Section 2.3
Financial Planning For New Enterprises And Your Business Venture

Dawn Thilmany, Wendy Umberger and Amanda Ziehl
Department of Agricultural and Resource Economics
Colorado State University
Section Summary

- Discuss managerial need for budgeting as part of marketing and financial planning
- Develop a template for exploring financial impacts of new enterprises and marketing strategies
- Show a case study example of a partial-enterprise budget analysis
- Obtain a loan for your farm
Budgets As A Decision Tool

• **Enterprise budgets**: analyze parts of the operation and do break-even analysis to set yield or price goals

• **Partial budgets**: analyze potential change to the operation (new activity, enterprise or asset)

• **Integrate enterprise and partial budgets** to compare two choices: production methods, marketing strategies, financial decisions (leasing vs. owning)
Enterprise Budgets

- Relate to specific production activities of farm operation (or new marketing activity)
- Mini-income statements that focus primarily on operating activities pertaining to a particular enterprise (not investment or financing activities)
- Focus on variable and fixed expenses
  - Be able to differentiate variable and fixed costs per enterprise
Developing Enterprise Budgets

• Estimate receipts or revenue from an enterprise

• Revenue = Output * Price

  ‣ Use average historical yields for “output”
  ‣ Use average historical price or contract price (if you use futures contracts) for “price”
  ‣ Multiply output and price for estimated revenue from the enterprise
Developing Enterprise Budgets

Estimate costs incurred from an enterprise

1. Variable costs are on a per-unit basis
   - Change with output level (more head of livestock means more total variable costs)

2. Fixed costs represent overhead to business, include management salaries, depreciation, mortgage payments
   - Many are related to items on the balance sheet (asset-oriented) and change little from previous years
Break-Even Analysis

• Used to determine if a firm should invest in an enterprise

• Helps to determine breakeven price, yield, cost ceiling (used when price and yield are certain)
  ‣ Break-even yield = Total costs/Price
  ‣ Break-even sale price = Total costs/Yield

• Looks at changing an established enterprise to a new strategy
Partial Budgeting

• Partial budgeting is similar to enterprise budgeting, but:
  ‣ Looks at changes in an enterprise
  ‣ May look at an asset investment rather than a specific production-based enterprise
  ‣ More of a comparative analysis than break-even (of two or more choices, which will be better?)

• Helps to make managerial decisions during periods of change or strategic planning
Making A Partial Budget

- Calculate advantages of new enterprise/asset
  - Additional returns/sales
  - Reduced costs

- Sum = Total Benefits
  - ✔ Net change = Total Benefits – Total Costs
  - ✔ Analyze whether advantages outweigh disadvantages
  - ✔ Simplified cost-benefit analysis

- Calculate disadvantages of new enterprise/asset
  - Additional costs
  - Reduced returns/sales

- Sum = Total Costs
Case Study Example

- Developed partial-enterprise budgets for 3 marketing ventures for a natural beef producer in Colorado
  - Freezer beef
  - Farmers markets
  - Retail store
- Based on financial information provided by Colorado Homestead Ranches, Inc. (CHR) located in Paonia, CO
Colorado Homestead Ranches

- 5 ranches started selling freezer beef in 1997
- Product attributes: local, naturally grazed beef, no feedlot antibiotics or hormones
- Began selling processed meats in year 2000
- Participate in two farmers markets
Colorado Homestead Ranches

• Opened Homestead Market and started a ready-to-eat entrée product line in May 2002

• Sells product to restaurants

• Provides other services at Homestead Market to help generate revenue to cover overhead costs for entire operation
  ‣ Wild game processing, leasing a commercial kitchen, selling other locally produced products (fruits, vegetables, gift baskets)
Background Information

• Goal: return $1400/head ($2.00/lb. per carcass) to each producer
  ‣ Labeled as returns to meat in following budgets
  ‣ Shown as a cost to calculate gross profit/loss

• CHR producers contribute sweat equity (they are not paid for their labor contribution)

• Future goal: pay each producer for contributed labor as market and sales expand
Background Information

- Each enterprise allocated a portion of total overhead costs: following table shows total overhead cost schedule with future cost estimates

- Advertising/marketing costs high in 2002: market research and promotion costs to open the retail market and new product line

- Legal and professional fees high in 2003: costs of upcoming research performed by Colorado State University
## CHR’s Overhead Costs With Future Projections

