

2007

PROFITABILITY

Higher prices have meant an improvement in the profitability of cereal farms. However, most businesses are still relying on the Single Payment for their profitability. The results from Loam Farm (Andersons' 600 hectare example farm) are shown below: -

<i>LOAM FARM BUDGETS - £/Ha</i>	2006	2007	2008
Gross Margin	392	424	419
Overhead Costs	256	268	274
Pre-Rent and Finance Margin	136	156	145
Rent and Finance	126	124	124
Drawings and Tax	100	100	100
Margin from Production	(90)	(68)	(79)
Single Payment and ELS	238	220	212
Business Margin	148	152	133

Even the reasonably efficient Loam Farm has some work to do to improve performance so that it remains profitable as support falls. Prudent prices have been budgeted, feed wheat at £88 in both 2007 and 2008, but it would need an extra £12-15 per tonne on wheat, OSR and beans to reach break-even point without support. It should also be remembered that market support has all but disappeared for cereals. With increased market volatility businesses may have to start thinking about building up reserves in the better seasons, to help them through years of low prices.

CONCLUSION

Better prices have seen cereals farmers' optimism rise. There is also a more general perception that a PR battle is being won, and farmers, as producers of food and fuel in a dangerous world, are beginning to be valued once again. But the feel good factor can mask some unpleasant truths about the profitability of many cereals farms. Better returns should not be used as an excuse to sit back and let the business drift. Producers need to think strategically about where their businesses need to be in 5 or 10 years time, and how to get there. Andersons' consultants look forward to helping the UK's arable farmers find the right solutions for their own businesses.

Andersons are leaders in independent business consultancy in UK agriculture. For more details on the topics covered in this publication please contact your local Andersons Office:

Melton Mowbray
2 Nottingham Street
Melton Mowbray
Leicestershire
LE13 1NW
Tel: 01664 503200

Bury St Edmunds
East Barton Barns
Great Barton
Bury St Edmunds
Suffolk
IP31 2QY
Tel: 01284 787830

Salisbury
Lower Courtyard Office
Renshaw Barns
Upper Woodford
Salisbury, Wiltshire
SP4 6FA
Tel: 01722 782800

Thirsk
The Old Post Office
Market Place
Thirsk, North Yorkshire
YO7 1TF
Tel: 01845 524455

Edinburgh
58 John Street
Penicuik
Edinburgh
EH26 8NE
Tel: 01968 678465

www.andersons.co.uk

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ARABLE BRIEF

Are You Prepared For 2013?

June 2007

ANDERSONS

the FARM business
CONSULTANTS

INTRODUCTION

Now is the time, while the arable sector is enjoying some better prices, for farmers to think strategically about their businesses.

- What will replace the large reductions in Single Payments?
- Will price and yield increase be enough?
- Can overhead costs (especially labour and machinery) be reduced – possibly by cooperation or collaboration?
- Does your business require major reinvestment in machinery or storage?
- Are you threatened by NVZ / WFD restrictions?
- Do you have a successor in place?

This article provides some background on the four P's: Prices, Policy, Performance and Profitability, so that farmers and their advisers can start thinking about finding long term solutions.

PRICE PROSPECTS

The world enters the 2007 harvest year with the lowest level of grain stocks for almost 30 years. With global production only having met consumption once over the last seven years there has been a rundown in stores. With modern communications and shipping the world may be able to cope with lower stock levels, but they are now so low that markets are worried – hence the higher prices seen recently, and increased volatility. A single piece of news can send the market shooting up or down.

The strong upward growth in demand for grains is driven by population growth, and wealth increases particularly in China, S.E. Asia and South America. But the new factor recently has been biofuels. Although there has been a lot of interest in the UK's fledgling biofuel industry, only a few plants are currently operating, and it is still tiny on the world stage. The US bioethanol industry is predicted to use 140m tonnes of maize in 2008, about ten times the UK's total wheat crop.

