Module 8
Growth and Transition Management

Module Outline

Introduction
Capital Budgeting and Growth Management
Sensitivity and Breakeven Analysis
Expansion Metrics
Economic Feasibility
Time Management
Business Transition and Evolution
Action Plan to Evolve the Business
Family Affairs
Senior Generational Issues
Family Business Meetings

Learning Objectives

The learning objectives for this module are for participants to:

- Be aware of financial and non financial issues, challenges, and actions that are important in the expansion of farm and ranch businesses.
- Understand the importance of properly budgeting capital expenditures, revenue, and expenses in expansion plans.
- Learn the elements of the evaluation of transition management either to family members or business partners.
- Discover practical suggestions and actions managers can take to evolve the business in a competitive global marketplace.

Introduction

Now we are going to examine effective principles and concepts to help you grow and transition your business for long run continuity and sustainability. Some of you are going solo, starting from scratch. Others are in family businesses, or established business owners are providing financial support and mentoring of management expertise. Regardless of the business model, most will face the challenges involved in growing and transitioning your business.

Capital Budgeting and Growth Management

Growth is the leading cause of business failure. Twenty five percent of small businesses, which include farms and ranches, file bankruptcy coming off their most profitable years. Before you all batten down the hatches, let's further explore some of the potholes and speed traps behind these comments. With a farm or ranch expansion, one of the biggest traps is underestimating the amount of capital and time required to complete the project. Producers, in some cases, can underestimate needs by at least 25 percent, resulting in delays of production and efficiencies. This can be the result of weather, supply shortages, inflating input costs, changes in design in the middle of the project, or contractual disputes.

Producers often divert operating cash flow, liquid assets, and in some cases labor in attempt to complete the project. Some will look for secondary sources of financing and capital, leading to delays in paying suppliers and placing high balances on credit cards, at a higher cost. This creates a ripple effect in financial performance 12 to 24 months after expansion.

Producers also need to be aware that expansion not only influences financials, but can tax labor, natural resources, overall capacity of facilities and equipment resulting in inconsistency in performance and business execution.

An action to proactively handle this issue is to overestimate capital needs by 25 percent prior to change and expansion and determine cash flows and payback strategies given the scenario.

Second, prior to expansion, build net working capital reserves to a minimum of 25 to 33 percent of revenue or expenses. Assets that can be quickly turned to cash are a fallback position for an unexpected turn of events.

Third, attempt to think through the expansion from a capital, time, human and natural resource, operational, and marketing standpoint. Determine the ripple effect the change will have in each area and on the business as a whole.

Finally, if possible, get bids, contracts and agreements on paper before the expansion. Discuss how modifications of plans will be handled and negotiated upon. Failing to plan is planning to fail.

You, Inc. – In the module Workbook, outline some strategies that will help you carry out a smooth expansion, including how you will build working capital prior to expansion, and what resource constraints you anticipate during the expansion (labor, capital, natural resource, etc.).

Sensitivity and Breakeven Analysis

Expansion analysis including basic sensitivity tests to production, marketing, expense, revenue, and interest rate variables are critical. With computer software templates sensitivity testing can be conducted rather easily. This basic analysis includes developing a best, worse and average case scenario for production, price, cost and interest rate with five to ten key assumptions.

For example, shock test these assumptions:

- 20 percent reduction in revenue
- 20 percent increase in expenses
- Three percent increase in interest rate, if the rate is variable.

Shock only one variable at a time while holding the other variables constant. Conduct a similar analysis on the other variables.

ROAD TEST #1: Now let's practice sensitivity testing. A producer plans a $250,000 expansion in land and buildings, financed at 8 percent interest for 10 years. Given the key assumptions in the "Base Case", observe how the conditions in the 4 Shock Tests each affect business performance.

Roadside Test					
Projections	Base Case	Shock #1	Shock #2	Shock #3	Shock #4
Revenue	$500,000	$500,000	$425,000	$500,000	$450,000
Expenses	$400,000	$500,000	$400,000	$400,000	$400,000
Net Income	$100,000	$0	$25,000	$100,000	$50,000
Non-Farm Income	$50,000	$50,000	$50,000	$50,000	$50,000
Subtotal	$150,000	$50,000	$75,000	$150,000	$100,000
Depreciation & Interest	$100,000	$100,000	$100,000	$100,000	$100,000
Subtotal	$250,000	$150,000	$175,000	$250,000	$200,000
Living Expense & Taxes	$75,000	$75,000	$75,000	$75,000	$75,000
Subtotal	$175,000	$75,000	$100,000	$175,000	$125,000
New & Old Debt Principal & Interest	$100,000	$100,000	$100,000	$120,000	$120,000
Coverage Ratio	175%	75%	100%	146%	104%
Margin	75,000	-25,000	0	55,000	5,000

Shock Test #1 – Expenses increase 25%, or $100,000, holding everything else constant. This eliminates net income.

