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

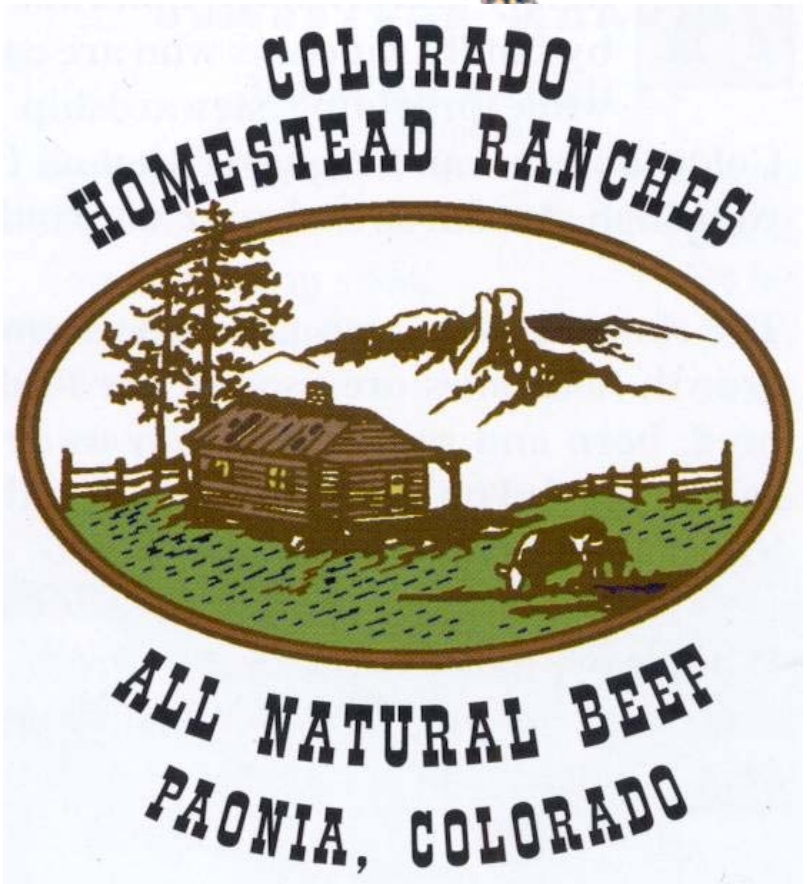
- Calculate disadvantages of new enterprise/asset
  - Additional costs
  - Reduced returns/sales
- Sum = Total Costs

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

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

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

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

Partial Budget for Freezer Beef: 2002

	Quarters	Halves	Whole
Gross Revenue	$35,170	$35,170	$35,170
Number of Items Sold	113	57	29
Cost of Goods Sold (Processing & Packaging)	$17,387	$17,685	$17,994
Gross Margin	**$17,783**	**$17,485**	**$17,176**
Returns to Meat	**$39,550**	**$39,900**	**$40,600**
Inventory Cost	$833	$833	$833
Payroll	$900	$900	$900
Gross Loss	-$23,500	-$24,148	-$25,157
Returns to Meat, Management & Overhead	**$16,050**	**$15,752**	**$15,443**

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	
Revenue from Primals	$35,150
Revenue from Entrées	$17,575
Revenue from Specialty Meat	$17,575
Total Sales	$70,300
Returns to Meat	**$21,000**
Primal Processing & Packaging	$4,620
Entrée Processing & Packaging	$7,875
Specialty Meat Processing & Packaging	$2,625
Total Cost of Goods Sold	$15,120
Payroll	$900
Shrink	$100
Registration Fees	$450
Transportation	$1,785
Refrigerated Trailer	$6,000
Gross Profit	$24,945
Returns to Meat, Management & Overhead	**$45,945**

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”

Partial Budget for Homestead Market: 2002	
Revenue from Primals	$77,374
Revenue from Entrées	$21,102
Revenue from Specialty Meat	$42,204
Total Sales	$140,680
Returns to Meat	**$87,500**
Primal Processing & Packaging	$21,175
Entrée Processing & Packaging	$19,688
Specialty Meat Processing & Packaging	$13,125
Total Processing Costs	$53,988
Payroll	$11,250
Shrink 0.7%	$985
Rent	$10,320
Gross Loss	-$23,362
Returns to Meat, Management & Overhead	**$64,138**

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)

Source: "Agricultural Alternatives: Financing Small-Scale and Part-Time Farms", 1995.
Pennsylvania State University College of Agricultural Sciences, Agricultural Research and Cooperative Extension.

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

Source: "Agricultural Alternatives: Financing Small-Scale and Part-Time Farms", 1995.
Pennsylvania State University College of Agricultural Sciences, Agricultural Research and Cooperative Extension.