At the time of writing, it appears that crops in most of the main growing regions of the world will get through to harvest in reasonable shape. But even with no weather events, the predicted level of production will not rebuild stock levels. With the global situation as it is there is some hope that better prices may persist for a while, but a note

of caution should be sounded. Global output has always risen to match demand in the past, and there is still potential to increase grain production around the world. We have already seen better prices lead to an increase in planted areas this year. We should not assume prices will now be 'high' ad-indefinitum.

As the grain trade is truly global, prices are fundamentally determined at the world level. But there are market developments closer to home that should have a price impact as well. The UK biofuels sector is starting to pick up speed, promoted by the Renewable Transport Fuel Obligation (RTFO) which begins in April 2008. There should be five facilities fuelled by vegetable oils in 2008, but no wheat fuelled plants until 2009. But even if only a few of the planned wheat using facilities are built and use UK grain, this should boost prices. These plants, along with the Cerestar facility in Manchester, should see a part of the 2.5mt exportable surplus of wheat disappear. A change from 'export parity' to 'import parity' will not simply add pounds to all grain prices – but it should boost values in certain locations at certain points in the season.

POLICY OUTLOOK

It seems there may be a relatively settled period in terms of policy over the next few years (if the SPS can be thought of as 'settled' in England). The overall system of entitlements, cross-compliance etc. will remain until at least 2012. However, payments for arable farmers across the UK will reduce as the level of deductions rises. Later this year will see all the UK administrations launching their Rural Development Programmes for 2007-13. This will see new grant and environmental schemes, and new money flowing into some existing programmes. Farmers need to be aware of what is available, and be prepared to sign-up to the schemes as a way of recovering money lost through modulation of the Single Payment.

The EU Commission will produce proposals for its 'Health Check' of the Single Payment System (SPS) shortly. The biggest impact for cereals farmers from this exercise could be that compulsory set-aside disappears from 2009, or at least by 2012. For larger businesses, there is the spectre that 'capping' of the aid payments may be introduced – limiting the amount any one business can be paid under the SPS.

Further ahead there is the EU 'Budget Review'. This will set the spending priorities for the whole EU for the next

budget period 2013-2020. The UK government wants a big shift from Pillar I CAP funding (still over a third of the total EU budget) to other areas. It is unlikely that the UK will completely get its own way, but it does seem highly likely that there will be far less money for the SPS beyond 2012 as the overall CAP 'pot' is limited, and there is more focus on Rural Development. It is not inconceivable that by 2020, area payments under the SPS could be down to £60-£80 per Ha (*£24-£32 per acre*).

PERFORMANCE

With falling support payments, and uncertain prices, it is important that farmers focus on the factors they can control within their businesses. These are technical performance and cost control. Over the last 20 years, average cereal yields have risen, but appear to have plateaued recently. Compared with improvements in other crops, there seems scope to improve output. The situation with oilseed rape is even more stark. This is now the dominant break crop, but yields have been static for two decades, despite genetic advances. The crop may not be receiving the management attention it deserves.

Of course, it is not simply a case of blindly chasing yields. It is a case of optimising yields using the most efficient combination of inputs. With increasing legislation in the form of Nitrate Vulnerable Zones, and the Water Framework Directive, there continues to be the need for precise targeting of inputs for both economic and environmental reasons. Further in the future, the need to combat climate change is likely to bring more focus on agricultural inputs.

The biggest difference between farms tends to be in their cost structures – particularly overhead costs. This is illustrated in the huge range in performance of cereal farms. Statistics show that in 2005 the total value of inputs used by 59% of English cereal farms was more than the output they were generating. Unless farmers are happy to subsidise their farming from other income sources, this situation is unsustainable. Either performance has to improve, or businesses will have to exit the industry and allow other, more efficient, businesses to grow. Despite the strides already taken, there is still great scope to take costs out of the industry through reorganisation; increasingly this is being achieved by collaboration and co-operation.