised** capital gains.

A focus on net worth is powerful as an early warning tool in that any slippage in net worth is a sign for concern. Particularly in a small-scale farm business, excessive personal drawings from an otherwise top class, technically efficient operation can result in static or decreasing net worth. Benchmarking net worth, particularly of small-scale farm businesses should take this into account. Again, **<u>efficient</u> scale** overcomes the impact of perceived excessive personal drawings and its effect on net worth.

Cash generating ability:

A measure which banking institutions are tending to focus on and one which we in the farming community should fully embrace.
One banker described it as a refocus away from assets and equity and onto the business being able to borrow on multiples of the combined profits of their own business and the company or project they might be acquiring.

So, the ability to service large amounts of interest and principal repayments on capital out of profits, which have been productively invested, is why the banks so keenly study the cash generating ability of a business.
From the business perspective, the focus should be always on maximising the cash generating ability which will firstly cater for critical mass and the remainder directed into high return areas (<u>wherever</u> they are <u>identified</u> to be).
Businesses need maximum profits, which are often not associated with maximum production. As one accountant said: **"Optimal production may be more important than maximum production"!**
The debate over what is optimal seems to vary from country to country. There is little doubt that maximum production brings with it a necessity for massive capital investment in the form of plant and equipment. I witnessed truly incredible investment, particularly in the United States that had no focus on the cash generating ability of the business but total focus on the ability of animals to produce vast amounts of milk. This was over a seriously shortened lifetime because of the

animal stresses involved. Lack of research into profitable alternatives and quality extension services exacerbated the problem.

Leveraging and gearing:

Fixed assets which can be offered as security along with the cash generating ability of a business can then be used to "lever" more cash from lending institutions for investment into high growth businesses. Surplus cash is an asset just as for example, bricks and mortar, land or share certificates are. Many do not realise the extent of the surplus cash which they are generating from their businesses. This is because any existing capital repayments form part of surplus cash and are being used to pay off debt (hence increase net worth). The ultimate goal in financial leverage would seem to be in the use of "assets" to "lever" other people's money (OPM!), borrowed in as **tax efficient** a manner as possible, to fuel growth.

All of the successful businesses I visited had a strong grasp of the power of financial leverage and exploited it to the maximum (some would say to reckless abandon!). A simple example might be the use made of a £10,000 cash surplus where it is used as a straight investment <u>or</u> to fund borrowings in a <u>single</u> year which is also invested in a 15% return area:

Cash surplus	Interest paid	Sum "levered"	% return	Amount earned
£10,000	0	0	15%	£1500
versus				
£10,000 pays	10% on	£100,000	15%	£5000

Many settled farm businesses employ relatively large assets producing quite low returns. The collateral offered by these assets is often not exploited to the full. The challenge for those interested in growth and who are sitting on assets with few borrowings is not to waste the leveraging power of these assets but to identify investment opportunities which will **make these assets sweat** and in some cases double sweat!

How far some of these investors were prepared to push leverage is reflected in **"gearing"** which is a measure of the average debt to net assets employed or Debt / Equity ratio. Some claimed they had operated at close to 70% debt / 30% equity all their lives!
Particularly in a commodity type business like farming that is notoriously low return, high levels of gearing can be sustained only in a system that has proven high cash generating ability. Having seen both high and low output systems of milk production, I am certain that, (accepting climatic limitations) systems that allow the biggest percentage of production to come from grazed grass have the ability to service high

levels of debt and still grow net worth. This is partly because this debt servicing is channelled into largely **appreciating type assets** rather than depreciating ones. Capital investment and borrowing in the short term for areas such as environmental protection may be prudent for the long term viability of the business but only in the context of a clear overall plan and where there is a clear focus on “necessary” rather than “excessive” expenditure.

Compounding:

Once surplus money has been created the challenge then is to invest in high growth areas where compounding can work. Compounding is a fundamental principal that, time and again, people said to me should be “drummed” into all of us from infancy. The importance of compounding is lost on many and I was bombarded in my study with differing illustrations!

4 examples:

1.

Sum invested	Compound interest	Age at investing	Age at encashment	Total accumulated
£1000	15%	20	70	**£1.083m**
£1000	15%	40	70	£66,194

The extra odd million has accumulated because compounding has been allowed work over a further 20 years!

(Simply take a calculator and press 1000×115%×115%×115%... either 30 times or 50 times if you find this figure difficult to believe!)
The power of this example is in the **vital** importance of focussing on investing in high return areas from an early age.

On the flip side, a <u>static</u> business that is subjected to average yearly compounded inflation of 3% will be 25% worse off in 10 years. I feel this is a particularly strong message and that unfortunately, many farm businesses suffer from this static growth at present.