Shock Test #2 – Revenue declines by 15%, to $425,000, holding everything else constant. This brings net income down to $25,000.

Shock Test #3 – Interest rates increase to 10%, increasing payment to $120,000 annually.

Shock Test #4 – Revenue declines by 10% because of weather and prices, along with payment increase in Shock Test #3.

Test Results
Shock Test #1 would be most devastating to the business and could result in sale of liquid assets to meet losses, or revamp of management and financial strategies for long term survival.

Shock Test #2, while not devastating, would place the business in a marginal condition.

Shock Test #3 would be the least adverse.

Shock Test #4, including both revenue and interest rate increases, would place the business in a marginal situation.

You can take this one step further by shock testing various enterprises and commodities to ascertain a breakeven market price on production and price levels. This will provide the producer and the lender key metrics to compare actual performance to projected performance. This can enhance communication between producer and lender and managers or key employees and stakeholders.

ROADSIDE CHAT #1: "Why include the best case scenario?"
Lenders will often ask me this question. I like to see the cup half full rather than half empty. The best case scenario illustrates your hopes, dreams, and goals to strive for in a particular year. It is included in your business plan to stretch your management skills and returns expectations, and to motivate you to be proactive rather than reactive. However, as a dose of reality, it is important to test the worst and average case scenarios with a range of probabilities in each case.

Expansion Metrics

Generally speaking, a business must increase net income by 4 to 6 percent annually to remain ahead of long term inflation, which is 4 percent. This increase in net income can occur through growth of revenue, volume, improved efficiency, or a combination of these factors. As previously discussed, it is important to get efficient before getting bigger, and "better is better" before "bigger is better."

If one wants to double the size of the business in a given amount of time, use the rule of 72. That is, divide 72 by the annual growth percentage to obtain the number of years it will take to double. For example, if your business grows 8 percent in net income annually, it will double in size every 9 years. If you want to double the size of net income every 6 years, then your strategic business plan would have to garnish and reallocate resources to increase net income by 12 percent annually.

In the expansion metrics you will notice that we discuss increasing net income and rate of return on assets rather than average gross revenue or number of livestock. That is because many businesses have failed as the result of adding acreage, livestock, or customers because of the lack of management, marketing, or inefficient labor or natural resources, which resulted in unprofitable expansions.

A common question in business strategy, expansion, or addition of partners is how much net income is needed to successfully expand? As a general rule, it takes $40,000 to $70,000 of net income before depreciation to have a business entity stand on its own, or this much incremental income to add another partner. The net income can be less if there is off-farm income, or if the partners can reduce family living withdrawals and expenditures. However, this must be both a short and long term goal of family members and partners.

ROADSIDE CHAT #2: "How can generational warfare occur in a family transition?"
First, generational warfare or bickering behind the scenes occurs when family members argue over scarce income or allocations of scarce income. This bickering takes energy away from the business and personal lives, frequently resulting in family breakups or in some cases divorce. An old rule of thumb is the new partner must generate $40,000 to $70,000 a year in incremental income or the senior generation must give up their $40,000 to $70,000 withdrawal.

Economic Feasibility

Any business expansion or transition can cause some degree of apprehension. How do you know if all this additional risk and responsibility are going to be worth it? Well, put your best assumptions and projections to the test, including a range of sensitivity and scenario testing. A financial measure discussed in previous modules is return on assets, which measures profitability. Return on assets can be used as a test in determining economic feasibility of a business expansion.

Let's use the ROA or return on asset test in a model case for example. Calculate projected ROA after expansion.

Return on Asset Calculation	
Net Farm Income	$100,000
Plus Interest Paid	$50,000
Subtotal	$150,000
Minus Living Expenses	$50,000
Subtotal	$100,000
Total Assets	$1,000,000
ROA (Subtotal 2/Total Assets)	10%

- The first test is to ensure ROA is greater than the cost of money from your lender, or borrowed capital. If ROA is 10 percent and the cost of borrowed capital is 8 percent, then the expansion passes the first test.