<table>
<thead>
<tr>
<th>Total Overhead Costs for Whole Business</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising/Marketing</td>
<td>$23,390</td>
<td>$8,739</td>
<td>$2,146</td>
</tr>
<tr>
<td>Bank Charges</td>
<td>$1,742</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$6,586</td>
<td>$5,868</td>
<td>$7,494</td>
</tr>
<tr>
<td>Insurance</td>
<td>$2,892</td>
<td>$3,036</td>
<td>$3,188</td>
</tr>
<tr>
<td>Interest</td>
<td>$5,709</td>
<td>$5,395</td>
<td>$5,057</td>
</tr>
<tr>
<td>Legal &amp; Professional</td>
<td>$2,850</td>
<td>$66,270</td>
<td>$1,500</td>
</tr>
<tr>
<td>Office Expenses</td>
<td>$8,105</td>
<td>$6,553</td>
<td>$5,831</td>
</tr>
<tr>
<td>Repairs &amp; Maintenance</td>
<td>$30,590</td>
<td>$10,911</td>
<td>$11,457</td>
</tr>
<tr>
<td>Telephone</td>
<td>$111</td>
<td>$1,111</td>
<td>$1,167</td>
</tr>
<tr>
<td>Utilities</td>
<td>$8,772</td>
<td>$9,211</td>
<td>$9,672</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$90,747</strong></td>
<td><strong>$118,094</strong></td>
<td><strong>$48,512</strong></td>
</tr>
</tbody>
</table>
Partial Budget:
CHR Freezer Beef

- Freezer beef accounted for $35,170 in revenue in 2002, sold approximately 29 carcasses
- Sell at demand (about 1 carcass every 2 weeks)
- Whole processed hot carcass weighs 700# (sell whole, ½, or ¼ carcasses)
- Retail price
  - $1.72/lb. per whole (700 lbs.)
  - $1.75/lb. per half (350 lbs.)
  - $1.78/lb. per quarter (175 lbs.)
- Cost of goods sold includes $0.41/lb. processing and $0.47/lb. packaging
Partial Budget: CHR Freezer Beef

- Returns to meat are $2.00/lb. or $1400/head and shown as a cost
- Inventory costs 8.5% of $1400/head goal for 3 mo.
- 5% of labor used to market freezer beef
- Shows sensitivity of returns to meat, management & overhead at different carcass sizes sold
- Quarter carcasses sales generate best margin
- Freezer beef has a gross loss, $1400/head goal not met
<table>
<thead>
<tr>
<th></th>
<th>Quarters</th>
<th>Halves</th>
<th>Whole</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Revenue</td>
<td>$35,170</td>
<td>$35,170</td>
<td>$35,170</td>
</tr>
<tr>
<td>Number of Items Sold</td>
<td>113</td>
<td>57</td>
<td>29</td>
</tr>
<tr>
<td>Cost of Goods Sold (Processing &amp; Packaging)</td>
<td>$17,387</td>
<td>$17,685</td>
<td>$17,994</td>
</tr>
<tr>
<td><strong>Gross Margin</strong></td>
<td>$17,783</td>
<td>$17,485</td>
<td>$17,176</td>
</tr>
<tr>
<td>Returns to Meat</td>
<td>$39,550</td>
<td>$39,900</td>
<td>$40,600</td>
</tr>
<tr>
<td>Inventory Cost</td>
<td>$833</td>
<td>$833</td>
<td>$833</td>
</tr>
<tr>
<td>Payroll</td>
<td>$900</td>
<td>$900</td>
<td>$900</td>
</tr>
<tr>
<td>Gross Loss</td>
<td>-$23,500</td>
<td>-$24,148</td>
<td>-$25,157</td>
</tr>
<tr>
<td><strong>Returns to Meat, Management &amp; Overhead</strong></td>
<td>$16,050</td>
<td>$15,752</td>
<td>$15,443</td>
</tr>
</tbody>
</table>
Implications: CHR Freezer Beef

• Return to producer goal not met. CHR ventured into farmers markets and then retail to increase revenues and cover overhead costs

• Freezer beef market requires small investment of capital and management (low risk), but generates lowest returns

• Freezer beef returns can be used to cover between 10-15% of overhead costs
Partial Budget: CHR Farmers Markets

- CHR attends Aspen and Glenwood Springs farmers markets
- Accounted for $70,300 in revenue in 2002
- Operate on weekends for 15 weeks of the year
- Proportion of total product sold is: ½ primal cuts, ¼ entrées, and ¼ specialty meat
- Sold approximately 10,500 lbs. of meat through farmers markets
Partial Budget: CHR Farmers Markets

