



## Farm Growth: Challenges and Opportunities

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Farm size and growth are often discussed in the context of economies of size. Previous research suggests that the average cost curve in production agriculture is downward sloping or at a minimum L-shaped (Langemeier, 2013). Thus, in general, larger businesses have lower costs of production. Other motivations for farm growth include to provide opportunities to more fully employ the skill sets of managers, to add family members to the operation, and to receive better prices on inputs and products sold. In fact, farm growth is a "natural phenomena", in part because successful farm businesses have earnings that they must deploy, and using these earnings to expand the farm business is a logical choice.

Today's environment in which risk and uncertainty are dominant forces may seem like an odd time to think about farm growth. Risk is perceived by many individuals to be something that is "bad". However, entrepreneurs and business owners realize that without some risk and uncertainty, there is likely to not be much return or reward. Also, it is important to note that risk and uncertainty have both an upside and a downside (Boehlje, 2015). The key management challenge is to mitigate downside risk and try to capture the upside associated with risk.

This article discusses ten questions that should be addressed when examining the challenges and opportunities associated with farm growth. Future articles will delve into some of these questions in more detail.

### Why Grow?

There are numerous reasons why a farm may want to grow including the following: reduce costs, improve profit margins, improve asset utilization, bring in new family members, invest retained earnings, and more fully utilize the skills of key managers. Before growing, it is essential for an operation to think about their strategic direction. Is the operation interested in a commodity based strategy or a differentiated product strategy? A commodity product strategy focuses on cost control. In contrast, a differentiated product strategy focuses on value-added production or receiving an above average price for the farm's products. As an operation continues to think about growth, how growth impacts strategic direction needs to be addressed.

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## **What are My Options to Grow?**

There are at least six growth alternatives available to farms. These include the following alternatives: focus or specialize, intensify or modernize, expand, diversify, replicate, and integrate. Specializing in one activity (e.g., grain production rather than grain and swine production) can improve efficiency, reduce cost, and increase profit margins. Intensifying pushes more production through the same fixed asset base, which can lead to spreading fixed costs over more output and an increase in the asset turnover ratio. Expansion, one of the most commonly used growth options, involves increasing enterprise size. This option should be explored only after exploiting all of the efficiencies associated with the current operation. Diversifying, the opposite of specialization, involves the addition of new enterprises. This option is typically considered risk-reducing. However, in many cases, this option can also lead to economies of scope (i.e., improved asset utilization and reduction in cost). Replication involves expanding the operation through the development of multiple sites or plants. This option allows for decentralized management in smaller units. Integration involves moving forward or backward into production or processing. This option can ensure access to key inputs or outputs, but can also lead to efficiencies and cost reductions.

## **What Strategic Issues Should Influence My Growth Choices?**

When evaluating growth options, it is important to conduct an internal and external analysis of your farm business. An internal analysis identifies key resources, capabilities, and core competencies. One of the ways to assess resources, capabilities, and competencies is to ask yourself whether your operation has unique resources or core competencies that lead to a competitive advantage (see *farmdoc daily* [June 3, 2016](#)). As a farm grows, it needs to make sure that it is fully utilizing these unique resources and core competencies. It also important to examine the external environment or scan the horizon. What is the social environment and industry environment that the farm faces? How does the current environment and expected changes in the environment impact my growth options? Another way to grapple with the external environment is to think about the key drivers facing the markets for the products being produced by your farm.

## **How Should Growth Ventures Be Evaluated?**

Successful farms have numerous growth options from which they can choose. The key question is how does a farm choose which growth option to pursue? The following eight criteria can be used in making the choice: strategic fit, expected returns, risk, capital required, the cost and ease of entry and exit, value creation, managerial requirements, and portfolio fit. Many of these criteria are self-explanatory, but we would like to briefly elaborate on the first and last criteria. Strategic fit refers to whether the growth option being explored leverages the current resource base and core competencies of the operation. Does the new growth option require resources or skills that are currently not part of the operation? If so, how will these skills or resources be obtained? Portfolio fit refers to how the growth option being explored fits into the current farm activities. Does the new growth option increase risk or stretch the current management team too thin?

## **What Skills and Competencies Do I Need to Grow?**

This question elaborates on the importance of conducting an internal analysis of the farm business. In addition to identifying core competencies, it is important to conduct a skill assessment of the current employees. How strong or weak are the workforce's production management skills, procurement and selling skills, financial management skills, personnel management skills, strategic positioning skills, relationship management skills, leadership skills, and risk management skills? How will the growth strategy leverage these skills, or will new skills be required to be successful? For self-assessment checklists of skills see Boehlje, Dobbins, and Miller (2001).

## **How Do I Finance the Growth of My Operation?**

Besides using debt and equity (retained earnings), growth can be financed through leasing assets or joint ventures. Leasing assets rather than purchasing them can increase potential growth rates. However, when leasing assets, it is important to compare the relative impact of leasing on production cost and risk.

Joint ventures or strategic alliances are a common business model used to combine the resources of two or more businesses. This business arrangement may involve entire businesses or specific business activities (e.g., machinery sharing).

In addition to thinking about the funds needed to acquire assets, it is important to examine working capital funding. Many growth opportunities lead to significantly higher working capital requirements, particularly in the start-up phase.

### **What Business Model Do I Use to Grow?**

There are numerous business models that can be utilized to implement a growth strategy. For example, the following models can be used to implement growth: organic or internal growth, merger or acquisition, franchise, joint venture or strategic alliance, service provider, asset or service outsourcer, agricultural entrepreneur, or investor. Traditionally, most farms have used the organic or internal growth model. With this model, assets are acquired and added to the business through purchases or leasing arrangements. More information pertaining to business models can be obtained from Boehlje (2013).

### **How Will Expansion Impact My Current Operation?**

When evaluating growth options it is important to try to gauge how each option will impact the farm's balance sheet and income statement. This can be done using pro forma statements or projections. It is prudent to use at least three scenarios (worst case scenario, most likely scenario, best case scenario) when evaluating each growth option. Particular focus should be given to how each growth option impacts the profit margin, the asset turnover ratio, and returns on investment and equity under each scenario. In addition to examining the impact of each growth option on future financial performance, it is also important to gauge how each option will impact managers' attention and oversight.

### **What are the Start-Up Challenges?**

Growth options typically face challenges pertaining to construction delays, cash flow shortages, depleted working capital, and short-term operational inefficiencies and management bottlenecks. It is particularly important that differences in these challenges between growth options be explored. Cash flow and working capital requirements can vary substantially between growth options. If a particular growth option creates large cash flow shortages and depletions in working capital, a plan needs to be put in place to deal with these issues.

### **What is My Sustainable Growth Rate?**

The sustainable growth rate is the maximum rate of growth that a farm can sustain without having to increase financial leverage or look for outside financing. The sustainable growth rate can be computed using information on earnings, retained earnings or savings, and business withdrawals. Once this rate has been computed, it is often helpful to see how this rate changes with the use of borrowed funds. When computing a rate with borrowed funds it is extremely important to gauge how the use of borrowing funds increases risk.

### **Final Comments**

Growth enables farm businesses to increase revenue and earnings, take advantage of economies of size, and to more fully utilize the skills of current and future employees. This article briefly discussed ten questions that should be examined when thinking about farm growth. Future articles will elaborate on several of these ten questions.

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