- The second test is to ensure that the ROA is greater than or equal to the long term inflation rate. In our example, the long term inflation rate is 4 percent and ROA is 10 percent, 2.5 times the rate of inflation, which passes the test.

- Now let's drill down to the third and final test: comparing ROA to weighted cost of capital. Let's assume that the sample farm is carrying $600,000 of total (existing and new) debt and has $1,000,000 in total assets. Percent equity would be 40 percent and debt to asset ratio would be 60 percent (% debt), which in total equals 100 percent.

Weighted Cost of Capital Calculation					
40%	Owned Capital (% equity)	x	10%	Opportunity Cost	4.0%
60%	Borrowed Capital (% debt)	x	8%	Interest	4.8%
				Weighted Cost of Capital	8.8%

The equity capital of 40 percent is multiplied by an opportunity cost of 10 percent with comparable investments, like stocks, bonds, and CDs (40% x 10% = 4.0%). Opportunity cost shows what would happen if the business was liquidated and invested in alternative investments at 10 percent return. Now, let's assume that interest rate on borrowed capital is 8 percent. Multiply 60 percent of borrowed capital by 8 percent, for a result of 4.8 percent (60% x 8%= 4.8%). Thus, if you add the cost of debt capital (4.8%) to opportunity cost of owned capital (4.0%), the weighted cost of capital is 8.8 percent, which is less than the ROA of 10 percent. Therefore, this case illustrates the expansion is economically sound because it covers both borrowed and opportunity cost of capital and exceeds inflation expectations.

A producer could have used lower expectations on opportunity cost of investments or lower living withdrawals or management fee to pass the test; however, it should be tested against previously established business, family, and personal goals. You can now see how we are coming full circle in the business planning aspect where paper assumptions are tested under difficult conditions to see if they meet or exceed expectations.

ROAD TEST #2: What if ROA dropped to 5 percent due to a $50,000 decrease in net farm income? Would this business still pass the three expansion tests?

Return on Asset Calculation	
Net Farm Income	$50,000
Plus Interest Paid	$50,000
Subtotal	$100,000
Minus Living Expenses	$50,000
Subtotal	$50,000
Total Assets	$1,000,000
ROA (Subtotal 2/Total Assets)	5%

Results:
Test 1: Fail - ROA 5% < 8% cost of borrowed capital
Test 2: Pass - ROA 5% > 4% inflation
Test 3: Fail - ROA 5% < 8.8% weighted cost of capital

Now that we have looked at the numbers, let’s discuss practical considerations in expansion and transition planning.

Time Management

In your journey to a successful expansion or transition, time allocations are a critical element for success. Time often is not on our side because of the many demands of business and lifestyle.

How much time do you spend in the business versus participating in outside activities and community responsibilities? As young beginning producers who are full of energy and desire, attempt to limit business activity to 3,000 hours or less annually, or 300 ten-hour days. Planting and harvesting or periods during expansion will tax these limits; however, in the long run exceeding this guideline will tax your mental, physical and spiritual health, possibly impacting quality of life. Many that exceed these rates will burn out in their late 40s and early 50s.

Some of you are profitable agricultural producers who also hold full time off-farm employment. In this case, the limit on farm and ranch activities is 1,000 hours annually, or 100 ten-hour days. This may result in most of your weekends and vacation days being occupied by the farm business. As family responsibilities increase, these limits may be adjusted to 500 to 750 hours annually.

A maximum of 500 hours per year is the limit for participation in outside organizations. As you become more established, successful, and influential in the community, you will be asked to serve in community organizations and activities, such as church, school board, fire department, or coaching youth sports. Limit these activities to 50 ten-hour days per year if possible. Do not let the senior generation put you on a guilt trip. Yes, they may have worked many more hours but it was physical more than mental. Yes, working on the computer, text messaging a supplier, or negotiating a deal with the machinery dealer over the cell phone counts as time spent in the business.

<u>You, Inc.</u> – In the module Workbook, calculate the number of hours you spend annually on your business, and evaluate your time commitment relative to the guidelines just discussed.

________ hours worked in farm or ranch business annually

________ hours worked in off-farm employment, if applicable

________ hours spent in community involvement/other activities annually

How does this compare to guidelines discussed? Are any changes needed?