2. “**Rule 72**”.
This is an example, which helps to illustrate the power of compounding. Basically it is a quick method of calculating how long it will take to double any sum of money at a given percentage return. The figure of 72 is used as the common factor into which the annual return is divided.
For example:

Sum invested	% rate of return	Compounded sum	Years to double	
£1000	10%	£2000	**7.2**	(72÷10)
£1000	15%	£2000	**4.8**	(72÷15)
£1000	20%	£2000	**3.6**	(72÷20)

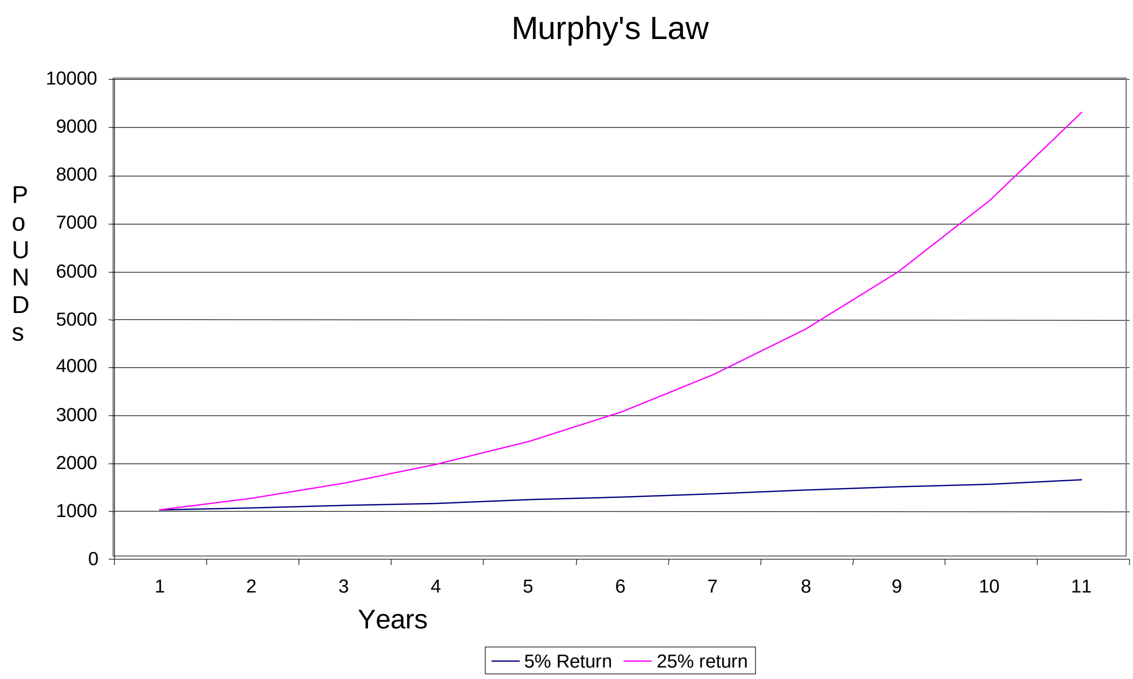
Hence when a company says it has set itself a target of 15% growth in earnings per annum, it is basically saying it is going to double its earnings in 4.8 years.

3. The concept of compounding a long term investment in a quality business versus a "short term" trading mentality as prevails for many dealing in the stock market is shown here:

Taking a £1investment that doubles in price each year, is sold, 34% capital gains tax paid and then the proceeds reinvested in a similar fashion for the next 19 years. The net gain on this venture would be £25,200 with £13,000 tax paid.

Alternatively, the same £1 invested in the same venture, not sold yearly but left to compound for the full 20 years would gain £692,000 after paying taxes of £356,000!

4. A graph, jokingly named after Michael Murphy, Irish dairy farmer and entrepreneur, who has relentlessly scribbled this example on dirty car windscreens or wherever the message will take ink! Describes the necessity to always focus on investing every £1000 in as high a return area as possible.



So: **Compounding** = **Cash x Time x High rate of return**

Return on capital (ROC):

Said by most to be the **key** measure. Defined as:

$$\frac{\text{Net profit minus unpaid labour \& management charge plus interest} \times 100}{\text{Total assets (debt plus equity)}}$$

2 points:

- Unpaid labour/management must be taken account of (often it is not!)
- Because we are looking for a return on **total** or **gross** assets, we must assume there are **no borrowings,** therefore any interest on borrowings previously taken out of the profit and loss a/c should be added back to give a true picture.

The successful entrepreneurs I met **always** focus on high return on capital.
They do this by always extracting high surpluses on:

• Using someone else's assets (leasing),

• buying assets well below current market prices or in areas where no one else will go or
• Paying market rates but with a capability to effect dramatic efficiencies over and above the industry average.

