



# op/ed

by rob whiteley

## STUD FEES AND PROFITABILITY: THE REAL STORY

**A deepening crisis.** Two years ago, I wrote that our American breeding industry's chief service providers (stallion owners, sale companies, and veterinarians) needed to be proactive and reduce their fees 50% to address an emerging crisis in breeder profitability. I pointed out that as breeders disappear, there will be fewer and fewer horsemen and horses to "service," and revenues for all groups will decline, even after the general economy regained strength. In other words, I argued that it is actually in the best interest of service providers to work with breeders to lower production costs in order to keep them afloat.

So where are we two years later, after service providers collectively have made only minor adjustments to their fee schedules? As expected, everyone has been greatly affected. Stallion owners are *making less money*. Veterinarians are *making less money*. Consignors and sale companies are *making less money*. However, breeders (who form the business foundation for the other three groups) are experiencing *heavy losses*. It is easy to see where this will lead.

**Unequal pain and expense.** Breeders carry the expense of the full production cycle and therefore have the most risk and exposure and suffer the most pain. The boarding farms that depend on the breeder for their existence are similarly exposed. As my friend James Keogh observed during the recent September sale, "The sales scene has a lot in common with an egg and ham sandwich. The stallion owners, vets, and sale companies are like the chickens and the breeders are like the pig. The chickens make an important contribution, but the pig is fully committed."

Breeders and all sales participants are especially struggling because of structural and operational problems in the broader industry and international economy. However, breeders also carry the unique burden of disproportionate expense. Unless our industry's service providers dramatically cut their fees immediately, there won't be any ham in the egg and ham sandwich. And when the ham is gone, the eggs will follow. We will only have a bunch of barren chickens.

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**Relief as we continue to sink.** It is magical thinking to believe that things will get substantially better any time soon. Racing drives the sales scene, and the racing industry with all its fundamental problems lacks the leadership and cooperation necessary to fix its disconnected and broken business model. More deterioration and contraction is ahead throughout the Thoroughbred world, and our sales world. No matter how much positive spin various pundits and non-breeding commentators use to describe the recent Keeneland September sale, it did not have a "surprising rebound," nor did it "bounce back." We are still in a "perfect storm."

The good news, however, is that the sale's aggregate results compare favorably to those of last year. Most of the positive comments that I have heard, I believe, came out of a feeling of relief that the sale wasn't worse than 2009. (This measure of temporary stability is a testimony to Keeneland's successful efforts to bring in a spectrum of international buyers.) The perception that perhaps the market may be forming a bottom is a very good thing because, whether we are talking about the stock market or the horse market, people are hesitant to step in and buy with confidence if they think that prices are still falling. Therefore, for the time being at least, we can be grateful that yearling prices have stopped their free-fall.

The bad news, however, is the same as the good news. No matter how glibly we spin the spin, September sale results were very similar to last year's disaster. It's hard to jump up and down with joy when the 2010 gross of \$198.3M is slightly less than half of the \$399.8M figure obtained in 2006, and 16% less than the \$233.0M gross in 1999, achieved more than a decade ago. This sober reminder of how far we have sunk is enough to underline our degree of misery while defining our need for major change in the way we do business.

**We need to be proactive.** We will not fix our problems unless we take cooperative action and work together to fix them. We cannot passively wait for the cavalry to come over the hill. There is no cavalry. Some observers, for example, say that producing fewer horses in the future will serve as a significant price support. This is wishful thinking. True, supply of sales horses will drop with reductions in the size of the foal crop. However, given the steady descent of racing throughout the country and a shrinking number of owners, we are also likely to see fewer domestic buyers bidding on fewer horses. Thus, a decrease in demand will offset a decrease in supply, and related effects on prices will at best be a wash. In addition, those who wait for Chinese horse racing to bail us out need to listen to Elton John's *Rocket Man* because "I think it's gonna be a long long time."

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Plain and simple, I believe that the most we can hope for in the foreseeable future is to stay in place at current levels. Yet, in order for breeders, and therefore all sales participants, to survive at current levels (as you will see from the data below), a new formula for fees charged by service providers must be enacted to reduce the cost of production and give breeders a fighting chance to at least break even and stay in place. People used to say, "As General Motors goes, so goes America." It is not a stretch to say that as breeders go, so goes the long-term welfare of the service providers and the viability of our auction business. If all service segments continue to excessively feed off the host (the breeder), it's only a matter of time until there is nothing left to feed on.

