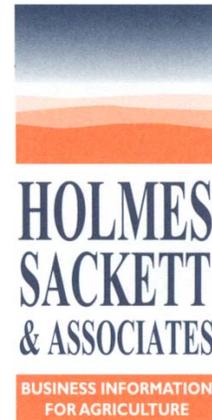


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## Why should you stay in wool?

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The current low historical price being received for wool has many speculating as to whether the market is in terminal decline and this is the end of profitable wool production. This view may prove correct but the evidence available suggests otherwise. It is easy to be swayed by the thoughts and opinions of others and make poorly informed and rash decisions. If you allow yourself to fall into this trap, you may ultimately sacrifice the long term profitability prospects of your business.

The purpose of this article is to offer some perspective on the profitability of wool production and why the present and future prospects might not be quite as bad as some people think. Hopefully it will allow a more informed decision to be made or at least prompt thinking before any decisions are carried out.

### Current wool flock performance

Before any analysis is conducted on the performance of wool flocks it is worthwhile putting into context the prices being currently received for the commodities produced by the major grazing enterprises. Table 1 shows the price deciles for wool, sheep meat and beef for the last ten years as well as the nearest decile to where they traded in the 2004/05 financial year. The reason for using what may seem like dated price information is that performance analysis will be completed on data from the 2004/05 period which is the most recent database available. The trends and issues relating to this analysis have changed little over the subsequent 12 months.

If you are unfamiliar with price deciles, the 50% line is the median, either side of which half the prices lie. At the 20% decile the price has been higher than this during the period for 80% of the time and at the 80% decile, the price has been lower than this for 80% of the time. Deciles tell us the long term spectrum of prices and where current prices sit in that spectrum.

**Table 1: Price deciles (1996 to 2005) and 2004/05 price deciles for livestock commodities**

Decile	Wool - c/kg Clean			Sheep meat - c/kg Dwt		Beef - c/kg Dwt	
	17.5µm	19µm	21µm	Lamb	Mutton	Steers	Cows
0%	720	672	476	109	39	164	108
10%	964	857	529	149	60	195	136
20%	1,013	914	582	171	66	204	160
30%	1,059	944	634	189	73	220	175
40%	1,126	971	670	201	82	235	200
50%	1,228	1,001	716	227	95	268	219
60%	1,330	1,045	771	282	157	289	247
70%	1,448	1,105	827	317	181	327	269
80%	1,580	1,228	882	350	198	340	279
90%	1,844	1,321	1,008	377	216	359	302
100%	2,194	1,535	1,382	498	263	397	364
<i>2004/05</i>	<i>1,048</i>	<i>952</i>	<i>779</i>	<i>358</i>	<i>193</i>	<i>369</i>	<i>296</i>
	Nearest decile to the 200/05 price						

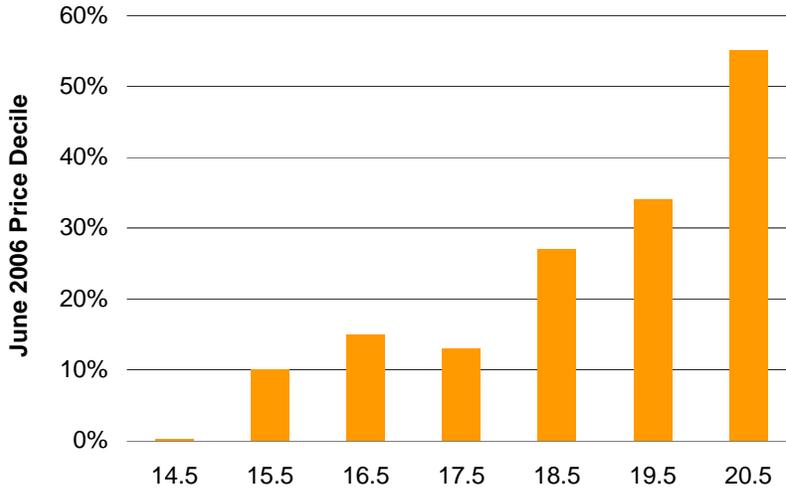
From the price decile data two distinct messages are clear - that red meat prices are high in historical terms whilst wool and in particular finer microns are low in historical terms.

