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Sheep Updates 2016

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Foreword

On behalf of the Department of Agriculture and Food, Western Australia, it gives me great pleasure to welcome you to the 2016 Agribusiness Sheep Updates: Sharpening the Sheep Business.

The WA sheep industry is an important part of the WA economy. The combined farm-gate value of sheep meat and wool is over a billion dollars, with the vast majority of products being exported. There are also significant flow-on effects to regional WA.

However, if the industry is to grow in value and to reach its potential, doing the same today as we did yesterday is not an option. This event has a clear focus on the business of the industry, its prospects and opportunities. While a number of the papers are forward looking, others contain current financial data that should assist the whole value chain plan for this exciting future.

Sheep Updates are being delivered by the department’s Sheep Industry Business Innovation (SIBI) project, made possible by the State Government’s Royalties for Regions investment.

The SIBI project is building industry capacity, both human and physical, to help deliver the volume and quality of products required by new and existing markets. An important objective is to increase the business skills of all those involved in the supply chain, including producers, processors and the various service providers.

I hope that you enjoy the program and leave today with the intention of doing something different tomorrow that will help grow the WA sheep industry.

Dr Bruce Mullan
Director Sheep Industry Development
Department of Agriculture and Food Western Australia
The Australian sheep industry in 2025

Mick Keogh, Australian Farm Institute
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Over the last thirty years, the Australian sheep industry has undergone fundamental changes. The wool industry was the glittering jewel of the agriculture in 1988, with close to 180 million sheep and historically high wool prices. Even the Prince and Princess of Wales were enticed to support the industry in a lavish gala presentation at the Sydney Opera House. At that time, sheepmeats were considered a by-product, and given little attention.

The good times did not last, and within three short years the wool industry was in a world of pain, which took more than a decade to repair, and which saw many producers depart the industry. However, what has emerged since that time is a much more market oriented industry, with wool being just one of a number of value generators, and in fact lamb, sheep meat and live sheep exports in total are now almost equal in value to wool exports.

Given the scale of these changes, it is a risky proposition to try and be definitive about the changes the sector might experience over the next decade, however there are a number of trends and developments emerging that will undoubtedly be important in the future development of the sector.

Consumer needs and wants. Both wool and lamb are premium products, which command prices significantly higher than competitor products. The consumers of these products are wealthier and can afford to pay the premium prices, but are also fussier. They demand providence and credence characteristics that reaffirm their decision to pay a premium. These credence characteristics, in particular, include issues like animal welfare standards, environmental sustainability, and the fair treatment of workers. This means that there will be increasing pressure over the next decade for the Australian sheep industry to demonstrate that it delivers these characteristics. Issues like mulesing, lamb survival rates, chemical use, on-farm environmental management, shearing shed practices, and post-farm supply chain environment and labour standards will continue to become more important as part of the ‘package’ of values that the industry delivers to consumers. A challenge for the industry is whether these requirements will be imposed by specific value chains (e.g. some of the meat processor and retailer accreditation standards), or whether there is an advantage in a ‘whole-of-industry’ approach. This clearly requires some careful thinking, but in the context that these requirements are likely to increase, not diminish, over the next ten years.

Productivity gains. The sheep industry and particularly the wool industry has been a sector that has exhibited some of the lowest levels of productivity growth over the past two decades, reducing its competitiveness. This has also lead to a loss of investment in the sector, as producers depart, and industry infrastructure is allowed to fall into disrepair. Better returns from sheepmeats, in combination with some
better seasons have improved the profitability of the industry, but significant re-investment will depend to some degree on the availability of new technologies that enable productivity growth through the reduction of labour requirements, in particular. To some degree there has been complacency about the need for productivity growth in the wool industry, and reduced focus on investment in research and development. This is not a viable long-term strategy, and the challenge will be to find ways to reinvigorate productivity growth in the industry over the next decade.

**Digital technologies.** The rapid growth of digital technologies and computing power is resulting in major disruptions within sectors as new business models develop and technologies are utilised in new ways. It seems likely that over the next decade, a new generation of managers in the sheep industry will effectively ditch the paper notebook and replace it with digital applications that are simpler and more efficient. These are emerging, and will be widespread within a relatively short period. The interesting questions that emerge from the use of these applications and platforms include the likelihood of moving to ‘single-animal’ management as distinct from flock management, and the extent to which such applications and platforms will be integrated into downstream supply chains. Applications that are capable of transferring information along supply chains as the product moves along that same supply chain are already available, and are likely to become more prevalent in the future.

**Robotics and automation.** There are already several lamb processors in Australia that have implemented fully automated robotic carcase processing. These have the potential of significant cost reduction for processors, but also generate an enormous amount of objective carcase data. This is likely over the next ten years to enable those processors to develop very detailed profiles of the performance of different farms, lamb genetics, and farm management systems, and drive the adoption of value-based market systems (with farmers paid based on the marketable meat yield of an individual animal, rather than a flock average). These systems will reward the better performers, but disadvantage the ‘average’ producers. They are also likely to reward those of sufficient scale and expertise who can manage what is required for successful supply chain integration, but disadvantage smaller-scale and/or less professional sheep farmers.

**The global economy.** It is generally understood that wool and sheepmeat demand is more susceptible to changes in global economic conditions than more staple agricultural products such as wheat or corn. As a consequence, sheep businesses face a greater amount of risk from changes in the global economy. While the US economy seems to be recovering steadily, the situation in Europe and Japan is a lot more uncertain, and China appears to be continuing to experience economic growth, albeit at a slower rate than in the past. This suggests that the demand conditions facing the sheep industry are likely to continue to remain subdued, and therefore there does not seem to be much potential for a significant increase in prices over the next five years, at least. This reinforces the need for the industry to find ways to improve rates of productivity growth in order to retain current levels of profitability.
Post-farm market changes. By far the biggest impact of digitisation and automation is along the supply chain, rather than inside the farm gate. There is likely to be substantial rationalisation along supply chains over the next decade, something which has already occurred in non-agricultural supply chains. The centralisation of wool sales and the adoption of computerised selling systems are likely to increase over the next decade, especially as telecommunications access and computer technology develops. These have the potential to result in quite fundamental changes in financial and risk management in the future.
Decision making in a risky environment

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‘All business proceeds on beliefs, on judgements of probabilities and not on certainties.’