**Cost of Production.** The following research is intended to provide a factual basis for understanding and addressing the problems that we face in order to motivate proactive cooperation among groups.

First of all, it is important to realize that breeders' expenses related to cost of production fall into two categories: (1) fixed costs; and (2) variable costs. Fixed costs are roughly the same for all sales yearlings, whether they bring \$10,000 or \$1 million.

Table 1 identifies fixed costs to a mare owner who boards his or her mares. A small niche breeder who owns his or her farm without a mortgage, has no employees, and does all the work without a salary might produce the same sales yearling for about 20-25% less in fixed costs than a breeder who boards. Labor costs would provide most of the savings, assuming the farm owner-breeder works for free. Variable costs, however, remain the same for all breeders, whether they board or own the farm.

**TABLE 1**

<b>FIXED COSTS OF YEARLING PRODUCTION</b>	
	<u>Cost</u>
Boarding, breeding, transport, maintenance of the mare through pregnancy	<b>\$14,500</b>
Pro-rated cost of maintaining mare through non-productive (30% barren or slipped) years	<b>\$ 4,000</b>
Foaling, registering, nominating, and raising foal to Jan. 1st.	<b>\$ 4,500</b>
Raising yearling and sales prep to mid-Sept.	<b>\$10,000+</b>
Sales entry fees and repository x-rays	<b>\$ 1,500</b>
Misc. sales expense (vanning, stall card, halter, sales board, and advertising, etc.)	<b>\$ 500</b>
<b>TOTAL FIXED COSTS</b>	<b><u>\$35,000</u></b>

In short, before breeders even think about a stud fee and sales expense, etc., they are looking at around \$35,000 in fixed costs if they board, and approximately \$27,500 if they own their own farm and have no debt or employees and do not pay themselves.

Variable costs are detailed in Table 2 using a hypothetical stud fee expenditure of \$20,000. These costs would be the same whether someone boards their mare or owns their own farm.

**TABLE 2**

<b>VARIABLE COSTS OF YEARLING PRODUCTION</b>	
	<u>Cost</u>
Stud Fee	<b>\$20,000</b>
Kentucky Sales Tax	<b>\$ 1,200</b>
Depreciation (assumes use of a \$25,000 mare for a \$20,000 stud fee)	<b>\$ 3,500</b>
Opportunity cost of money or bank interest on expenses over 2 ½ years at 4%	<b>\$ 2,500+</b>
Sales company and consignor commissions on a break even sale price of \$70,000	<b>\$ 6,000</b>
Insurance (or pro-rated cost of foal or yearling deaths or unsaleable individuals)	<b>\$ 1,800</b>
<b>TOTAL FIXED COSTS</b>	<b><u>\$35,000</u></b>

Fixed costs and variable costs are approximately the same when using a \$20,000 stud fee, as shown in Table 3, adding up to a \$70,000 break-even point for someone who boards, breeds, and sells. A small farm owner might save a little on fixed costs and reduce the total accordingly.

**TABLE 3**

<b>TOTAL PRODUCTION COST USING A \$20,000 STUD FEE</b>	
	<u>Cost</u>
Fixed costs for farm owners or boarders, respectively	<b>\$27,500-35,000</b>
Variable Costs	<b>\$ 35,000</b>
<b>BREAK EVEN SALE PRICE</b>	<b><u>\$62,500-70,000</u></b>

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As the reader will note, total cost of production on a \$20,000 stud fee is about 3.5 x stud fee. At lower stud fees of \$10,000 or less, fixed costs remain the same as for any yearling, and the stud fee to total cost ratio therefore will rise to 5 x fee or more. When the stud fee is above \$100,000 or more, however, total cost of production is roughly 2 x stud fee, unless a particularly valuable mare is used which would inflate the variable costs. For example, using a \$500,000 mare on a \$125,000 stud fee would increase variable costs so that the break-even point for the yearling is approximately \$300,000, or 2.4 x stud fee (whereas using a \$150,000 mare on a \$125,000 stud fee creates a break-even point in the neighborhood of \$250,000, or 2 x stud fee).

**Breeder profitability.** Going into the September sale, the scariest statistic for breeders was the one that detailed 2008 stud fees for all catalogued yearlings. Total 2008 fees at advertised rates totaled a staggering \$220,866,377, including tax, at advertised prices, and clearly indicated that the chief issue for breeders would not be profitability, but survival. To break even on the entire group, the gross would need to reach \$500 million (more than \$100 million over the all-time record of \$399.8 million set in 2006).

