

Quivira Coalition Speech – Allan Nation, Publisher, The Stockman Grass Farmer January 14, 2005

My job is to keep you awake after lunch, so I'm going to talk about money.

I noticed you have put together a very attractive agenda of speakers. I also noticed I am the only one who plans to talk about the nasty subject of money..

Apparently, talking about money makes many of us uncomfortable particularly at ranching functions.

I think this is because a lot of people don't think there is a big profit in ranching. But there is. For some.

To find the big profit in ranching you must first ask yourself, what business am I in?

First ranching is a business and not a lifestyle. Your business produces your lifestyle, not the reverse.

You have all heard the figure of 3% average return from ranching. This is misleading for several reasons.

One is it based on the average. The average has been described as "where the worst of the best meets the cream of the crap."

In today's economy, in any business where skill is involved we find that half of the total profits of that industry are made by the top 2% of the participants. To see the true profit potential of an industry you must study this 2% and not the "average" producer who is actually losing money most of the time.

When we look at the top rather than the average we find that the top 15% of ranchers are able to create an annual return of around 8% or roughly equal to what a well-run manufacturing business would generate.

Personally, I am not satisfied by this figure. It is still too low to attract the best and the brightest of our young people. Manufacturing is in almost as much of a decline in America as agriculture.

Are there ways to get this figure up? Yes, there are.

Ranching has been described as a business of land and livestock. However, it is really a land business and a livestock business. This is a key point in finding that elusive profit.

If we take the deeded land out of a well-managed ranch and make it 100% leased we will often see the net returns increase from eight to 14 to 15% per annum. This is because lease rates are tied to production profitability whereas land prices aren't.

And this is particularly true of deeded rangeland. Currently, in West Texas the land cost per cow on deeded rangeland has recently been estimated at \$14,000 per cow. Cattle prices are high but not high enough to drive land prices that high. As you can guess, even a 3% return will be impossible with such outrageous land prices.

Today's truth is that if you have enough money to buy a deeded rangeland ranch large enough to provide you with a living, you have enough money to live without working. Currently low-risk government bonds are paying over 4% return and inflation-indexed government savings bonds showed a 6% return in 2004.

Ranch land is primarily priced today by its aesthetic and recreational value rather than its ability to produce a profit from traditional ranching. Will this trend continue? Maybe, here's one reason why it might.

I recently read that some 70 million urban Americans want to move to the country. The key point here is they want to "live in the country." Thanks to computer technology and the Internet, the best and the brightest can now live virtually anywhere they want.

The point is that these people are not moving to the country to work as a rancher even though they like the idea of wearing a big hat and pointy boots.

There is no shortage of people who want to play the role of a rancher, and by role I mean as in a Hollywood movie. But very few people want the daily responsibility that domestic livestock require.

A byproduct of the world economy is an increasing need to travel frequently and at short notice. This has made people commitment-phobic to anything requiring daily responsibility.

While this Urban Cowboy phenomenon will mean that deeded ranches will become increasingly dear, it also indicates that grazing lease rates could actually decline to zero and beyond. I'll talk more about this later.

Once we remove deeded land costs, the key elements in these high return ranches are that they own a minimum amount of machinery per head, feed a minimum amount of hay per head and keep their cows reproductive rate above 85%. However, the amount of hay fed is the primary determiner of ranch profits.

The high return producers do not produce above average weaning weights or any other production factor. They concentrate on keeping capital and labor costs per head low.

As Bud Williams, a famous Florida rancher told me, "Ranching is really a simple business. The hard part is keeping it simple."

This return to the best managed ranches on leased land is in line with the very best technology companies. It still isn't good enough for me, but it is certainly competitive for labor and capital.

The key point is that any ranch that is 100% deeded property will necessarily show a poor percentage return even with exceptional management. It will do this because the value of the land is not correlated with the production profit of the land.

Interestingly, the return on investment has everything to do with price of land and very little to do with the price of cattle. I examined the books of Argentine ranchers who were earning 18 to 19% returns selling 2-year old grassfed steers for 40 cents a pound!