ROADSIDE CHAT #3: "I can't get it all done in the time limits you suggest. What can I do?!"

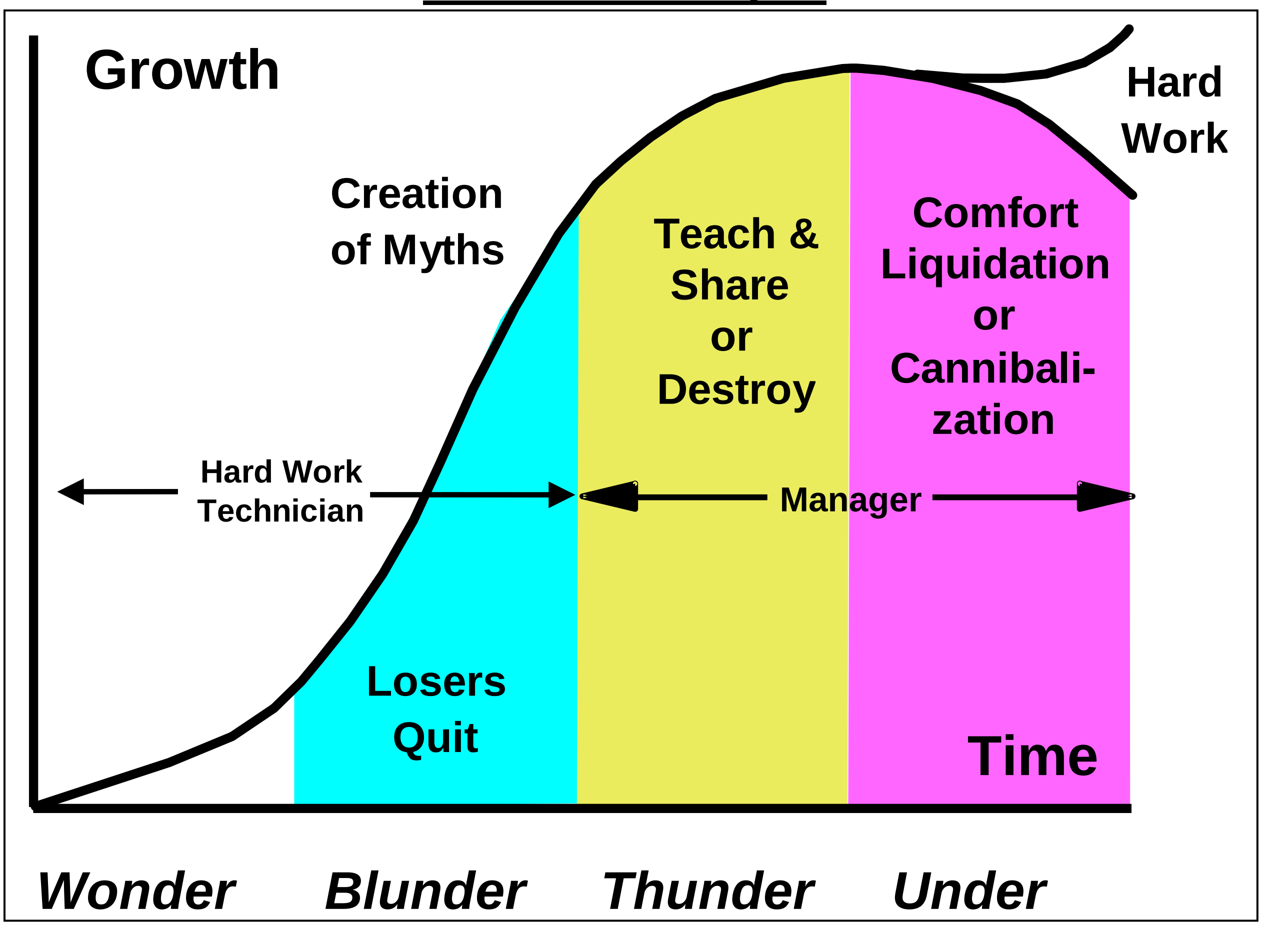
I recommend delegating responsibility to others. Yes, as a young business owner you need to get it right, but you must develop the skills of others as well. They may not do things as well or "your way" but that is the compromise that must be made.