The picture for those breeders who will be left standing is not much better. Although 2010 stud fees dropped over two years by roughly one-third on average from 2008 levels, half of that overall drop was accounted for by just 10 stallions (A.P. Indy, Awesome Again, Bernardini, Distorted Humor, Empire Maker, Ghostzapper, More Than Ready, Mr. Greeley, Smart Strike, and Unbridled's Song). Given the decrease, if 2010 fees were hypothetically used to produce the 2010 yearlings, the total expenditure with tax would be \$142,057,490. Even making this fee substitution, however, the recent sale would have had to gross \$385 million before breeders could break even as a group.

Table 4 below specifically details just how ugly and unsustainable the landscape is for breeders, and provides an understanding of why a considerable and growing number of breeders have disappeared from the scene, with many others poised to follow.

The two break-even and profitability figures for 2010 in Table 4 are actually inflated slightly because they include RNAs at the recorded hammer price. Some of the RNAs will be sold privately, but we can assume that the other yearlings will be absorbed into racing programs or be kept as broodmares, and will mostly be a continuing expense to their breeder-owners. In addition, we can reasonably assume that some of the 683 "outs" were sold privately or kept for racing, but quite a few probably had "issues" that prevented them from showing up while the meter keeps running.

**TABLE 4**

<b>SEPTEMBER YEARLINGS THAT BROKE EVEN OR TURNED A PROFIT</b>						
<b>Session</b>	<b>2008</b> (using 2006 stud fees)		<b>2010</b> (using 2008 stud fees)		<b>2010</b> (using 2010 stud fees)	
	<b>Yearlings</b>	<b>%</b>	<b>Yearlings</b>	<b>%</b>	<b>Yearlings</b>	<b>%</b>
1	93	38.1	45	48.4	52	55.9
2	92	36.5	42	46.2	50	54.9
3	154	38.4	95	31.4	100	33.1
4	144	35.9	72	24.7	77	26.5
5	143	34.9	89	31.9	88	31.5
6	110	26.5	76	25.6	87	29.3
7	86	21.6	55	14.6	77	20.5
8	84	21.0	54	14.2	71	18.7
9	54	13.5	20	5.4	30	8.1
10	32	8.0	17	4.6	26	7.1
11	21	5.3	7	1.8	12	3.1
12	10	2.5	4	1.1	4	1.1
13	7	1.8	1	0.3	1	0.3
14	4	1.2	0	0.0	0	0.0
15	1	0.3				
<b>OVERALL</b>	<b>1035</b>	<b>18.6%</b>	<b>587</b>	<b>14.0%</b>	<b>665</b>	<b>15.9%</b>

Thus, these group percentages for break-even or profitable yearlings are even bleaker than they might appear.

**The plight of the small breeder.** In particular, sales results from Books four, five, and six reveal the degree of devastation currently faced by small breeders. Because of their typically lower level of capitalization, most small breeders must trade in the realm of modest or moderate stud fees. Thus, small breeders are truly vulnerable. Many small breeders are 'Mom and Pop' operations, and, as "hands-on" horse people, serve as the symbol of what love for and involvement with horses is all about. I believe that they are the backbone of the industry. Unfortunately, however, in this environment they are an endangered species, as many of their horses end up in Books four, five, and six because they can't afford to breed to the more fashionable flavors of the day. Even though many "low-end" and lower-priced yearlings end up as stars on the track, they are nonetheless a tough go in the sales arena.

The term devastating might not quite be sufficiently nuanced to adequately describe results from Books four, five, and six in 2010. I'll let the reader judge. After two-and-a-half years of expense, care, and preparation, and from 2,507 yearlings catalogued, only 49 (1.9%), or one out of 50, reached a break-even price. Hypothetically substituting 2010 stud fees instead of 2008 fees merely increases the break-even number to 73 (2.9%), which is one out of 35.