Most long-time ranchers do not realize what a marginal return they are receiving because they do not mark the value of their land to market for analysis. And, neither do other land-intensive industries such as railroading and forestry.

The older generation can ignore the poor returns as long as there is adequate cash flow but this lack of correlation also means that the production from the land will not pay for it as in years past.

Today, starting a ranch and paying for it from its own production is impossible if 100% of its land is deeded property. It is this paradigm of deeded land that is keeping young people out of ranching far more than the price of cattle. What is needed is a change of paradigm.

Today, a leased ranch can generate enough money to pay for land on a piecemeal incremental basis. Of course, the greater the percentage of deeded land you start with, the more frugal your personal lifestyle will have to be. This is because land payments can only be made from after-tax dollars.

Paying for land has been described as a "forced savings program." Savings have been defined as deferred consumption and saving rather than spending is no more popular down on the ranch than it is in urban America. We like to spend money. Not save it.

Land principle payments are much more onerous than lease payments due to the tax laws.

All small business people soon learn that the real return of owning a business is that much of your lifestyle can be paid for with before tax dollars. Land principle payments are not tax deductible whereas lease payments are. This means lease payments can be made out of the much bigger pool of before-tax revenues.

Tax law considers land to be an investment and not a production expense. Investments are designed to protect wealth. They are not designed to generate it.

For example, the interest return from a bond is never enough for you to borrow money to buy the bond. Investments are structured so as to protect wealth - not generate it. Typically, only tax-favored businesses generate the after-tax cash flow necessary to buy investments.

So, has ranch land been a good investment?

Since 2000, ranch land has significantly beaten the returns from non-stock financial investments. In many areas, the increase in value has been on the order of 10% per year over the last three years. However, this increase has not been driven by any factor within control of the rancher. This makes owning land an extremely high risk proposition.

Few of today's ranch land investors remember that farm and ranch land fell in value by 50 to 80% from its peak in the early 1980's. In much of America, we are just now returning to the farmland prices of the late 1970's. However, range land is now far higher than we have ever seen it.

Land is said to exist in only three stages. These are fully priced, falling in price and recovering from a price collapse. And, only the last stage is profitable for the investor. These means than a land investment that is totally dependent upon capital appreciation has two chances in three of being wrong.

Despite an uncertain future, the land business has been a good investment for the last 25 years but is only feasible for people who have surplus after-tax dollars. Start-up operations do not have these because family living expenses eat up the majority of the cash flow and surplus after-tax dollars are few.

So, we have a land business that is a good business. And a livestock business that is a good business. But a combined land and livestock business that is a poor one.

We see that the best way to increase the return to ranch management is to eliminate land ownership.

But, what if we eliminate cattle ownership? What if we just sell our management on a per head or per pound basis to others.

Well, then things start to get really interesting. We see the returns jump from 8 and 14% to 100% to 500% in one instance I know of.

Why the big jump?

This is because of two major factors. One, services drop much more of the gross income to the bottom line. It is not uncommon for service industries to operate on margins exceeding 80%. This is because they are primarily selling knowledge.

Two, brood stock which tends to dominate ranching loses value as it ages. Cow depreciation makes a cow-calf operation a better tax dodge than a generator of after-tax dollars.

This cow depreciation factor is amplified by the cattle cycle. If we take the decline in the value of the cow between the top of the cycle and the bottom we find that this normally exceeds the total after-tax return of all the calves the cow produces.

And with stocker cattle it is not much different where the majority of the positive production margin is invariable eaten up in negative price margin.

Another big factor is that custom graziers tend to be seasonal and to only have livestock during the green season. This eliminates the biggest cost in ranching which is winter feed costs.

This latter factor is what really raises the return in areas with short green seasons.

It is also supplies a viable alternative in areas such as the Southwest where there can be multiple year droughts. Ranchers are loathe to sell cows during dry times because of the negative spread between what they sell them for during a drought and what they will pay to replace them when the drought ends.