Commodity prices have a tendency to range above and below their long term median price over time. This is due to a combination of supply, demand and price interactions. If prices are high they tend to trend lower toward the median and when they are low they trend higher toward the median over time. By combining this knowledge and price decile data we know where prices currently are in relation to their median and predict where they are most likely to move in the future. This is the most accurate and reliable method available to predict future commodity price, it is not always totally accurate but is better than any alternative method.

The current fine wool prices are very low in historical terms. Graph 1 shows the price deciles of various micron groups for June 2006. The graph distinctively shows the finer the micron category the lower the current price decile. Some people have attributed this lower price for finer wools to a lack of demand from the market.

However Table 2 shows the changes that have occurred in the volume of various micron groups sold at auction. The supply of the finer micron categories has and continues to increase dramatically since the second half of the 1990s whilst the broader categories (23 and 24 micron) have decreased in volume. This has been a major contributing factor behind the current trend in prices.

**Graph 1: June 2006 wool price deciles by micron group.**



Source: Independent Commodity Services

**Table 2: Wool auction volumes by fibre diameter**

	Fibre Diameter						
	<16	16	17	18	19	23	24
2005–06 compared to average 1996-2000	+2059%	+535%	+253%	+76%	+18%	-66%	-70%
2005-06 compared to 2004-05	+46%	+19%	+10%	-7%	-7%	-4%	-8%

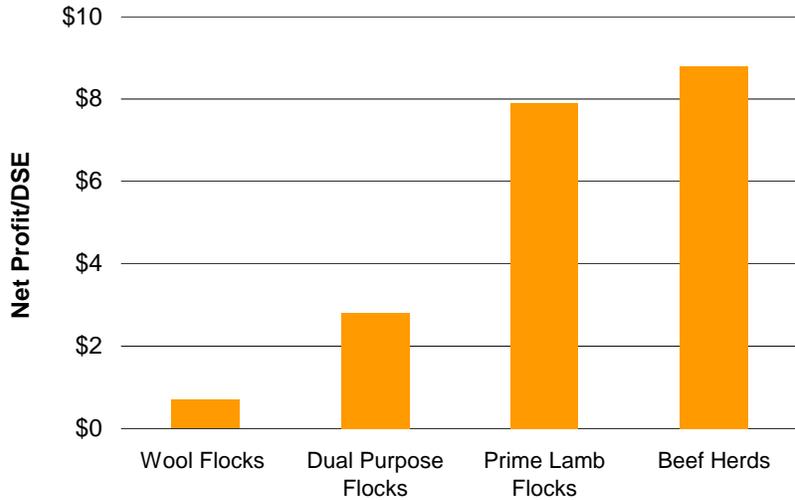
Source: Independent Commodity Services

Fine wool prices are well below their long term average median price and given there has been no obvious reduction in demand, rather increased production, it is likely that they will rise toward this median price in time. Without analysing the red meat market, the most reliable indicator would suggest that prices for these commodities may trend down to their long term average over time.

The net profits per DSE of the major grazing enterprises from the Holmes Sackett & Associates (HSA) 2004/05 benchmarking are shown in Graph 2. The HSA benchmarking database covers farm

businesses from a wide geographic spread across southern Australia from the Northern Tablelands of NSW to Tasmania and South Australia.

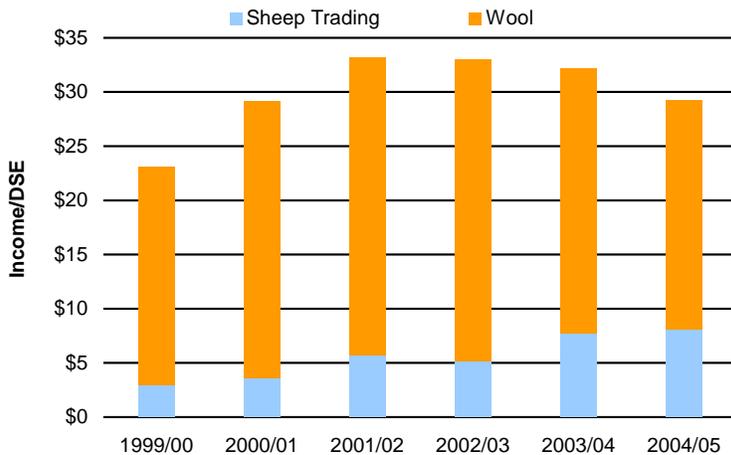
**Graph 2: The comparison of average net profit/DSE performance of the major grazing enterprises**