- Charles W. Eliot (1834-1926)

As Charles Eliot founder of Harvard College states, ‘in business, there is no such thing as a sure thing’. This is especially true in agricultural businesses operating in Australia.

Risk management is often seen as a subject to be studied in isolation. This often results in us having things called a ‘risk work shop’ as if the issue of risk is something that should be handled in isolation. The reality is that risk management is simply something we do every second of the day. From the time that we learn to walk we incorporate either consciously or subconsciously risk management into every decision we make.

So what is risk and why is it important in decision making? There is often confusion over the difference between risk and uncertainty as if these are separate issues. The reality is they are the same accept one has consequences while the other is value free. Hardaker et al (2004) defines the difference as 'uncertainty is imperfect knowledge and risk as uncertain consequences, particularly exposure to unfavorable consequences.' A simple example would be that I might say I am uncertain if it might rain tomorrow but as it has no consequences to me it is consequence free. However, let’s say I am looking to cut hay today. If it is a significant rainfall event tomorrow it will have financial consequences to me – this is risk, the event has both uncertainty and consequences.

Risk decision making needs to be looked at from two angles. Firstly, how can we design a decision making process so that we have the best chance of making a good decision? The second angle is to understand why, even when given the facts to make a rational decision, we don’t. What influences our decision making and therefore the level of risk that we incorporate into our business?

It could be argued, that as human beings, at a personal level that our decision making is very rarely rational. Why do people smoke, drink drive and speed when we all know statistically that these behaviours significantly increase our likelihood of death. What are the influencers that means that some will indulge in these high risk activities even when that person is fully cognizant of these facts? Why do we, in some cases, find people that then give up these risky activities – what has changed and why?
When looking at a farming business, are our business making decisions any more rational? Or are the same influencers that mean we take irrational risks in our personal life framing our decision making in a business sense?

**A rational risk decision making process**

To consider a rational approach to decision making let’s first look at the operating environment. Agricultural businesses are a unique combination of biological, human and financial capital. No other business has an operating environment that is so open to factors outside of the control of the operator. The decisions that farmers make in managing these interactions will determine the outcomes achieved and the amount of risk they are prepared to accept.

It is important to realise that each business is unique in both the makeup of its capital and its required operator outcomes. Furthermore, the environment surrounding the business will also be unique in its combination of risk factors. Therefore, two farms, side by side, operating similar farming systems can achieve dramatically different outcomes based on the permutations and combinations of the decisions that the farmer makes and the differing mix of availability of capital (physical, human and money). As such, rules of thumb and comparison of performance or benchmarking based on the maximisation of a single capital component needs to be used with great caution when analysing the performance of a business. An example would be that most benchmarks focus on maximising capital productivity input, for example, maximizing Water Use Efficiency per Ha. But what if that comes at such a cost to either human capital or a financial capital that a focus on this single factor actually puts the farm at a greater risk of failure. Ed Hunt’s analysis suggests traditional financial indicators or benchmarks can be very poor in providing worthwhile information to base future farm plans on.

“Since each farmer’s business is different, a one size fits all approach is not appropriate. Rather, what is required are simple budgets and guidelines which allow farmers and their advisers to feed in their own figures and ask the “what if” questions appropriate to them.” Ed Hunt (2010)

His analysis also concluded that 'Understanding the sensitivity of change to farm systems and investments with volatile seasons is essential to achieving profitability and managing risk. Traditional farm business analysis techniques often do not pick up risk.' Ed Hunt (2010)

**No return without risk**

William Bernstein in his 2002 book ‘The Four Pillars of Investing’ stated that;


However, that is not to say that all investment with high risk delivers higher returns than those that have lower returns.

Therefore risk (defined as volatility of returns) is an inherent part of investing. For most farmers, farming is an investment not a job. Most of their wealth creation will
come from the return from the farm investment, both in the form of earnings and capital appreciation, rather than the salary they pull from the farm. Thus does it not make sense to look at our farming as would an investor who is trying to maximise their return for risk? The Investopedia website makes the following statement: ‘The intelligent investor manages risk by recognizing its existence, measuring its degree in any given investment and realistically assessing his or her capacity to take risk. There is nothing wrong with investing in a high-risk fund if the fund’s return is equally high. The questions to ask are: Can I afford the loss if it occurs? Am I emotionally prepared to deal with the uncertainties of high-risk investments? Do I need to take this kind of risk to achieve my investment goals?’ So would it not seem reasonable to incorporate good risk analysis into business decision making on farm and not simply focus on returns.

How do investors measure risk?

As we can see risk measurement in the investment world is a critical part of the investment decision just as much as the analysis of the return. What the investor is wanting to measure is the return on risk just as they want to know what the return on asset is. A question I often ask farmers is how many know what their expected gross margin is for that crop? Generally the majority of hands go up. When I ask them what their likelihood of loss for that crop is? Very few if any hands go up.

The hard part about adding risk into the analysis is data. While we only need one year’s results to measure return on assets we need numerous sets of years to measure risk in any sensible way. The most common method used is a measure called standard deviation. Standard deviation simply measures the scatter around the average. The bigger the scatter around the mean the larger the standard deviation is and therefore the greater variability or risk of the investment. The measurement is often used in measuring variability of fleece micron or variation of crop yields across trial plots.

Combining risk and return

In the investment world we combine the two measurements so that we can compare the risk/return performance of different asset classes

If we look at the main investment asset classes for the period (1988-2015) they have achieved the following results:
So if we look at this simply from a return perspective the best investment is Australian shares. Let’s add risk to our analysis.