In an Executive Roundtable discussion, a business person reinforced my advice on this issue. He had been working 4,400 hours a year annually. Three years later, he had reduced it to 2,300 hours by working smarter, not harder, and profits increased four times! Delegate, delegate, delegate!

Business Transition and Evolution

An expanding business will go through four distinct phases, each with its challenges and rewards. The first stage involves turning a dream into reality, frequently called the "Wonder" stage. It is an exciting time for producers because the startup or expansion plan is being implemented. The second phase is called the "Blunder" stage. This stage is characterized by cost overruns, surprises such as material and labor shortages, and declining or even negative working capital. If the producer succeeds in this stage, then they move into the most dangerous period, the "Thunder" stage. Cash flow is strong, and equity and wealth are being accumulated. In this stage, the manager has to develop a succession team. The manager must teach and share business expertise or face destroying the business. Often producers wait too long before sharing records and management responsibility with younger partners or employees. Larger operations often depend too heavily upon outside resources such as accountants and financial planners and fail to utilize their own analysis in business decision making.

Business Life Cycle



The optimal period of time to operate and manage a business is 25 to 35 years. New ideas and management techniques are imperative for a business to thrive in the long run. Producers that fail to teach the business to others then move into the "Under" stage. A producer in this stage exhibits a lack of motivation in the business and is easily distracted from management of the operation.

A critical aspect in expansion and transition is cannibalization of the business by older partners. Frequently, business partners in their 50s and 60s contemplate retirement physically and mentally, but are still a financial burden to the operation because of their living withdrawals during the retirement years which can last 25 to 35 additional years. This can cannibalize the younger partners and place the business in a non-competitive position because of excessive withdrawals, preventing re-investment into the business for growth.

ROADSIDE CHAT #4: "Dr. Kohl, can you tell the story from Kansas about sharing the books with the younger generation?"

I was in Kansas doing a seminar and an 85 year old gentleman indicated that he liked my description of the wonder, blunder, thunder and under stages of business. He indicated that he realized it was about time he shared his books with his boy who was in partnership with him. The boy in this case was 68 years old, and kind of long in the tooth!

Action Plan to Evolve the Business

An action plan to evolve the business through expansion and transition is to:

- Ensure the younger generation is making major management decisions within a six year period. If they fail to do so, they often become just an employee for life.
- The senior generation should have at least 50 percent of retirement income generated from a source other than the farm. To do this, the senior must develop a living budget and then generate an earnings profile including Social Security income, retirement, pension, and sale of business assets.
- Third, determine cost of living increases and the impact of inflation. For example, if you need $50,000 per year today, at a 3 percent inflation rate, ten years later $65,000 will be needed to maintain the same buying power.
- If you have siblings or partners joining the business with you, make sure that they work three years minimum away from the business first to gain experience and an outside perspective
- As your business grows and evolves, job responsibilities and areas of expertise must be matched with human resource talent. This often establishes the rules of engagement between generations.
- Finally, have agreements in writing, which include specifics on cash wages and total compensation packages that clearly spell out fringe benefits and other perks of the business. Failure to do so can create communication problems even with those family members not involved in the family business.

ROADSIDE CHAT #5: "You suggest the younger generation work three to five years away from the farm. Why?"

First, some seniors will say to me that this idea sounds good in theory but their son or daughter is their best worker and they cannot let them go because they may not come back. That is the point. Your goal should not be to develop the best worker, but the best manager. If the senior owners are good managers, they will find a way around the loss of the youngster, make it an attractive business to own and manage, and the youngster would be likely to come back!

Family Affairs

Farm and ranch businesses are becoming more complex, particularly relating to expansion and transition. Frequently one or two family members are responsible for the management and growth of the business while other non-farm children either have little or no desire for the business operations and ownership. This frequently changes with the death of a senior partner or change in family status such as divorce or marriage.

There is an old saying that you cannot treat everyone in the family equally in dividing up the business, but you can treat them fairly and equitably. Loosely held business arrangements sometimes work while the parents are still living; however, after death, serious challenges arise as active partners in the business are required to buy out non-farm siblings who are interested in cash. This problem can escalate exponentially when farms and ranches have alternatives such as development potential or recreational use value.

To remedy this situation, transparency and clarity is needed in buy-sell agreements within the family. Some transition specialists recommend life insurance coverage on senior partners often with premiums paid by family members and partners. These proceeds can be used to pay non-farm children, estate taxes, and provide working capital if expansion or business transition occurs.