From Graph 2 it is evident that the net profit performance of average wool flocks during the period was considerably lower than the average of other grazing enterprise options presented. This is not surprising given the current and historic price data presented previously. Both the prime lamb and beef enterprises rely on the prices of red meat for their profitability and with prices so high historically their net profit performance should come as no surprise.

Although the net profit of wool flocks was low in comparison to other enterprises during 2004/05 the income produced by the average wool flock has remained relatively stable over the last six years. Graph 3 shows the income/DSE produced by the average wool flock from the HSA benchmarking database.

**Graph 3: Income per DSE for average wool flocks 1999/00 to 2004/05**



The proportion of income generated by sheep trading has increased over the last two years as sheep meat prices have increased. Previous to 2003/04 the proportion of income derived from sheep trading had been from 13% - 17%, this increased to 24% in 2003/04 and 28% in 2004/05. Although this is a significant jump in percentage, it should be noted that the average wool flock still derives 72% of its total income from wool sales. This is contrary to the accepted theory that wool is a minor contributor to wool flock income and producers need to chase meat production in breeding decisions.

Considering the fact that lamb and beef prices are almost at their highest level for the last decade and that wool is near its lowest, the low profit per DSE for wool flocks in comparison to beef and lamb production enterprises is to be expected. If prices follow their historical trends it is likely that wool prices will improve in the future and that red meat prices will trend downward. Before any consideration is made on departing wool production for an alternate enterprise this should be kept in mind.

### **What are the implications of a change of enterprise**

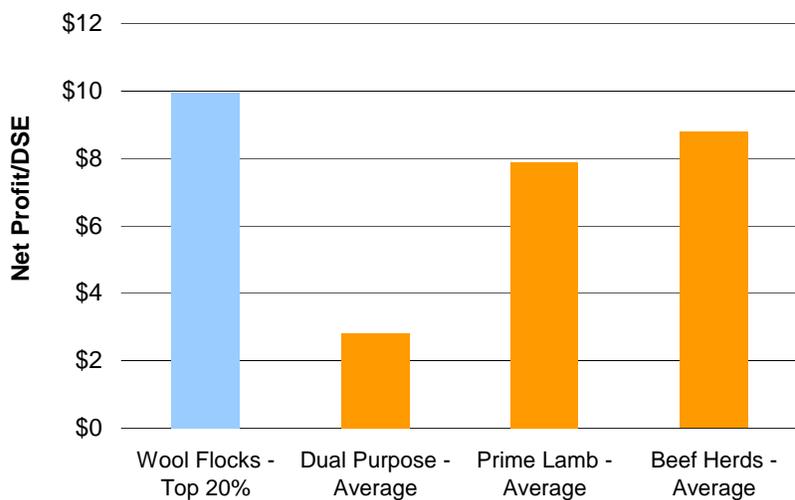
As we have seen the recent price trends have resulted in higher profitability of enterprises with more exposure to meat than wool. This has prompted many producers to question both the breeding objectives of their wool flock and the enterprise mix of the whole farm. In some cases this has led to radical changes to breeding programs and dramatic changes to their enterprise mix. Such a decision will not necessarily automatically result in any improvement to profitability, although this would appear a valid conclusion to draw.

Efficient wool production requires a mix of good genetics and good management skills. Alternative enterprises such as beef and lamb production are no different. In order to be a profitable producer you need to have genetics and management under control. If wool production has been the primary focus of your farm business for a significant period of time it is reasonable to expect that you have the genetics and management of your flock to a reasonable level of competence.