### Table 2 ROA vs Standard Deviation (SD)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Return on Assets</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aust Shares</td>
<td>9.20%</td>
<td>12.34%</td>
</tr>
<tr>
<td>Int Shares</td>
<td>7.10%</td>
<td>17.10%</td>
</tr>
<tr>
<td>List Property</td>
<td>8.40%</td>
<td>15.76%</td>
</tr>
<tr>
<td>Cash</td>
<td>6.60%</td>
<td>3.71%</td>
</tr>
<tr>
<td>Aust Bonds</td>
<td>8.50%</td>
<td>5.94%</td>
</tr>
</tbody>
</table>

Source: Vanguard Website

So what does it mean? If we look at Australian Shares you would have averaged a return of 9.01%. For two thirds of the years the return has varied between (3.7%) and 21.35% return on assets, this being the average return 9.01% +/- 12.34%. Cash on the other hand achieved an average return of 6.88%. For two thirds of the years cash return falls between 3.21% and 10.55%. Given this what is the better investment? Is achieving a negative return less than (3.3) % two years in ten important to the investment requirements? What is the best return for risk profile and how can you optimise it?

**How does combining Asset Classes optimise your return for risk**

Peter Bernstein (no relation to William) in his book ‘Against the gods’ made the following comment:

‘*The word ‘risk’ derives from the early Italian risicare, which means “to dare.” In this sense, risk is a choice rather than a fate. The actions we dare to take, which depend on how free we are to make choices, are what the story of risk is all about.*’  
_P Bernstein (1996)._  

Fundamental to investment management is the concept of portfolio management. Portfolio management is about setting the level of risk you are prepared to accept for a given level of return. By allocating a proportion of our money to different asset classes you can optimise your return for risk. Figure 1 shows the risk/return profile for each of the asset classes. The efficiency frontier, highlighted in figure 1, is the lowest level of risk that can be achieved for a given level of return for the period studied. This is achieved by optimising the asset class mix.
For example if we had 100% of our funds allocated to Listed Property our investment would have achieved an average return of 8.4% with a standard deviation of 15.76%. This means two thirds of the annual returns achieved for this period were between (7.36%) and 24.16%. The question is could we have achieved the same return with a smaller standard deviation or risk? The answer is yes. By allocating our investment to other asset classes we could have achieved the same return with much less volatility.

The optimal mix of assets classes that can deliver the lowest level of risk (volatility) and achieve an 8.5% return over the period was 34.6% AgTop25\(^1\), 49.50% Aust. Shares and 15.90% Aust. Bonds. This will deliver a standard deviation of 2.9% and an 82% decrease in risk for the same level of return.

**The magic of Correlation**

In designing an investment portfolio which can maximise return and minimise volatility we need not only to consider the return we can achieve and the volatility of the different asset but how the return and volatility between the asset classes are correlated over time.

We measure the degree of correlation by a thing called the correlation index. It ranges from 1 being perfectly correlated to -1 one being inversely or negatively correlated. Assets that are positively correlated mean that as one of the assets return improve so does the other. Assets that are negatively correlated mean that as one of the assets returns improve the other declines.

If we look at the asset classes described in Table two the correlation between the asset classes can be describe as follows (table 3).

\(^1\) Ag Top25% is based on ABARES farm survey of farmers across Australia. It is defined as the average result achieved by the farmers classified as top 25% by their return on asset.
Table 3 Correlation for return between Asset Classes

<table>
<thead>
<tr>
<th></th>
<th>Ag</th>
<th>Aust Shares</th>
<th>Int Shares</th>
<th>Property</th>
<th>Cash</th>
<th>Aust Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ag Top 25%</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aust Shares</td>
<td>0.14</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Int Shares</td>
<td>0.01</td>
<td>0.53</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>List Property</td>
<td>0.11</td>
<td>0.75</td>
<td>0.48</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>-0.11</td>
<td>-0.14</td>
<td>-0.04</td>
<td>-0.09</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>Aust Bonds</td>
<td>-0.59</td>
<td>-0.21</td>
<td>0.01</td>
<td>0.07</td>
<td>0.44</td>
<td>1.00</td>
</tr>
</tbody>
</table>

So in interpreting table 3, if we look at the correlation between Australian Shares and Listed Property we can see they are strongly positively correlated with a correlation index of 0.75. This means that Listed Property and Australian share returns have basically moved in line with each other over this period. On the other hand Ag Top 25% and Australian Bonds correlation index is negatively correlated, (0.59). That means, that in general, when bond returns have improved Ag Top 25% returns have declined and vice versa. So why is this important in portfolio creation?

If we can find asset classes that achieve a similar return but their volatility is negatively correlated, by combining them, we can maintain the same average return but significantly reduce the volatility of our portfolio.

In the above example if we look at Australian Bonds and Ag Top 25% we can see that the returns and volatility are very similar (table 4).

Table 4 Ag Top 25% vs Aust Bonds

<table>
<thead>
<tr>
<th></th>
<th>ROA</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ag</td>
<td>8.2%</td>
<td>5.94%</td>
</tr>
<tr>
<td>Aust. Bonds</td>
<td>8.5%</td>
<td>5.94%</td>
</tr>
</tbody>
</table>

However if we have a portfolio made up of 50% Ag Top 25% and 50% Australian Bonds we achieve the following risk return profile (table 5).

Table 5 Ag Top 25% vs Aust Bonds

<table>
<thead>
<tr>
<th></th>
<th>ROA</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ag</td>
<td>8.2%</td>
<td>5.94%</td>
</tr>
<tr>
<td>Aust. Bonds</td>
<td>8.5%</td>
<td>5.94%</td>
</tr>
</tbody>
</table>

By combining the two assets with similar returns and similar volatility we have maintained our return but substantially reduced our risk of returns from 6.18% for Ag Top 25% and 6.13% for Aust Bonds to 2.8% for a 50/50 portfolio mix which is a 46% decrease in risk. The reason for this is that the asset classes are negatively correlated (see Table Three) but have a similar average return for the period and level of volatility (Table Two). This means that the assets work together to nullify the volatility but maintain the same level of return.

Understanding both our risk and return profile of our investments means that we can better tailor an investment outcome to better reflect the required risk/return profile of
the investor. If they want a higher return and therefore higher corresponding risk then we would look at a portfolio that is mainly made up of Australian Shares. However if we want a portfolio with a slightly lower return but a substantially lower volatility then we can look at mixing the portfolio with other asset classes that will deliver this outcome.

Why not take a similar approach to a farming investment? Can we identify investment choices on farm that provide the farmer with different risk/return profiles?