• Returns to meat = $21,000. Shown as cost to calculate gross profit/loss

• Processing and packaging costs:
  ‣ $0.88/lb. for primals
  ‣ $3.00/lb. for entrées
  ‣ $1.00/lb. for specialty meats

• About 2% of labor used to market product at farmers markets

• Inventory costs calculated within shrink of $100
Partial Budget: CHR Farmers Market

- Registration fees at both markets total $450
- Transportation costs $0.34/mile or $1785 per year (includes fuel)
- 2 refrigerated trailers purchased at $3000 each
- Returns to meat added back into gross profit to calculate “Returns to Meat, Management & Overhead”
### Partial Budget for Farmer's Markets: 2002

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue from Primals</td>
<td>$35,150</td>
</tr>
<tr>
<td>Revenue from Entrées</td>
<td>$17,575</td>
</tr>
<tr>
<td>Revenue from Specialty Meat</td>
<td>$17,575</td>
</tr>
<tr>
<td><strong>Total Sales</strong></td>
<td><strong>$70,300</strong></td>
</tr>
<tr>
<td>Returns to Meat</td>
<td><strong>$21,000</strong></td>
</tr>
<tr>
<td>Primal Processing &amp; Packaging</td>
<td>$4,620</td>
</tr>
<tr>
<td>Entrée Processing &amp; Packaging</td>
<td>$7,875</td>
</tr>
<tr>
<td>Specialty Meat Processing &amp; Packaging</td>
<td>$2,625</td>
</tr>
<tr>
<td><strong>Total Cost of Goods Sold</strong></td>
<td><strong>$15,120</strong></td>
</tr>
<tr>
<td>Payroll</td>
<td>$900</td>
</tr>
<tr>
<td>Shrink</td>
<td>$100</td>
</tr>
<tr>
<td>Registration Fees</td>
<td>$450</td>
</tr>
<tr>
<td>Transportation</td>
<td>$1,785</td>
</tr>
<tr>
<td>Refrigerated Trailer</td>
<td>$6,000</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td><strong>$24,945</strong></td>
</tr>
<tr>
<td>Returns to Meat, Management &amp; Overhead</td>
<td><strong>$45,945</strong></td>
</tr>
</tbody>
</table>
Implications: CHR Farmers Markets

- Producers prefer to have weekends off, but need farmers market revenue to cover overhead costs
  - Can cover 20-25% of overhead costs
- Requires moderate investment of capital and management; generates moderate returns to meat
- Little potential for increased sales growth as the market can become quickly saturated
Partial Budget: CHR Homestead Market

• Budget figures come from CHR products, not other products sold at Homestead Market

• CHR products account for 50% of total sales

• Generated $140,680 in revenue in 2002

• Proportion of product sold:
  ‣ 55% primal cuts
  ‣ 15% entrées
  ‣ 30% specialty meats

• Sold approx. 43,750 lbs. of CHR meat through Homestead Market
Partial Budget:  
CHR Homestead Market

- Returns to meat = $87,500; shown as cost to calculate gross profit/loss
- About 25% of labor used to market product at Homestead Market
- Inventory costs are part of shrink; calculated at 0.7% of sales
- Rent = $860/month (mortgage paid on store building)
- Added returns to meat back to gross profit/loss for “Returns to Meat, Management & Overhead”
<table>
<thead>
<tr>
<th>Partial Budget for Homestead Market: 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue from Primals $77,374</td>
</tr>
<tr>
<td>Revenue from Entrées $21,102</td>
</tr>
<tr>
<td>Revenue from Specialty Meat $42,204</td>
</tr>
<tr>
<td><strong>Total Sales</strong> $140,680</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Returns to Meat</strong> $87,500</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Primal Processing &amp; Packaging $21,175</td>
</tr>
<tr>
<td>Entrée Processing &amp; Packaging $19,688</td>
</tr>
<tr>
<td>Specialty Meat Processing &amp; Packaging $13,125</td>
</tr>
<tr>
<td><strong>Total Processing Costs</strong> $53,988</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Payroll $11,250</td>
</tr>
<tr>
<td>Shrink 0.7% $985</td>
</tr>
<tr>
<td>Rent $10,320</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Gross Loss</strong> -$23,362</td>
</tr>
<tr>
<td><strong>Returns to Meat, Management &amp; Overhead</strong> $64,138</td>
</tr>
</tbody>
</table>
Financial Implications: CHR Homestead Market

