Does Your Farm Need to Expand?

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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 *farmdoc* article (here), discussed ten questions that should be addressed when examining challenges and opportunities associated with farm growth. This article focuses on the first question: why grow?

Reasons for Farm Growth

There are numerous reasons why a farm may want to grow including the following: reduce costs, improve profit margins, improve asset utilization, bring in new family members, invest retained earnings, and more fully utilize the skills of key managers. The reduction in costs and improvement in profit margins and asset utilization are related to economies of size. As farms become larger, fixed costs per unit of production decline. These fixed cost declines are typically related to machinery and equipment, and labor costs. In addition, as farms expand they are often in a better position to purchase and adopt new technology. These technologies often reduce per-unit machinery and equipment costs and improve labor productivity.

On a related note, Boehlje (2013) suggests that farm growth is a natural phenomenon. The relatively larger operating profit margins per unit of output combined with higher output levels allows larger farms to reinvest more of their earnings into the business. For many small and medium sized farms; salaries, withdrawals, and payouts to the business owners and managers typically account for a relatively high percentage of the farm's annual earnings resulting in fewer funds that can be used to reinvest in the farm business. The larger absolute amount of retained earnings for larger scale farms means that larger scale farms can acquire more resources and increase their output more rapidly than a smaller scale business that may need to use most of its earnings to support withdrawals or payouts to managers.

Besides economies of size, there are many other reasons why farms expand. Many managers are motivated to expand their businesses to provide more opportunities to employ the skill sets of an increasingly capable management team or to bring in another family member or key employee. Growth often allows managers to focus on one or two aspects of the business rather than trying to manage all aspects of the business.

Growth can also allow a farm to capture pecuniary economies of size. These economies of size may relate to input purchases and output sales. Larger farms often can purchase inputs, such as seed, at a relatively lower per-unit cost and sell products at a relatively higher per-unit price. In addition, buyers of products often prefer to do business with fewer firms and so will provide preferred supplier incentives to businesses with larger and growing volumes.

Strategic Direction

Before growing, it is essential for an operation to think about their strategic direction. Is the operation interested in a commodity based strategy or a differentiated product strategy? Figure 1 depicts situations in which a firm can obtain a competitive advantage. A firm can obtain a competitive advantage by having below average per-unit costs of production and receiving average prices per unit for their products (commodity based or low cost strategy) or having average per-unit costs and receiving an above average per-unit price for their products (differentiated product strategy). Box 3 depicts a situation where a firm has below average per-unit costs of production and receives above average per-unit prices for their products. Though this situation is possible, it is not commonly achieved. It is more common for firms to be in box 2 or 6.

The agriculture of the past has been primarily a commodity business, and consequently the key to long-term success in farming has been to be a low-cost producer. As producers increase their efficiency through better management and adoption of technology, cost declines and margins increase. However, over time, the continued adoption of the cost saving technologies by the industry results in increased production and margin pressures. In the long-run, the only way to compete successfully in the farming business dominated by commodity production is to be a low-cost producer.

Despite the fact that many farms still pursue the low cost strategy, the basis and dimensions of competition in agriculture are changing. As agriculture is transformed from a commodity to a differentiated product business, competition becomes multi-dimensional - it is not just being cost competitive that will lead to financial success. Differentiated products typically have a broader spectrum of quality features than commodities, and those quality dimensions or features often improve over time. In most non-food products consumers' purchase, quality standards continuously improve over time, and thus consumers are expecting food products to exhibit similar continuous quality improvement. It is important to note that product differentiation is not a permanent phenomenon. Differentiating attributes become commoditized over time so the successful farmer must constantly evaluate new opportunities for differentiation and be an early adopter or first mover in these new differentiated products before the premiums or margins are pressured by increased numbers of producers who enter the market. Consequently, in differentiated product markets, producers not only compete with respect to cost; they also compete with respect to quality attributes of their products and with respect to the speed or response time to introduce new products as consumer demand and market conditions change.

Conclusions

Growth enables farm businesses to increase revenue and earnings, take advantage of economies of size, and to more fully utilize the skills of current and future employees. As an operation continues to think about growth, how growth impacts strategic direction needs to be addressed.

References

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Figure 1. Identifying a Farm's Competitive Advantage.

Relative Cost Per Unit		**Relative Price per Unit**		
		Lower	Average	Higher
	Lower	1 - Indeterminate Position	**2 - Competitive Advantage**	**3 - Competitive Advantage**
	Average	**4 - Competitive Disadvantage**	5 - Parity Position	**6 - Competitive Advantage**
	Higher	**7 - Competitive Disadvantage**	**8 - Competitive Disadvantage**	9 - Indeterminate Position

Adapted from Hunt, *A General Theory of Competition.*