Custom grazing shows more clearly than any other activity, that you are not in the cattle business or the beef business. Your job is to manage livestock to harvest grass. You don't need to own either the land or the cattle to sell this knowledge.

To sum up, the secret to generating wealth today is as Forrest Gump said, "Don't own nothing. Even rent your shoes if you can." You want to sell knowledge and not things.

This increase in efficiency extends to the cattle owner as well. Custom grazing offers the livestock owner the ability to buy both land and labor on a per head basis. This is extremely important. As matching labor and land resources with the stocking rate is the most difficult management job in ranching.

Fixed costs do not stop because there is a drought and you sell the livestock but as buyer of custom grazing services my land and labor costs end immediately with the sale of the livestock and is by far the most labor and capital efficient way to raise livestock.

For example, the "average" cow-calf producer can buy year around care and grass for a cow from a professional grazier for roughly half of what he can provide it himself.

Custom grazing also offers an easy way to geographically diversify and buy complimentary climate forage resources. You may live in cow country but you can buy yearling gains elsewhere or the opposite.

Livestock owners must be specialists in marketing to offset the high risk of owning an asset that can quickly lose value. Graziers must be specialists in production meat from grass. I have yet to meet a rancher who was really good at both. Custom grazing offers an easy way for the best of both worlds to work together. It is a win-win deal.

A major problem is that farmers and ranchers want the same income as people in the general economy and yet pay little attention as to why they are losing out to the urban economy. Ranching, and farming even more so, bought into the industrial paradigm just as the general economy was leaving it and was moving to higher returning services.

The amount of capital required to produce a dollar of net profit in off-farm America is plummeting because we are outsourcing the high-capital, high-labor, low-return manufacturing portion overseas and concentrating on high knowledge services, R&D, marketing and distribution.

America is 5% of the world's population and yet is responsible for 20% of the world economy and 50% of the world's net profits. We are absolutely kicking butt in the profit department because we are concentrating on margin rather than production! And ranchers who want urban equivalent incomes will have to learn to do the same. Here's an example of this new economy.

The Chinese manufacturer who manufactures and assembles the Apple I-Pod makes a net profit of around \$4.00 per unit. Apple computer who supplies the R&D and marketing makes around \$65 per unit. The American company that designed the chip makes a net profit of \$4.00 per unit just for supplying the plans for the chip via e-mail.

Now, here's the kicker in this deal. The minute someone else in the world offers a cheaper manufacturing deal, we are gone and leave China with the huge economic problems of right-sizing an over-built production plant and labor resource. Just ask our Mexican neighbors about this. Profits from production are high risk. The locomotive in the value chain train is the person who creates the customer.

Those of you who read the Stockman GrassFarmer know that I am not wild about anyone staying in the commodity priced arena. One, commodities expose you to the international pressures I just outlined, but more importantly, because commodities punish excellence.

The commodity market is like grading on a curve. The A student gets downgraded to a B and the D student gets upgraded to a C.

Those of you who have been in the stocker business know that the leverage is in upgrading D cattle to C's and not in buying A cattle and selling them for a B price.

The person who really gets forgotten in this deal is the consumer who invariably gets a less than optimal quality product.

Currently, the only way to get an A quality product to an A quality consumer is through direct marketing. And the returns from this form of marketing can be remarkable indeed if you have a truly different product.

Unfortunately, most "niche" marketing is an attempt to sell the same old crap at a higher price and does not attempt to create a truly different and distinctive product. Truly distinctive products create their own marketing and as a result are not only easier to sell but much easier to sell at a profit. Now, let's shift this discussion of selling services to public lands.

I grew up as a rancher's son in Mississippi, running cows on leased government land. In our case it was the Mississippi River levee and our land lord was the Corps of Engineers and its public face the Levee Board.

We paid the princely sum of one dollar per annum for each mile of levee we grazed. This grazing included not only the park-like bermudagrass of the levee but the jungle and native grasses of the batture between the levee and the river. This gave us a land cost of less than a penny per cow.

However, there were stipulations that went with this lease.