Warren Buffets observation on stock market investment is that of buying a "business" for the long term as opposed to a stock market speculation. He achieves a high rate of return by isolating the intrinsic value of a business which encompasses its future predicted profits and attempts to buy the stock at a discount to that intrinsic value. As he says : "Price is what you pay, value is what you get"

Care needs to be taken in the valuation method used in relating to capital employed. This area seems to be fraught with confusion in terms of the value individuals attach to capital employed. Book value would seem to be the more accurate method particularly where benchmarking between businesses.
Market value on the other hand can effect decisions particularly in a bull market scenario. Obviously ROC drops in a situation with static profits and increased market value of capital employed. One manager I met had taken the decision to capitalise

his high value land assets in one particular region and moved to a much larger base in an under developed area where land values were dramatically cheaper.

Return on Equity (ROE):

This measure takes account of net assets or equity i.e. Total assets less principal liabilities. It is defined as:

<u>Net profit (after interest is deducted) minus unpaid labour & management charge×100</u>

Net assets

Any business giving a return less than the cost of capital (interest) is destroying money.

The following example may help to illustrate this:

Example: Assume 10% interest

Profit	Total assets employed	Debt	ROC	**ROE**
£70,000	£1m.	0	7%	
£70,000	£1m.	£500,000		**4%**
£100,000	£1m.	0	10%	
£100,000	£1m.	£500,000		10%
£200,000	£1m.	0	20%	
£200,000	£1m.	£500,000		**30%**

At £70,000 profit there is only £20,000 left after paying £50,0000 interest on the £500,000 borrowed. So £20,000 on £500,000 equity (owned assets) is 4% ROE.

At £100,000 the proposition is breaking even with the cost of funds.

Conversely a highly profitable business throwing off £200,000 gives a ROE of 30%

If ROE is lower than ROC then capital is being destroyed. In other words if the return on net assets (freehold capital less borrowings) is less than the cost of borrowing money then the business is going backward. The bottom line will always come back to achieving a **high level** of profit in relation to net assets employed. It is the ability of a business to service debt and still leave a surplus reward.

Most entrepreneurs I met applied a “hurdle rate” over which they targeted investment. This was <u>always</u> related to bank interest rates.

For <u>most</u>, a 15% return generally created a “margin of safety”. Farm businesses might

focus on a “margin of safety” over and above the cost of funds. One individual stated that he always looked for a 20% return on his <u>own</u> money.
In the world of investing, this “margin of safety” would be buying stocks when the market price is at a <u>significant</u> discount to the underlying business value.

2 golden rules of business investment quoted time and again were:

Rule No.1: Never destroy capital
Rule No.2: Never break rule No.1!

Capital gain:

Depending on the state of the market, I found capital gain was only alluded to when times were good! In general, land values, certainly within Ireland, have struggled to keep pace with inflation over the past 20 years. In countries like New Zealand, fluctuation in land value is common, reflecting the cyclical nature of their commodity prices. Argentina on the other hand is experiencing increasing values, part driven by massive foreign investment but also an increasingly stable political scene is focussed on improved infrastructure allowing more efficient trading.
Warren Buffett, one of the worlds wealthiest individuals has been quoted as saying: **“**In a bull market one must avoid the error of the gloating duck that quacks boastfully after a torrential rainstorm, thinking that it’s paddling skills have caused it to rise in the world”.
To many of the entrepreneurs I talked with, capital gain was a bonus to their main objectives of high cash surpluses. **So capital gain is not a particularly good measure of efficiency but combined with good trading surpluses sensibly invested, is the ideal mix for sustained growth**

Valuing a business:

I briefly refer to the importance of valuing a business. The <u>immediate</u> answer I received from one very successful manager to this question was: **“what can we make out of this business?”** Finance theory suggests that, over time, there is a direct correlation between the value of a company and it’s cash generating ability. Is there a **margin of safety in this venture?** All other influences like what the average in the market place is paying or worse still, the old “gut feeling”, go out the window! Denis Brosnan of the Kerry Group outlined his philosophy in this regard: He said “We are never frightened of paying a price that is too high relative to the profits that the company is making today. What frightens us is if we are forced to pay a high price relative to what we think we can make down the line”

Again: **Any business giving a return less than the cost of capital (interest) is destroying money.**

Conclusion:

You will have read the summary of the conclusions on page 3 of this report. The very last sentence of that summary refers to the necessity to keep a balance in life, which is a feature that must be incorporated into the overall strategy for planning future growth. Charles Handy in his book “The Hungry Spirit” referred to the observation of one of his children who said that, in their younger days, they always thought that “Daddy was the man who came to dinner on Sundays!” Farm business by its nature, is a wonderful environment in which to raise a family. Preserving that “environment” and mixing the inevitable sacrifice that growing a business entails, is the key challenge.

On a personal level, the past year has been a tremendous learning curve and we look to the future with infinitely more confidence than heretofore. As always we will focus on profits, which is what this whole growing a business bit has been all about.

As one Kiwi said:
Good profit is like good sex …it’s wonderful when it happens
Bad profit is like bad sex…it’s better than nothing!

I also like J Paul Getty’s formula for growth, which was:
“Rise early, work hard and strike oil!”

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