**Asset Allocation at a farm level**

We can use the same process at a strategic level to identify potential risk return outcomes on farm. An analysis of gross margin information derived from the South West Victorian Monitor Farm study shows the following risk/return outcomes based on forty four years of information.

Table 6 Real* Return and Standard Deviation of Returns (1971-2015)

<table>
<thead>
<tr>
<th>Gross Margin per DSE</th>
<th>Wool Sheep</th>
<th>Prime Lamb</th>
<th>Cattle</th>
</tr>
</thead>
<tbody>
<tr>
<td>27.10</td>
<td>31.38</td>
<td>19.37</td>
<td></td>
</tr>
<tr>
<td>SD</td>
<td>14.70</td>
<td>13.09</td>
<td>10.78</td>
</tr>
</tbody>
</table>

* Real means adjusted for inflation

Figure 2 maps the risk return relationship of the different asset classes, Wool Sheep, Prime Lamb and Cattle and what the optimal portfolio mix of the different enterprises would be to achieve the least level of risk for the level of return. This is identified by the curve.

Figure 2 Efficient Portfolio 1971-2015

The black arrows identify the difference between the best performing portfolio for risk compared to a portfolio that was completely wool sheep. If we had run a mixed operation of 36% Cattle averaging a return of $19.37 and 64% Prime Lamb averaging $31.38 we would have achieved the same return but with a 31% reduction in volatility.
In deciding if the diversification benefit is worth it the reduction in risk needs to outweigh the loss in return. If the asset returns are closely correlated then the value of diversification is highly questionable if one asset class is performing much stronger than the other. In the above example the correlation of the different asset classes, Wool Sheep, Prime Lamb and Cattle are as follows:

Table 7 Correlation Matrix

<table>
<thead>
<tr>
<th></th>
<th>Wool Sheep</th>
<th>Prime Lamb</th>
<th>Cattle</th>
<th>GM$(DSE)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wool Sheep</td>
<td>1.00</td>
<td></td>
<td></td>
<td>27.10</td>
</tr>
<tr>
<td>Prime Lamb</td>
<td>0.90</td>
<td>1.00</td>
<td></td>
<td>31.38</td>
</tr>
<tr>
<td>Cattle</td>
<td>0.32</td>
<td>0.26</td>
<td>1.00</td>
<td>19.37</td>
</tr>
</tbody>
</table>

As table 7 shows Wool Sheep returns for the period are strongly correlated with Prime Lamb, 0.9. However, the returns are lower GM$(DSE). So adding a wool sheep enterprise into the business would have little or no benefit in reducing return volatility but would reduce returns. On the other hand the cattle enterprise is less correlated to the Prime Lamb enterprise, 0.26. So even though the returns are much less than wool sheep the benefit in risk reduction is significantly higher therefore it provides a much better risk return relationship than adding wool to the operation. This would seem counterintuitive if we only focused on returns and did not take into consideration risk and correlation of returns.

The analysis completed in WA looking at the value of a mix farming operation is in its initial stages. However, the first set of data has shown the following relationships.

Figure 3 identifies the optimal mix of cropping and sheep that provides the best return as measured by GM$/Ha. It shows from zero cropping up until 31% cropping there is an increase in return and a corresponding reduction in risk. However over this point we get both an increase in return and an increase in risk. Based on the
numbers provided so far there is a clear value in a mixed enterprise system in reducing volatility of returns faced by farmers within this particular sample group.

Figure 4 Risk Return profile for differing percentage of cropping

Figure 4 represents the different risk-return choices. As figure 3 shows that at $280 GM/Ha you achieve the highest average GM/Ha for the period but you are also faced with the biggest volatility ± $171. At 46% cropping percentage you have the lowest risk profile but not the lowest return profile (210 ± $78) therefore providing you with the best return for risk. The management decision that needs to now be made is do we chase the best return with the highest risk or are we better to take a 25% reduction in average returns for a 54% reduction in risk?

Care needs to be taken in interpreting these results as they are based on a particular set of returns for a particular area. Also just because one enterprise mix has a greater level of risk it does not mean that it is any worse or better than one with a low level of risk and lower returns. What we need to do better is to ensure that farming systems better suit the risk return profile of the farmer and their debt servicing requirements. To do this we need to start measuring and understanding what volatility means to a farming system rather than just ignoring it and focusing simply on averages.

References

- Hunt E (2010) Improving farmer capacity to manage profitability and risk, GRDC
Decision Making in a Risky Environment.

Notes:

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With each new generation the need for farmers to continue to maintain a dynamic and growing agricultural business is paramount. With a view to growing a farming business, this paper seeks to explore avenues for growth, including the role of production management systems as a means of freeing up management time to focus on business development and expansion, as well as strategies and opportunities for family business transition.

There is currently much discussion around the ability of agriculture to feed an increasing population into the future and the opportunities this may present to farmers around the world. Indeed, as the population heads towards eight billion by 2030, the pressure on limited resources, such as water, land and energy, will increase and food prices are predicted to rise. Whether this will deliver increased returns and margins to producers is unclear; for example, energy costs and hence the prices of farm inputs also are predicted to continue to rise.

There is currently renewed interest in investment in agricultural land and water worldwide, by individuals, fund managers and companies, as food security becomes a mainstream issue. This further highlights another area of critical shortage in global agriculture, that being skilled management capability. It is vital to increase investment in the building of capacity of the human capital involved in agriculture.
Those with ambition and an open mind may be able to take advantage of and design opportunities to leverage and utilise their skills internationally.

Businesses wishing to take advantage of potential opportunities from increased agricultural commodity prices, technology advances leading to higher productivity, or change in land use and intensification, need to carefully consider the growth strategies to be pursued. Some common strategies used by businesses ranging from commodity farms to direct market growers, include, capacity expansion, replication, diversification, specialisation, and integration.

Capacity expansion and replication are similar strategies. Expanding business within an existing area of expertise is an obvious path to business growth. Risk is low, as production methods are already proven, marketing and supply channels established, and strategies and systems can be expanded as growth occurs. Overhead expenses can be spread across a greater production base and one of the key assets of a business, management skill, can be leveraged.