We were to maintain the access road, cattle guards and all fences. We were to prevent the growing of trees on the levee face and were to make sure the sod on the levee face was unbroken to prevent erosion which might cause a levee failure.

This meant that we could not use any wheeled vehicles during the wet winter months and all supplemental feed had to be transported in by horses or mules.

And, oh yes, the levee was to be maintained so as to be appear parklike. No weeds, no tall grass.

This meant frequent mowing in the summer months when tractors were allowed.

And, we thought we had a good deal. But you know who had a better deal? The American taxpayer. But first a little history.

In 1973 when calf prices hit a dollar a pound, my father correctly saw the wreck that was coming. We liquidated our cattle and our let our neighbors take over our levee lease. Due to the high land inflation in that time period, virtually everyone began to borrow their lifestyle rather than produce it. By the early 1980's this resulted in a general financial collapse in the Mississippi Delta.

A byproduct of this collapse was that the bankers seized all liquid assets and cattle were among their favorite targets. By 1982, the several hundred miles of levee had been virtually swept clean of cattle.

And now, rather than getting paid for maintaining the vegetation on hundreds of miles of levee, the Levee Board had to pay millions to have it mowed. They found that the park-like appearance to which everyone had become used to was damned expensive to create and maintain with a mowing machine.

Belatedly, they learned that each cow grazing the levee was worth at least \$40 to \$50 a year in vegetation control expense. This was a true paradigm shift in how to value the worth of a cow's mouth.

Now, I fear that some of you involved in public lands in the West may not appreciate the same thing. Like the Levee Board, you will not realize the vegetation control value of a cow until all the cows are gone.

In reading the literature of the Qvivera Coalition I noticed how frequently the theme of landscape appears. A healthy riparian zone should look like this. A stream bank like this. The grass, browse, brush mix like this.

This concept of landscape is probably the easiest way to find consensus in an urban dominated economy. Currently, much of the farm subsidies in Europe are paid out to create and maintain a desired rural "look" that will attract urban tourists to the hinterland.

Such landscape-drawn "green tourism" lies at the heart of much of the rural American West as well.

How much will it cost the taxpayers to create and maintain that desired look without grazing? How many bulldozers and mowing machines?

And, ranchers how much are you willing to charge to create that look? Half of the cost of a machine? One-quarter? One-eighth? This is the value proposition all of us in ranching need to be creating for ourselves with the urban public.

What if you stopped calling yourselves ranchers, and started calling yourself Vegetation Control Specialists? Or Landscape Rehabilitation Specialists. This is already happening in the private land sector. Currently, a recent survey in my home state found that 25% of our state's beef cows were valued primarily for the low-cost vegetation control they offered. As the Levee Board found out, cows are cheaper than mowing machines.

I have a friend getting paid 50 cents a day per goat on 4000 goats to remove fire fuel vegetation in steep canyons for the Union Pacific Railroad. This is a fraction of what they were spending on largely ineffective herbicides and they love the long-lasting control they get from the goats.

Why should you public lands ranchers be paying the government to do their work for them? Let the taxpayer decide the landscape they want and then charge them to create and maintain it. They wouldn't expect you to pay to do it with a mowing machine, don't do it for free with a grazing animal.

Now, let's go back to those 70 million future play-ranchers I discussed earlier. Most of them would be happy for you to graze their acreages for free but that's not the deal. They should pay to have their ranches landscaped by your cattle.

Again, I have another friend who has been given the grazing rights to two huge private ranches on the promise that will stop being a huge money pit for the owners. They owners want the landscape and the quiet but not the hassle of dealing with cows - and more importantly - with cowboys. As my friend said, "They've got money. They want happiness."

In conclusion, to figure out how to make a higher profit we must first ask what business we are in? Do we want an 8%, a 14% or a 500% return on our investment per annum?

The more we can make our business the business of selling knowledge the higher our return on investment will be.

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Why Wait? Move to EarthLink.

Note: If you would like to know more about The Stockman Grass Farmer please call 800-748-9808 for a sample copy.