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How Do I Finance the Growth of My Operation?

Michael Langemeier and Michael Boehlje

Center for Commercial Agriculture
Purdue University

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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 sixth question: how do I finance the growth of my operation?

Retained Earnings and Farm Growth

One of the most important sources of income for farm growth is retained earnings, which can be computed by subtracting owner withdrawals (e.g., family living expenses) from net farm income. Because this source of income is so important to farm growth, it is absolutely essential for farms to compute accrual net farm income and the change in equity from the beginning to the end of the year. Changes in equity can be decomposed into retained earnings and changes in asset values, particularly those associated with farm land. A higher level of retained earnings positively impacts the change in equity and creates additional funds that can be used to purchase assets or grow the business. Funds for farm growth can also be obtained from off-farm income and/or from a transfer of funds into the business. Transferring profits from a non-farm business into the farm operation would be an example of a transfer of funds.

Langemeier and Boehlje (2017) list having a profitability and growth focus as one of the key drivers of future consolidation in production agriculture. Larger farms have two advantages with respect to this driver. First, financial performance tends to be relatively higher for larger farms (Hoppe and MacDonald, 2016). Second, larger farms tend to retain a relatively higher percentage of their net farm income. In other words, a relatively smaller percentage of net farm income is withdrawn from the business (e.g., family living expenses). The combination of higher per unit profit and lower payout ratios (lower operator withdrawals as a percentage of net farm income) results in more money available for farm growth. This increase in money available for farm growth is as important in many instances as economies of scale.

Another way of thinking about retained earnings and farm growth is to view farm growth as a natural result of business success. Successful businesses have more natural growth potential because of their typically higher savings or retention of farm profits compared to less successful businesses. To the extent

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that larger farms are relatively more successful, larger farms have a higher sustainable growth rate, resulting in large farms becoming even larger.

Debt Financing and Risk Management

Debt financing and utilization are often related to a farm's ability to retain net farm income. Farms that accumulate retained earnings more rapidly are typically better positioned to obtain more debt as well. Moreover, in this instance, a larger portion of business profits are available to service that debt. Thus, larger farms typically have both more debt and equity resources available to expand operations compared to smaller farms, and consequently often have a faster rate of growth.

As to risk management, larger farms typically have the resources to acquire the capabilities and instruments to manage business and strategic risk at a lower per unit cost of production compared to smaller farms. More effective management of business and strategic risk enables these farms to safely use more debt in both absolute and relative terms. The combination of more income available to service debt and less variable income due to an enhanced ability to manage business and strategic risk means that larger farms can be more highly leveraged (i.e., have a higher debt to asset ratio).

Concluding Thoughts

When evaluating farm growth options, it is important to think about sources that can be used to finance farm growth. Retained earnings, net farm income remaining after operator withdrawals, off-farm income, transfer of funds into the business, and debt financing can be used for farm growth. When using debt, is important to consider how risk is impacted by leverage. Unless business and strategic risk can be mitigated through the pursuit of a growth option, the increase in leverage will increase the farm's exposure to risk. Future articles will explore business models and start-up challenges pertaining to farm growth.

References

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