- Goal of returning $1400/head to producers not met
- Sale of CHR beef products is 50% of total sales at Homestead Market
- 30-40% markup on other products sold at Homestead Market offsets the loss
- CHR is drawn to diversity. Selling other products helps cover costs and draws more consumers into Homestead Market
Financial Implications: CHR Homestead Market

• Can cover between 35-40% of overhead costs

• Requires high investment of capital and management (high risk), but generates the highest total returns to meat

• Retail budget for CHR products may be improved in the future with lower packaging and processing costs for entrées and specialty meats
Concepts From CHR Case Study

- Calculate revenues, variable costs and fixed costs from each enterprise to estimate benefits, costs, and profit/loss potential of changing an enterprise.

- Enterprise/partial budget: may show weakness in your operation, help push need for change or improvement in current practices.

- Case study budgets show different marketing alternatives, but can also be developed for production or processing.
Budgeting A New Marketing Venture

• Determine which situation best fits your production goals and capital resources

• Look at additional benefits and costs of marketing alternatives that fit your operation

• Use partial-enterprise budgets to help you calculate any needed financing

• Be realistic about the numbers. May want to underestimate revenue and overestimate costs
Calculating Overhead Costs

• Represent capital inputs
  › Personnel, management, professional services
  › Real estate and building (interest and depreciation for long term assets)
  › Equipment, fixtures and vehicles

• Often not connected to revenue, so difficult to allocate
Allocation Of Overhead Costs

- Similar to CHR, can use enterprise budgets to determine how much overhead costs to allocate to an enterprise. CHR example:
  - Freezer beef - 10-15%
  - Farmers market - 20-25%
  - Homestead Market - 35-40%

- Can allocate different amounts from year to year
Financing Issues

• Set realistic goals for financial resource needs

• Use enterprise budgets to develop financial plan

• In financing new enterprises:
  ‣ Challenge to secure funding with no past performance
  ‣ Use sweat equity as a growth strategy

• In financing cooperatives:
  ‣ Equity financing and redemption present challenges to cooperatives
Financing Issues

• There is a limit to how much sweat equity can be expected as some ranchers experience burn out and may go broke before the business becomes stable, especially if there is a limited number of people working to get the business started

• If grants are used for start-up, need to eventually become viable without the grant support

• May need additional money beyond equity financing for research and development and building the infrastructure
Equity Capital

- Funds or assets contributed by owners, partners, cooperators
- Unpaid labor resources (sweat equity), often practiced in early stages of business
- Contributors exposed to more risk, but have more control
Debt Capital

• Long term: use for long-term assets

• Short term: use for working/operating capital

• Guarantee payment on capital to lenders
  ‣ less risk to debtors, but more risk to business
  ‣ makes capital more accessible
Long-Term Debt Capital

- Length of financing should equal productive life of asset (terms of 10 years or more)

- Payments generally follow depreciation schedule
  - Long term assets should create cash flow from their productive value at the same rate they are paid off
Short-Term Debt Capital

- Terms of one year or less, used for operating expenses or as working capital
- Most expensive and least growth-oriented of any debt, so manage aggressively
- Two forms of short-term debt:
  - Operating line of credit offered by banks, credit unions
  - Trade credit offered by input suppliers
  - Both allow borrower some flexibility to take advantage of seasonal discounts
Leasing: An Internal Finance Strategy

- Provides ability to use an asset without tying up capital needed to purchase it
- Useful for managing taxes and minimizing down-payment requirements
- Three main types of leases:
  - Operating (equipment)
  - Capital (land or building)
  - Sale and lease-back arrangements (breeding stock)
- Provides temporary access to assets, but lessee more exposed to inflation risk on assets
Obtaining A Farm Loan

- Know your farm enterprise, develop expertise in production and marketing
- Budget cash flows
- Know your collateral
- Have a written plan
- Prepare financial statements (balance sheet, income statement, cash-flow statement)

Obtaining A Farm Loan

- Use your records to make informed decisions; know when to upgrade or modernize
- Treat lender as a valuable asset; find a lender with whom you are comfortable
- Lenders include:
  - Commercial banks
  - Farm Credit System borrower-owned coops
  - USDA’s Consolidated Farm Service Agency
  - Individual credit unions, agribusiness suppliers