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How Will Expansion Impact My Current Operation?

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There are numerous motivations for farms to expand their businesses. Even in today's environment of tight margins, many farms are exploring expansion options. When exploring these options, it is important to address key questions pertaining to the farm's strategy. A previous article (*farmdoc daily*, August 5, 2016), discussed ten questions that should be addressed when examining challenges and opportunities associated with farm growth. This article focuses on the eighth question: how will expansion impact my current operation?

Impact on Financial Performance

When evaluating growth options it is important to try to gauge how each option will impact the farm's balance sheet, income statement, and cash flow statement. This can be accomplished using pro forma financial statements or projections. It is prudent to use at least three scenarios (worst case scenario, most likely scenario, and best case scenario) when evaluating each growth option. The most likely scenario uses your best projections with regard to input and output prices and quantities. For example, if you were examining the production of corn and soybeans on additional rented acres, you could use trend yields and futures prices for corn and soybeans in your most likely scenario. Your worst case scenario could use below average yields and prices, and your best case scenario could use above average yields and prices.

Growth options, such as renting additional ground, impact the farm's balance sheet. For example, working capital (current assets minus current liabilities) would likely change. If the growth option is profitable, working capital will likely increase due to an increase in cash balances and crop inventories.

Whether the value of non-current assets and liabilities changes in response to a specific growth option depends on whether the farm needs to purchase additional machinery and equipment to pursue the growth option. For example, a farm that is considering renting additional ground may or may not need additional machinery and equipment to farm the additional acres.

The impact of each growth option on the farm's balance sheet will depend on the scenario being examined (i.e., worst case scenario, most likely scenario, or best case scenario). You would expect the impact to be positive for at least the most likely and best case scenarios. If a growth option has a detrimental impact on the farm's balance sheet under the worst case scenario, the decision to pursue the growth option will depend on the farm's ability to weather downside risk which depends largely on the farm's liquidity and solvency positions.

Each growth option will have an impact on the farm's cash flow and income statements. Cash and accrual income should be projected for each scenario. Particularly careful consideration should be given to yield and animal performance projections. For instance, it would not be realistic to use above trend yields or above average animal performance in your projections in your most likely and worst case scenarios. Cost estimates should also be developed for each scenario. These cost estimates may or may not vary between scenarios. It is particularly important to project the overhead costs associated with machinery, labor, and land. Questions to be addressed include the following. Will you need to purchase machinery to pursue a specific growth option? If you need additional labor, will this involve family and operator labor, or hired labor? What is the cost associated with each source of labor? Is cash rent likely to go up under any of the scenarios? If so, factor these increases into your projections.

If you are pursuing a growth option involving enterprises that you do not have much experience with, you will need to pay particular attention to start-up costs. For these cases, revenue may be lower and costs higher than they would be for a farm that has experience with these enterprises.

Once a farm has examined the impact of each growth option on the farm's financial statements, it is possible to compute the impact of each growth option on the operating profit margin ratio, asset turnover ratio, and rates of return. The operating profit margin ratio is computed by dividing net farm income plus interest expense minus owner withdrawals by gross revenue. The asset turnover ratio is computed by dividing gross revenue by average total assets. The operating profit margin ratio, the asset turnover ratio, and the ratio of assets to equity can be used to compute the return on assets and return on equity (*farmdoc daily*, April 21, 2016). If the benefits of a growth option outweigh the costs, the operating profit margin ratio, asset turnover ratio, and the rates of return will be higher than a base case that does not include the growth option.

Impact on Managerial Attention and Oversight

In addition to examining the impact of each growth option on future financial performance, it also is important to gauge how each option will impact managers' attention and oversight. As noted in Langemeier and Boehlje (*farmdoc daily,* January 17, 2018), an assessment of current management skills and those skills required by a specific growth option (i.e., new venture) is an essential part of evaluating growth options. The following questions should be addressed. Will adding the new venture increase the managerial requirements beyond the current capacity of the business? Are additional managerial skills needed to be successful in operating the new venture? Can time be allocated by the current management team to "get up to speed" in the new venture? Will the acquisition increase the complexity of the current business? Will managerial resources need to be diverted from the current business to the new venture, thus putting increased pressure on the current management team? Will the farm and the new venture have a relatively separate management structure, or will the new venture be integrated from both a managerial and operational perspective with the current business?

Concluding Thoughts

Expansion is likely to impact farms in numerous ways. Each expansion option should be evaluated in terms of its impact on the farm's financial statements, financial performance, and managerial attention and oversight. Attractive expansion options should both improve the farm's long-term financial performance, and be a good strategic fit for the farm's owners and managers. Future articles will explore start-up challenges and a farm's sustainable growth rate.

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