A move from wool production to one of these alternate enterprises will require the acquisition of suitable new genetics and management skills. Unless these two requirements are met the enterprise is likely to be a poor performer until they can be brought under control. Therefore some period of time will elapse before adequate performance is produced from the alternate enterprise. If the price received for products varies during this period, as it is likely to do, there is potential for the new enterprise to be less profitable than the previous one. Also during the period of transition there may have been lower returns generated than would have been if the change had not taken place.

To demonstrate this concept the 2004/05 net profit/DSE performance of Top 20% wool flocks has been compared to the average performance of beef herds, dual purpose and prime lamb flocks in Graph 4. The data is derived from the HSA benchmarking database as in Graph 2 and the Top 20% flocks are ranked using net profit/DSE.

**Graph 4: Comparison of the net profit/DSE in 2004/05 for Top 20% wool flocks and average dual purpose, prime lamb and beef herds**



Graph 4 shows the Top 20% wool flocks are more profitable than the average of the alternate grazing enterprises. Therefore a move by an efficient wool producer into one of the other enterprises may provide a reduction in profitability. If a superior level of genetics and management

are not obtained in the new enterprise and average performance is produced, the move will prove costly in the long term. If price trend changes also occur the loss will be even more severe.

This also highlights the fact that within wool flocks there is potential for average producers to improve their profitability. This would make their returns higher than the average of other alternate enterprises negating the need to change at all. Generally the changes required to improve profitability are cheap to implement yet provide substantial rewards.

Wool growing can be considered a maintenance production system. It generally requires that sheep body condition, except for weaners, only be maintained. This is in contrast to lamb flocks and beef herds which require growth for the majority of the flock or herd in order to provide reasonable profitability. Therefore pastures that are adequate for wool production may provide poor performance for lamb or beef production systems.

In order to change these pastures to those of quality good enough to produce lamb and beef, substantial investment may be required, provided the environment allows the required change. So if your pastures are only producing maintenance feed or the country that you operate on is unable to sustain quality pastures, growing and fattening livestock such as lambs or steers are not what you require in your system. A change to these enterprises is not likely to be profitable as either gain made will be absorbed by expenditure on new pastures or the system will be of low productivity.

If you are currently running a profitable wool flock it is unlikely that a change to your current enterprise structure or mix will equate to any quick and dramatic increase in your profitability. If the profitability of your flock is low there is opportunity to improve and provide increased levels of return. Any potential change to another enterprise needs serious consideration and analysis before taking place.

### **Still get paid for quality**

Wool is one of the few rural commodities that can be differentiated to command a premium. The premiums offered for differentiating on micron are still quite considerable. For example the premium for a 17 micron over a 19 micron fleece has averaged around 40% over the last 14 years and is currently around 27%. Most other agricultural products have very little potential to differentiate on sale price.

There is little that can be done to achieve a premium with feeder steers except maybe by breed. Some breeds such as Wagyu may receive a premium however this is unlikely to be greater than 10 to 20 cents/kg. This equates to around a 5-10% premium in the current market. With lamb there is little that a producer can do in order to differentiate on price. Producers of beef and lamb are basically locked into being price takers and there is little that can be done with their product to increase its value. Wool offers the chance to be a price maker, not completely but certainly more so than other rural products which are really just commodities.

### **The Bottom Line**

The current historically high prices for sheep meat and beef have improved the returns generated from enterprises which rely heavily on these markets. The current returns from average wool flocks are low when compared to these alternatives however current wool prices are at historical lows. Above average wool flocks currently have better returns than the average of other grazing enterprise alternatives. It is reasonable to assume that long term the price for wool will trend upward and for red meat downward.

As a wool producer you need to know how your performance rates amongst your peers and make decisions regarding your business future on reliable information. If you have above average profitability and are considering a move to an alternate enterprise you need to consider the consequences and ensure that this is the right long term decision for your business.

If your current performance is average or below you are likely to be less profitable than alternative enterprises. You can either improve the performance of your wool flock or search for an alternative enterprise. This decision will be dictated by many factors within each individual business. If a decision is made to move into another enterprise, serious consideration should be given to the consequences of such a move. Thinking of long term consequences is imperative if your business is to succeed into the future.