More than 200 yearlings in this part of the catalog (some by solid sires who command substantial stud fees) brought \$2,000 or less, which does not even cover entry fees, guidance and repository X-rays, and the van ride to the sale. Although quite a few of these yearlings may have had physical "issues" or been light on pedigree, some well made-racing prospects brought little money simply because of their placement in the back-end of the sale where fewer buyers have less money to spend and bottom fishers rule. When small breeders cannot afford to take their yearlings home, they have no choice but to leave them unprotected. Thus, their horses end up bringing whatever they bring. Sometimes auctioneers have to beg for a bid when no one is there to raise their hand. This debacle occurs year after year, even though over 200 graded stakes winners have emerged from books four through six over the last 10 years, including the all-time earner Curlin (\$10.5 million) and recent GI star Unbridled Belle.

One disheartened breeder said to me at the sale, "How long can we go on when we sell one for a profit and nine at a loss?" As it turns out, he was exaggerating very slightly, although his ratio may have been true for his consignment. The historical data show that in 2008 we were selling one yearling for break-even or a profit and four at a loss. In 2010, we sold one at break-even or a profit and six at a loss. Thus, my breeder friend was right about one thing. How long can we go on?

**Some breeders will make it through.** Despite the challenges, a variety of breeders will still be breeding mares in 2015 no matter what transpires, and the last man standing may actually do okay when many other breeders have disappeared. When thinking about breeders, however, it is important to note that breeders actually compose two distinct sub-groups: (1) Individuals who breed commercially as their primary occupation and seek to at least break even each year in order to keep on doing what they love to do; and (2) individuals who have successful businesses or inherited wealth outside of the industry and who participate with discretionary income in order to enjoy themselves and share the excitement.

In the face of current adversity and against long odds, a few small breeders through sheer talent, love of what they're doing, determination, hard work, luck, and more luck will somehow find a way to keep on keeping on. A larger number of wealthy breeders will keep breeding simply because they can, and because they find horses and the colorfully kaleidoscopic horse scene so fascinating and contributory to their quality of life that they cannot give it up as a unique source of excitement, entertainment, and social interaction.

**Both breeder groups are being slammed.** In addition to their love of mares and foals and their amazing tolerance for the shared anguish that brings tears when a foal dies, or a yearling is hit by lightning, or a prized mare dies carrying their hopes of a future Derby hero, breeders rich and poor share something else in common. They are being severely and relentlessly hammered, whether they are in the front of the catalogue or at the back. This is important for service providers to keep in mind because neither breeder group will tolerate continual losses of the magnitude that have been occurring for three consecutive years.

Sustained losses will put the hands-on horsemen out of business (which is currently happening with increased frequency). The second group, those who possess substantial wealth from other sources, have more staying power and are generally willing to absorb a certain level of loss in order to participate in the excitement of the sales scene, especially if they feel that they are treated fairly and can use losses for tax purposes to offset gains in other investments or businesses. Nonetheless, their participation is almost always conditional and should not be taken for granted. My long-time acquaintance with people of wealth has taught me one basic generalization about these individuals. Although they may accept losses in order to enhance their quality of life or achieve personal objectives, they *do not like to lose money*, and they *hate to lose a lot of money*.

Neither breeder group, therefore, will indefinitely pursue an endeavor where losses continually mount year after year because of a broken business model. When the first group runs out of money, they will be gone. When it stops being fun for the second group, they too will be gone.

**Going forward.** In addition to presenting a stark picture of current reality, the research data presented in this study also contradicts the commonly expressed notion that fewer horses on offer in the future will likely lead to better prices and increased profitability. Note that 12.6% fewer horses were catalogued in 2010 than in 2008. Despite this reduction, however, 43.3% fewer yearlings reached the break-even or better threshold in 2010, compared to yearlings who sold in the very weak September sale of 2008. Even substituting 2010 stud fees in the calculation of 2010 results makes little difference, as 35.7% fewer would reach break-even or better with this hypothetical calculation vs. 2008.

Given the debilitated state of our breeding industry, we cannot hope to succeed as a viable sales community if we wait to see how things develop. We must attempt to guide our destiny by first acknowledging our predicament and then by committing to help each other make things better. If we are not part of the solution, we remain part of the problem. A time comes in everyone's personal life or business life when common sense needs to prevail over short-term interest. This time has come for stallion owners and other service providers.

Going forward, in order to nourish and secure the well-being of every sales group and to promote the long-term growth of the entire industry, ***stud fees need to be cut in half for 2011, vets need to make a similar adjustment (especially as they have generally lowered their prices only 10% or less during this agonizing three-year period), and sales companies and other service providers need to make corresponding and deep cuts in fees.***

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