The addition of new enterprises can reduce production risk, expose businesses to unrelated markets and utilise under-performing assets or seasonal capacity. If synergies between new and existing enterprises can be identified or developed, efficiencies can be gained. While a degree of diversification is an effective risk management strategy, too much diversity can reduce management’s ability to take advantage of the upside of seasonal variability. It also adds to management load and leads to inefficiencies if the enterprises are not complimentary. It is important to take into account the implications of added complexity on a business when considering further diversification.

Simplification or rationalisation of the enterprise mix can make way for specialisation within a business. By specialising, management can be targeted on the key profit drivers in a particular enterprise and the compromise that can come from integrating competing production systems can be eliminated. Specialisation can allow businesses to gain economies of scale within an enterprise, and, for example, invest in technologies and equipment that may be enterprise-specific delivering efficiencies and cost benefits. Specialisation leading to increased turnover within an enterprise gives management a better position from which to negotiate with suppliers and service providers, and forge stronger relationships with customers.

Integration, as a strategy for growth, involves a move either closer to the consumer in the value chain, or can be a move toward the input or supply side of the business. It may result in businesses within the supply chain forming joint ventures, or a group of similar producers working together to move up or down the chain. Vertical integration towards the market can add significant value to goods produced, while controlling costs is a motivation for integrating in the direction of inputs or supply.

Increasingly businesses are using codified, or written systems and procedures to streamline management, production and product delivery. Using Standard Operating Procedures (SOP) leads to gains in quality, consistency and reliability of production, as well as providing routine for employees. These procedures can facilitate training, ensuring consistency of instruction, and serve as a point of reference in the case of
employees filling in for jobs they do not perform on a regular basis. SOPs can be a simple instruction, for example, hand washing procedures in a packing facility, or describe the operation and maintenance of complex machines and systems.

Having codified policies and procedures in place can benefit businesses in many ways according to the New South Wales advisory service (Small Business NSW).

“Benefits of a documented system are:

- Better succession options for the business, including saleability.
- Ensuring that record keeping, compliance and reporting obligations are met.
- Smooth running of the business.
- Effective training of new staff.
- Reduction of administrative time.
- Assists in reducing risk.
- Clear direction for employees on how to operate within the business.
- Consistency in product or service delivered.
- The business not totally dependent on the owners.”

Some sectors within agriculture have been able to develop and implement production systems in order to simplify management input. Examples can be found in intensive livestock operations, such as dairy farms, which can be replicated in order to grow the overall business without needing to increase management overhead commensurate with the expansion. The system is effectively portable and can be modified to reflect local conditions, allowing for geographic diversity within the business. Having systems in place is not a pre-requisite for expansion, however they can assist with replication and simplify management.

Global population growth estimates, combined with rising affluence and a fast growing middle class in developing nations, is changing diet and driving increased food demand worldwide. There is evidence to suggest soft commodity prices will remain above long-term averages (OECD/Food and Agriculture Organisation of the United Nations, 2013), resulting in agricultural land continuing to increase in value, giving well-managed agricultural production businesses opportunities for growth. The strategies for expansion chosen depend on many factors, from the wishes and aspirations of the people involved in the business, to the available land resource, and economic circumstances surrounding the business and markets in which they operate.
Advisory Boards in WA Agriculture – making life ‘easier’ for everyone

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What are farm advisory boards?

Farm advisory boards are simply a process where farming families meet so they can plan and manage the strategic aspects of their business.

Farm advisory boards generally meet 2-3 times per year; and include all active members of the farming business [plus any off-farm children (if desired) and an advisor]. Advisory Boards can discuss anything from financing, machinery replacement, staff management, and farm policies, to on/off-farm investments.

WA mixed farming businesses have changed in the past 15 years. The businesses the new generation of WA farm managers are moving into is very different to those established or managed by the retiring generation. Business turn-over has increased 10-fold (despite the fact that margins have remained the same); business risk has increased through variable seasons and increased input prices: and there are more industry and government requirements (such as grain marketing, OHS etc) than in previous generations. For these reasons, farm advisory boards can be an asset for any family farming business.
Farm advisory boards are likely to become more common as the agricultural industry heads towards different financing and farm business ownership structures. Investors generally insist on industry-recognised business governance structures (such as boards and management structures) and require general governance policies and practices to be in-place. Establishing a farm advisory board is the first step for a farming family to improve their business’ governance, and will lead them towards better business management and more robust decision making.

Small, family businesses, of a similar turn-over, in other industries would be encouraged by their accountant or business advisor to establish an advisory board specifically to manage business risk. Family farming businesses should be no different. There are now well-structured plans for farm businesses to use, and many advisors who can support the family through their establishment.

**The practical experience**

Gerry Hinkley farms with her Dad, Don Thomson, and 2 full time staff at Braeside Farm, in Tincurrin. The farm business established a Farm Advisory Board in July 2014, following the unexpected death of her husband Wade.

Braeside Farm is a 10,000ac broadacre mixed enterprise farm cropping wheat, oats, lupins, sub-clovers; and managing 5,000 breeding Merino ewes.

Gerry will talk about the background to the advisory board, and its current function. She will discuss how the advisory board works, who is on it, and how they came to be invited. Gerry will talk openly about their experiences; “her pros and Dad’s cons”. She will also spend some time talking about the future of the advisory board in their business.
Passing on the family farm to the next generation is a challenge. Farmers do not address the issues of succession with enthusiasm or with thought to timeliness for some of the following reasons:

- There are equity and viability issues associated with handing management and assets to the next generation and maintaining the family business.
- There are difficulties associated with operating at the family/business interface. For example, agreement on roles, responsibilities, goal setting and decision making can be fertile ground for conflict.
- It can be difficult to realistically assess the risk associated with asset transfer, i.e. divorce and will contestation.
- There are often financial and emotional issues around the issue of retirement.
- There are usually complexities associated with providing defined career paths, adequate compensation and housing for the younger generation.
- There can be problems with the transfer of management and leadership, and fear of “losing control”.
- There can be a range of tax implications involved with succession planning, with legislation changes over time causing confusion.

The issues surrounding succession planning are complex. There is always emotional investment to consider as well as financial and associated business investment. It is important to realise that each family’s needs, and therefore solutions to the above problems, will be different.