One strategy is to divide the estate in a manner that non-farm siblings receive insurance proceeds and cash, which come with maximum flexibility and little or no risk. Family members that will continue to operate and manage the business receive the farm and ranch equity up to three times the amount of cash and insurance proceeds the non-farm siblings receive. The logic here is that the farm or ranch comes with various degrees of risk including environmental, competitive, market, and weather risk and thus needs to be treated differently.

Others will transfer ownership through corporations and LLC arrangements with a defined strategy of ownership and responsibility. Regardless, family business meetings often with a transition team consisting of a lawyer, accountant, financial planner and facilitator are valuable for providing expertise, guidance and direction to develop workable solutions to an age old challenge of business.

Senior Generational Issues

Prenuptial and buy-sell agreements are not just for the younger generation. The nationwide divorce rate is near 50 percent. With many seniors owning the farm business, the probability of remarriage is high in the case of the death of a spouse. High amounts of equity can result in disagreements concerning who has claim on business assets and a say in management. Responsibilities in the case of death and divorce, through prenuptial arrangements and buy-sell agreements can provide structure and clarity, protecting vulnerable assets and equity necessary to operate and manage a high performance business. If these arrangements are not finalized, the result can be more time and energy taken away from the transfer of the business.

One of the most contentious issues in business ownership transfer is where the senior generation is going to live. Will they live on the farm or in town? What about housing arrangements once health and mobility decline? These issues need to be discussed before transfer of the business, and put in writing.

Another factor to be discussed with the senior generation is provisions for long term health care, and final directives, such as living wills. This is an area where a lawyer or financial planner can be of great value.

Finally, do you have a will or an estate plan? Even young producers need a will because in many states, the state will decide who cares for children and division of assets if no formal arrangements are developed. The estate plan needs to be dusted off and updated every ten years and every five years if your age exceeds 50.

Family Business Meetings
Whether you are a starting up a business from scratch on your own or joining a complex farm or ranch business, business meetings are critical. Research shows that decisions in family meetings are more likely to be implemented if the meeting is conducted in a structured and professional manner.

This includes establishing an agenda. Compile and distribute minutes. Meetings should to be held away from the place of business to reduce distraction, with pre-established dates. Sometimes an outside facilitator and key resource people such as the lawyer, lender, and crop and livestock consultant can be valuable in the process to evolve your business regardless of what stage it is in.

<u>You, Inc.</u> – In the module Workbook, write down the family issues just discussed that are most pertinent to your business. Think of one action step for each issue that will help resolve the issue or help you move forward in addressing the issue. For example: If the issue is that you do not have a written will, the action step could be meeting with a lawyer this week to draft a will.

Issue 1:
Action Step:

Issue 2:
Action Step:

Issue 3:
Action Step:

