The Art of Arbitrage

The King Ranch examines how the principles of arbitrage and asset turnover ratio can be useful marketing tools rivaling retained ownership.

by ***Kindra Gordon***

FEEDER CALF MARKETING

Should you retain ownership of your calves? While that is a question that hinges on many factors for each individual operation, Barry Dunn and his former colleagues at the King Ranch Institute for Ranch Management (KRIRM) have some interesting thoughts on the subject.

Dunn, dean of the College of Agriculture at South Dakota State University and former KRIRM director, reports that Dave DeLaney, King Ranch vice president and general manager of ranching operations, says the question he is most frequently asked relates to why King Ranch does not retain ownership through the stocker and feedlot phase of all of the calves they raise?

For many years King Ranch's production and marketing plan has consisted of selling its raised calves after they have been backgrounded, stockering purchased cattle as pasture conditions permit and using its feedlot to finish cattle if the market seems favorable.

DeLaney explains that this plan allows him two distinct advantages over retained ownership: arbitrage and an increase in asset turnover ratio.

Here, Dunn explains more about these two principles:

ar • bi • trage: \är-be-'träzh\ n. the simultaneous purchase and sale of the same commodity in different markets in order to profit from price discrepancies.

What is arbitrage?

Webster's dictionary defines arbitrage as "the simultaneous buying and selling of the same commodity in different markets in order to profit from price discrepancies."

Dunn says, "While this — arbitrage — may seem like a big fancy word that only academics use, many ranchers use this business principle like an artist paints on canvas."

He explains, "When a rancher finds value in the market place, buys those calves, harvests cheap gains and creates additional value — he is using arbitrage. Ranchers often quickly reinvest that money and run the cycle again and again and again."

How do you define asset turnover ratio?

Dunn says, "Think of it this way: The implement dealer in your community has an inventory of expensive tractors and equipment. Because they are very expensive and require large investments, the dealer probably only has one or two tractors of each model on their lot and only sell a few each year. As a result they turn their investment over very slowly, perhaps only once each year.

"Compare that to your livestock feed dealer, who is buying and selling feed all of the time, perhaps every day. A feed dealer turns their investment in feed over very rapidly, many times each year. Of course each business has a different operating profit margin, but in terms of total profit, a business that captures their profit margin multiple times each year has an inherent advantage. They are frequently in the marketplace, capturing created value."

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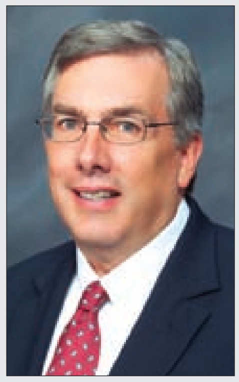

How do you tie that to calf marketing?

Dunn concludes, "The widely touted and promoted cattle management and marketing practice of retained ownership of a rancher's calf crop has advantages. Many ranches have made substantial investments in genetics and herd health, and one way of capturing that investment is to retain ownership of the cattle as far as possible into the cattle production system. This has been used very successfully by many ranchers."

However, he adds, "There is always a price tag." He goes on to say, "In this case, one of these is the opportunity to use the business principles of asset turnover ratio. Using it is not dependent on size or scale. If you have a successful business model, one way to take advantage of it is to turn it more often."

How might these business principles apply to a ranch?

Dunn suggests considering the drought management strategy of running a portion of your carrying capacity as stockers instead of cows. This builds flexibility into your operation, and as precipitation and pasture conditions permit, one choice you will have is to stocker your raised calves.

However, Dunn says that an alternative, which uses the principles of arbitrage and increasing your asset turnover ratio, is to sell your calves and buy back lighter, greener calves of less value. Stocker those, and sell them at a heavier weight, harvesting the cheap gain from your grass and, most likely, compensatory gain in the cattle.

He acknowledges that there are additional risks. One might be biosecurity. Another is the volatility of the cattle market. But, he adds, "Taking advantage of these opportunities might entail honing your marketing skills. But all marketing plans entail risk and require learning, even retained ownership."

What has the King Ranch's record been?

Dunn reports that a King Ranch Institute graduate student recently analyzed whether or not over the last eight years King Ranch would have been more profitable if it had retained ownership of its calves. The findings? "King Ranch's financial and production records revealed a tremendous advantage for arbitrage and increasing asset turnover ratio over retained ownership," Dunn concludes. **HW**