What are the implications of not addressing succession issues?

- Lack of direction and certainty for the younger generation - this will have implications for the motivation and employment longevity of individuals involved in the business.
- Lost opportunities – missing the opportunity to harness the enthusiasm of youth, planning for off farm investment to pay out off-farm siblings, building superannuation.
- Relationship deterioration – occurs as conflict builds due to lack of communication and planning.

A lack of planning will ultimately have an impact on farm productivity and therefore the ability of the business to continue into the next generation.
What do successful family business succession plans have in common?

- They are proactive – they start communicating and planning early, aim to be in control of their future, and involve all family members.
- They review plans frequently and are aware and accepting of the differing perspectives, and strengths and weaknesses of all family members.
- They ensure that all the family participates in formulating the succession plan.
- They understand that reaching agreement on business goals, roles and responsibilities is important.
- They are not afraid of seeking outside help – they acknowledge they can’t do it all themselves and realise the benefits of accessing outside expertise rather than solely focusing on costs.
- They allow risk taking on an incremental basis – they allow the younger generation to spread their wings. They encourage the younger generation to pursue education and experience outside the family business.
- They make plans that are driven by needs and goals rather than by tax minimisation or the fear of possible divorce.
- They make plans that are flexible.
- They are open – they submit their business performance to outside scrutiny and are business focused. They compensate contributors to the business at market rates and understand the difference between business and emotional returns.

What is possible if succession is addressed, and addressed early?

- Realistic expectations and outcomes can be communicated between the generations to help in decision making.
- Off farm investment strategies and retirement planning can be implemented.
- All family members have helped build the plan so they feel more likely to own the plan and less likely to contest it.
- Tax implications can be assessed and addressed early.
- Careers can be developed and compensation packages thoughtfully devised.
- Risks can be quantified, assessed and strategies put in place to mitigate them.
- Family relationships can be maintained and the business given every opportunity to prosper.
- The complexity of the process is addressed and more easily understood and dealt with over time.

In conclusion, farmers that want to minimise the risk of underperforming businesses and who want to be in control of the future of the business, start the succession planning journey early. They understand that it is a journey, they understand it is difficult to do on their own and they realise the importance of harnessing the power of the whole family to ensure that continuity of the business is achieved.
Take Home Messages

- Start succession planning early and review the plan often.
- Formulating a plan is not easy as there are many layers of complexity.
- A number of professionals will need to be accessed.
- Working in a multigenerational family business offers enormous opportunities but the family must realise that if the business is to continue, the participants must be objective and business focused.
- Decision making at the business and succession level must be formalised, employ processes that foster clear communication and involve all members who are directly and indirectly affected by decisions made.
Brad and Tracy Wooldridge run a small mixed farm at Arthur River in WA, running a 1900 head composite sheep flock and cropping barley, lupins, canola and oats.

15 years ago the farming system underwent a major change with an introduction to the concept of measuring pasture growth and production by satellite imagery and modeling. At the same time abandoning set stocking and moving to Dairy style rotational grazing.

We use historical data from Landgate’s Satellite imagery to analyse how pastures have performed over the last 22-year period and then compare how they could have performed given the season, - benchmarking changes to the management variable.

Quantifying seasonal variation allows for pasture performance predictions and the varying of stocking rate to match the seasons predicted potential avoids the risk of being overstocked.

A change to composite ewes with the aim of having lambs that grow faster led to other issues. But an analysis of total system feed requirements led to us using this technology to search beyond the farm gate to find a feed supply to reduce the risk exposure to the farming system.
“Big Brother” has been watching and we thought we may as well ask his opinion. The result from this was the purchase of another property to mitigate risk, ‘BB’ even helped choose it.

Over the past two years Meat and Livestock Australia and University of New England have been working with producers on an innovative project that has the potential to unlock a whole new world for sheep producers.

This journey has been made possible with guidance from DAFWA, CSIRO, Landgate, MLA and UNE.

Specific information on the tools using Pastures from Space technology will be available in your delegate satchel and a demonstration available in the foyer during breaks. Please take the chance to try it out.
Seasonality of Lamb Supply – Have We Interpreted the Price Signals?

John Young, Farming Systems Analysis Service
john@farmingsystems.com.au

Background

The lamb production system in WA is characterised by a large supply of lambs finished on green feed during spring and then a reduction in supply through summer, autumn and winter. This pattern of supply reflects the cost of finishing the lambs, with it being cheapest finishing on green feed and progressively more expensive as the season progresses. Higher prices are offered for out of season lamb, however, historically these premiums have not been sufficient to entice farmers away from the sucker lamb production system.

The change in profitability from delaying the turn-off of carryover lambs is a trade-off between a numbers of factors:

The change in price received for the lamb

The amount and quality of feed required for backgrounding and finishing the lamb and the timing of the demand. Delaying the turn-off, spreads the energy demand for the growth of the lamb and this reduces the average diet quality required, however the delay increases the total amount of energy required because of the extended period of time over which there is a maintenance requirement.
Husbandry cost and labour: The expense and workload associated with retaining animals for later turn off includes both the extra duration of feeding and monitoring required and the extra husbandry operations that need to be carried out.

Wool Income: Delaying the sale of carry-over lambs increases the quantity of wool grown.

Death Rates: Retaining lambs on farm for longer increases the chance of deaths.

This paper addresses 2 questions:

1. What prices are required later in the season for producers to breakeven with turning off lambs earlier?
2. How do the breakeven prices compare with the historical prices?

The analysis was carried out with the MIDAS suite of wholefarm optimisation models, using the Great Southern and Central Wheat belt regional versions. The MIDAS model is suited to this analysis because it can evaluate the trade-off between the extra feed required by the later carry over lambs and the lower feed quality.

The merino genotype was a fast growing, medium wool sheep and surplus ewe were mated to a terminal sire. It is the turn-off of this 1st cross lamb that is the focus of this paper and the results are presented as a break-even price for the carryover lamb. The break-even price was calculated to provide the same profit as the sucker lamb system.