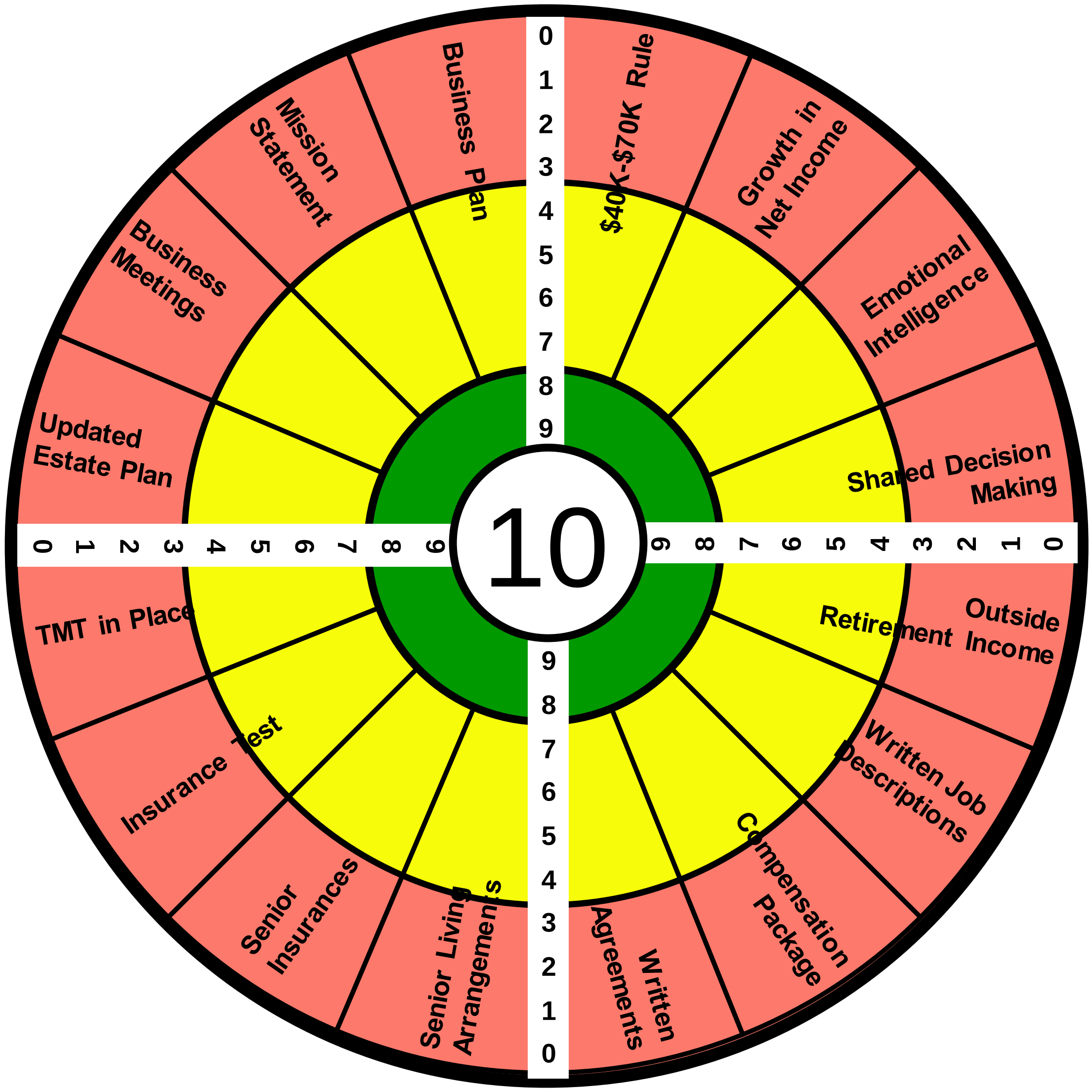
Sweet Sixteen Golden Rules of Transition Management

Indicate the number that corresponds with your business:
0-3 = Red, 4-7 = Yellow, 8-10 = Green

Score

Score		
______	1	Do you pass the $40,000-$70,000 Rule, or are you willing to accept less living withdrawals, or have additional non-business revenue?
______	2	Will the business model provide for a minimum of a 4% to 8% increase in net farm or business income annually over the next five years?
______	3	Has the younger generation experienced 3-5 years away from the business in outside experience to develop emotional intelligence?
______	4	Has the older generation committed to shared decision-making by the sixth year upon the younger generation's entering the business?
______	5	Do you pass the older generation financial rule? Does Mom or Dad, or business partner who is retiring have at least 50% of retirement income from outside the business investments?
______	6	Do you have written job descriptions with performance measures that are evaluated on a periodic basis?
______	7	Do you have a cash wage and total compensation package that lists the values of fringe benefits and other "perks"?
______	8	Do you pass the written agreement test? Is your business transition plan written, with buy-sell agreements and a fair, but not equal, treatment concerning non-active family business members?
______	9	Has the senior generation made plans for living arrangements and housing in their retired years?
______	10	Does the senior generation have long term health care, disability insurance, & final directives?
______	11	Do you pass the insurance test? Does the business have proper insurances such as life, disability, long term health care, and key person for family members?
______	12	Do you have your TMT (Transition Management Team) in place, including an accountant, lawyer, outside facilitator, and other crop/livestock and financial specialists?
______	13	Has the written estate plan been updated in the past 5 years?
______	14	Do you have periodic family business meetings away from the business with an agenda, minutes and use of an outside facilitator?
______	15	Do you have a written mission statement with specific short- and long-term goals that are discussed with the management team and family?
______	16	Do you have a written business plan including mission, goals, tactics & action statements covering financial, marketing operations, risk management and an exit plan?

Sweet Sixteen Golden Rules of Transition Management Bull's Eye



Any spoke < 4 needs immediate attention
Any spoke 4-7 needs improvement
Any spoke > 8 continue to do well