



# HOW TO WORK WITH ‘OPERATING LEVERAGE’

Last month I wrote about the pros and cons of financial leverage. This had to do with the ratio of assets to liabilities and what the impact of gains or losses on those assets can have on bottom-line profitability.

There is another kind of leverage: operating leverage. It has to do with costs, rather than assets and liabilities. The concept focuses on the amount of costs that are fixed compared to those that are variable, based on revenue.

The higher the percentage of fixed costs to total costs, the higher the operating leverage. If you have high operating leverage, a small change in revenue equates to a large drop in net profit. Conversely, if you have low operating leverage and more costs are variable, thus dropping when revenue drops, profit margin varies less and although smaller, remains positive.

Over time the more variable your costs can be, the better you can manage margins. Why? Because costs could go down.

Agriculture is precariously cyclical and, therefore, could benefit by having more variable costs if costs go

down. In years like 2008 that's not the case. But understanding the concept and applying it year in and year out can add to your bottom line over the long run.

**ACCORDING TO** Scott Hazlett, president and CEO of MachineryLink, "Productivity, optimal use of assets and return on capital are defining the future successful farmer," he says. "It's increasingly critical that farmers borrow a page from their industrial brethren whose survival, like their own, hinges on their creativity in extracting every measure of utility and productivity from their physical assets – land, equipment, grain storage and buildings."

Aggressive asset management is becoming the prevailing wisdom in agriculture. Return on capital and return on assets are business imperatives and key measures of management effectiveness espoused by ag lenders, financial advisers and tax preparers, Hazlett says.

Hazlett challenges farmers to realize that a farm is a factory. "As the manager of that factory, you have to challenge every cost. The future of farming hinges on creative means to

liberate non-essential costs and put capital to work in ways that drive real economic return."

Often, equipment management is a place to concentrate. In our client base, the machinery and labor cost per acre has a combined variance of \$200/acre. These are big rabbits to chase.

The farmers who prosper in the future will be those who recognize idle steel in the shed or labor that is not optimally utilized as a readily available and cheap source of capital for reinvestment in grain storage, alternative fuel production or equipment. This then allows you to diversify your operation and improve productivity, marketing leverage, revenue growth and cash flows. **CSO**

## ATTITUDE ADJUSTMENT

**A**t seminars this winter I've spoken to many farmers who, even though they'd sold some \$4 corn, were not excited and were even a little depressed. This surprised me. In asking more about their thinking I found they were disgusted at themselves for not getting \$5/bu.

I suggested that they change their perspective. They should look at margins, goals and returns vs. trying to pick the top of the market. Picking the top of the market cannot be done, unless you're lucky. But managing a business based on sound business principles can be done.

Remember, you control your own destiny. ◀◀

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