In each region, 4 turn-off times were compared for each of 2 lambing times. The turn-off times were a sucker at about 4.5 months, and a carry-over lamb at either 7, 9 or 11 months. The analysis was done assuming that breeding, backgrounding and finishing is all done on the same farm and that the profit from varying the turn-off time of the lambs is captured by the one farm. In practice it is possible that this will be spread across 2 or even 3 farms, however, the total profit to be shared will be as for the single farm (minus some transaction and transport costs). The allocation of the profit between the farms will be determined by the price of the store lamb.

The post-weaning nutrition of the carryover lambs was managed to achieve a turn off weight of 48kg yielding a 22kg carcass. The later carryover lamb had a period of backgrounding with a target growth rate just above maintenance then finished with growth rates above 150g/hd/d. The growth paths include a period of fast growth post weaning on green feed and this period is much shorter for the later lambing.

Results and Discussion

The system selling the maximum possible draft of lambs as suckers off their mothers at weaning is the lowest cost system. The carryover systems require a higher price in order to breakeven and the later that lambs are turned off the higher the breakeven price with an increase of between $0.30 and $0.35/kg DW/month required. In the Great Southern the price of lamb in May/June would need to be between $5.50/kg DW and $5.80/kg DW for farmers to be enticed to produce carry-over lambs at this time rather than producing suckers at $3.75/kg to $4.25/kg in
Oct/Nov/Dec. In the Central Wheatbelt the range in the prices required to breakeven is slightly greater, $5.35 to $6.35, but the prices are comparable and cluster together at a level above the historical market average (Figure 1).

In all scenarios the increase in the breakeven price is greater than the average increase observed in the market over the last 5 to 10 years. This is consistent with producer decisions of not having widespread adoption of the late carry-over lamb system and focussing instead on sucker lamb production.

The increase in the breakeven prices with later turn-off is greater on farms with fewer crops (up to $0.50/kg/month) because less stubble is available to background the lambs that are being carried over. These results indicate that crop residue handling systems, such as chaff carts, which increase the accessibility of crop residue to animals and thereby increase animal performance, are likely to reduce the increase in breakeven prices required. This is an area that needs more evaluation.

**Conclusions**

This analysis indicates that a price increase of $0.30 to $0.35/kg DW/month is required in order for farmers to make equal profit from turning off lambs later. This is greater than the 5 year average of $0.16/month during the period 2010 to 2015. This result, and the seasonal turn off pattern that is observed in the WA lamb industry, both indicate that to entice more carryover production that a larger seasonal difference in price is required.

Furthermore, a larger price increase per month than that calculated may be required to achieve practice change on farm because of the risk associated with carrying the lambs longer. The risks include both production and market risk. The production risk includes risks associated with animal health and increased death rates or reduced rate of liveweight gain in the feedlot. The market risk includes risks associated with
the price of grain required for feedlotting and also the price received for the lamb. This later risk could be reduced if processors introduced a strong forward pricing mechanism that farmers believed and could plan their production around. In the absence of a forward pricing mechanism farmers will require much larger premiums, but it is difficult to calculate the level.

This analysis was commissioned by the Sheep Industry Business Innovation project as part of its work around understanding the barriers to increasing supply of lambs in WA and a full report will be available at www.agric.wa.gov.au/sibi after the Sheep Updates.
A comparative analysis using Gross Margin for grain and sheep enterprises

Ashley Herbert, Farm Management Consultant, Agrarian Management

It is generally accepted that cropping is more profitable than the sheep enterprise. However, the difference has been reduced significantly by the high prices currently being received for sheep and wool and poor pricing expected for cereals.

Currently, the sheep enterprise is generating gross margins in the range of $35 – $45/ dse. This is significantly above the medium term average of $25/dse.

The figures in table 1 illustrate the comparative gross margins for crops and sheep enterprises typical for the West Katanning area. The two scenarios presented represent an average outlook for production and an above average outlook reflecting the exceptional seasonal conditions of 2016.

At average production levels there is very little difference in the profitability between the crop and sheep enterprises at current grain prices. Significantly above average production is required for cropping to maintain a significant profit advantage over sheep.

Table 1 Estimated enterprise gross margins with current price expectations for the 2016 season for West Katanning WA

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<tr>
<th></th>
<th>Prime lamb</th>
<th>Merino</th>
<th>Wheat</th>
<th>Barley</th>
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<tr>
<td>Average production</td>
<td>$385</td>
<td>$349</td>
<td>$394</td>
<td>$327</td>
<td>$454</td>
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<tr>
<td>Current season</td>
<td>$450</td>
<td>$409</td>
<td>$561</td>
<td>$434</td>
<td>$595</td>
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<td>production estimates</td>
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This analysis was commissioned by the Sheep Industry Business Innovation project as part of its work around understanding the barriers to increasing supply of lambs in WA and a full report will be available at [www.agric.wa.gov.au/sibi](http://www.agric.wa.gov.au/sibi) after the Sheep Updates.
Tri Lamb Focus Program

Jamie Heinrich
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The Tri-Lamb Group was formed to collaboratively explore opportunities to enhance the profitability of the lamb market in the United States. It is a partnership between the Sheepmeat Council of Australia (the nation’s peak body representing and promoting the national and international interests of Australia lamb and sheepmeat producers), and the peak bodies of both USA and New Zealand (American Sheep Industry Association (ASI) and New Zealand Federated Farmers).

The partnership began in the early 2000s following a WTO dispute over US import tariffs on lamb. One of the outcomes of the process was agreement that the Australian, NZ and US sheep industries would develop a closer working relationship to gain a deeper understanding of each countries industry issues with the hope they could work together for the good of the sheep industry as a whole.

While Tri-Lamb does not exist as a formal structure anymore, the relationship has strengthened over the years and has focused on increasing consumption of lamb in the US through collaborative marketing programs. The consumption of lamb each year in the US is less than 1kg per person, although it is still the largest value export market for Australia. A real opportunity exists where if lamb consumption in the US
were to be increased by only a few hundred grams per person each year, supply would struggle to keep up.

The three country partnership has several key goals, including:

- Improve demand for lamb in the United States.
- Strengthen the sheep industries in all three countries by taking whatever actions necessary to ensure that markets in each country are at a level that will be profitable for each segment of the industry, especially the producer (farmer) and feeder.
- Enhance export market opportunities for lamb and lamb products.

Photo: Jeff Murray (Sheepmeat Council of Australia President, from WA), Jamie Heinrich, and Burton Pfliger (American Sheep Industry President)

The Sheepmeat Council of Australia’s delegation as the inaugural Youth Ambassador. The aim of this trip was to set up a three country collaboration to develop youth leadership capabilities. He made the same trip to the US again in January 2016 to help finalise the initiative.

Following the successful establishment of the youth initiative, four young US sheep producers, along with two young Australian and two young New Zealand producers have been chosen for a two week tour of Australia and New Zealand. This incorporates the 2016 Lambex conference in Albury. The trip runs in Australia on August 10-14 followed by New Zealand on August 15-18. The program is designed to create a forum of young sheep producers and leaders to share ideas, network and to broaden the understanding of sheep production practices in all three countries. Each country also selected two experienced producer leaders to serve as mentors on the trip. Jamie Heinrich and Jeff Murray have assumed these roles for Australia.

The Sheepmeat Council of Australia in partnership with MLA are also running other leadership development initiatives as part of the ‘Building Leadership Capability for the Sheep Industry’ project. The project’s objective is to ensure that the Australian sheep industry attracts and retains people with leadership skills to contribute to the long-term viability of the industry by developing industry capability and capacity.
The Dorper Lamb Company and Brand was established in 2005 to be a breed specific Lamb Brand. This brand is based on the Dorper Sheep breed, which was initially established in the 1930’s by crossing a Dorset sheep from Britain and a Black Faced Persian sheep from Iran.

The Dorper Breed was mainly introduced into South Africa and prospered in the Southern African savannah farming areas, before being introduced into Western Australia via embryo transfer by innovative Livestock breeder Stanley Alexander Dorman from Dale River.

In 2003/2004 while exporting breeding livestock from Australia, Graeme Howie and Stan Dorman were approached by their Chinese clients to send about 1000 Dorper Sheep to Shandong Province in China.

During the selection and buying of the Dorper Sheep, Graeme Howie sat down for lunch with Maggie Maslin from Bakers Hill and had his first taste of Dorper Lamb (Loin chops). The taste and quality was immediately noticed - "Tasty and clean flavoured lamb with a very mild aroma, low and non-intrusive fat that crisped up under the grill".

The Dorper Lamb was bred for Chop's and not Socks.

Being a shedder and a non-wool producing sheep, many benefits had been identified for this breed to be promoted and separated from other lamb, many animal husbandry practise's had been eliminated and this sheep breed was producing a premium lamb quality with an interesting story to be told.

Inspired by the success of the Mount Barker Chicken Brand and seeing how the branding of wines had been developed from a choice of white and red to a great deal of varieties and regions, it was now planned to try Lamb branding by breed marketing in the 21st century.

We established the Brand and starting selling the Whole Lamb Box.

The Dorper Lamb brand logo and registration was applied for and accepted. This was the easy part. Now to breed more Dorper sheep, process the lamb into a nice range of cuts, carefully vacuumed packed and then sold and delivered to the market.

It was immediately noticeable that everybody was quite happy to buy the racks, however, a strategy was needed to sell all the cuts together until I could work out how to sell all the cuts in balance, once we could reached a certain level of production.

The Whole Lamb Box sale was established and the market was very receptive, and during the early days was quite successful.
Enter Polly Trefort and the Hillside Abattoir. Polly had been busy building the Q Lamb Brand over the years, which was very successful and he had established his distribution. Polly, whom I had met as a student at the Narrogin Agriculture College was a sharer of information and could see the benefits of helping me. He set me straight on what to do, processed and packed the Dorper Lamb and within a few months we had become a valuable client to the Hillside Abattoir. We had a couple of good years together with Hillside but their circumstances had changed and the works changed hands to an overseas company who didn’t wish to process.

Ups and Downs of Lamb Processing

During the Hillside years - Dorper Lambs came in from both our own supply and a growing band of other Dorper Lamb farmers and the sales where building. Although the mining boom was creating steady domestic sales, the costs of processing and distribution were increasing. The strong Australian Dollar also made exports difficult during this period.

The Dorper Lamb Company had been well capitalised on recommendations by our Chairman. We had increased distributions via our four Dorper Lamb vans, had established ourselves as a player in the food service industry. The company had spread to Melbourne, Singapore and Kuala Lumpur. But processing at Hillside had ground to a halt. Domestic processing was arranged at various processing rooms in Perth - but the quality of the packing wasn’t as good as an export accredited works. We pressed on and developed support from WAMMCO in sourcing, cutting and packing with the Western Meat Packer Group, and now with V & V Walsh. We have now grown enough to become reliable clients of these processors.

Although the Dorper Lamb food service and export sales were growing steady, expansion means more money needs to be spent on staff, marketing and business development. Cost of production continues to increase and lamb prices across the board have been stronger. Trying to obtain consumer price increases over the past two years at the same pace as the farm gate price and processing cost increases, we have found to be unachievable. The consumer will switch to other cheaper proteins - such as pork and chicken.

With the mining boom over, down came the Aussie Dollar. Exports started to grow and now the export expansion in sales means more money is needed to fund this growth.

The current result after 10 years in the business - The Dorper Lamb brand and distribution is well established, and it has taken time and money - always more than what you think.

What we are doing less of

Most forms of advertising and promotions are not value for money. Word of mouth and social media is much better and a lot cheaper. No discounting and free
promotions - If the product is good, good people will buy it. We are always aiming to keep our overheads down and looking for better value in everything we do.

What we are doing more of

Client focus - Visit them - talk to them face to face - listen and identify from them what is needed and match food service needs. Create and recreate ways to sell our product.

Improve on-line sales by better portion size.

Lift up the staff we have - finding more young people with sharp intuition and people skills.

Overseas education and training - very important - 99% of people in the region still haven't had their best Dorper Lamb experience yet!

The Dorper Sheep Society in Australia, following our lead and are asking their 600 members to produce a consistent product to be known as prime Dorper lamb. These growers all producing the same quality MSA grade lamb opens up a great supply chain of product across Australia.

The Dorper Lamb Company and the Dorper Brand continues to grow strongly.