

Evaluating Strategic Options

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Today's business climate for farmers is fraught with uncertainty. Making smart long-run strategic decisions in this business climate is difficult. When the future is so uncertain, one is tempted to just hope for the best. However, don't ever forget, hope is rarely a good strategy. In addition, remember that uncertainty creates opportunities as well as challenges. A farm's task is to identify and exploit these opportunities. An earlier article discussed the assessment and management of strategic risk (see [here](#)). This article discusses a framework that can be used to evaluate strategic options and will provide a couple of examples of decisions for which this framework could be used.

Strategic Planning

Conventional planning typically assumes that managers can make projections using predictions from experiences and assumptions that remain relatively stable. This approach works well when dealing with projects with limited uncertainty. When dealing with projects or new ventures that are uncertain, assumptions made at the beginning of the project do not hold over time, resulting in substantial adjustments to the plan. Discovery-driven planning offers a way to approach a project involving uncertainty (McGrath, 2013; McGrath and MacMillan, 1995; McGrath and MacMillan, 2009). With this approach, learning as the project evolves and making adjustments to the initial plan are important aspects of the plan. Discovery-driven planning includes the following steps: define success, do benchmarking, define operational requirements, document assumptions, and plan to key checkpoints (Gallo, 2017).

Discovery-driven planning frequently uses an "options" framework. This framework or approach recognizes strategic decisions can be structured using a multi-step process where initial financial and resource commitments are limited, insights are obtained from results of the initial experiment, and time is managed to gather additional information before further commitments are made. The options framework is structured to reduce downside risk while still maintaining upside potential.

The two examples below illustrate uncertain situations for which discovery-driven planning is helpful. The first example involves making long-run cash rental decisions. The second example examines adding organic crop production enterprises to a farm.

Farmland Rental Decisions

Contribution margins have declined substantially since 2013. Cash rental rates, on the other hand, have declined but not as precipitously. History suggests that cash rental rates will adjust downward in response to reductions in contribution margins, but continued strong competition for land resources means the adjustment will be slow and may take place over a period of several years.

What should a farm do in this challenging operating environment? Langemeier et al. (2015) suggested using an options framework to determine how much you must pay to control the land and then assess the implications on the farm's working capital position. The process is relatively straightforward. First, determine an economic or breakeven rent based on the profit potential given expected prices, costs, and yields. Second, calculate the option premium as the difference between the expected market rent minus the breakeven rent. This premium will depend on the willingness of the landowner to adjust rents, the competitiveness of the local rental market, and speed of recovery of profit prospects. Third, determine the burn rate in working capital. Fourth, assess whether the premium being paid to maintain control of the property will be recovered in future years when profits improve, and whether or not the working capital burn rate is too high for the business to absorb the expected losses without threatening the viability of the business. If a farm decides to continue renting a particular tract, the profit prospects will be recomputed at least once a year to adjust for changes in assumptions regarding expected prices, costs, and yields.

New Venture

An examination of a new venture or enterprise typically involves more uncertainty than decisions to expand enterprises that a farm is already involved in. As an example, let us discuss the examination of organic crop production on a farm that is currently growing conventional corn and soybeans. Organic production will involve the production of corn, soybeans, and forages. We will use the steps pertaining to discovery-driven planning described above to think about this new endeavor.

First, we need to define success. Given the uncertainty with regard to profit potential, how much extra income is needed to engage in organic crop production? How many acres is the farm willing to devote to these new enterprises? Second, do benchmarking. Given our expected costs and yields, what prices are needed to make the enterprises attractive? Third, define operational requirements. How do field operations and timing of these operations differ between conventional crop production and organic crop production? Where are we going to obtain the manure needed for organic production? How long is the transition period between conventional and organic crop production? Fourth, document assumptions. How do budgeted costs and

yields, and organic crop prices change over time? Are adjustments in production practices needed as we obtain more experience in producing organic crops? Fifth, plan to key checkpoints. Even though a farm may intend to produce organic crops on a portion of their crop acres long-term, a natural checkpoint may be before each crop year. During this checkpoint, a farm can decide whether to continue production or expand production, and to think about adjustments to production practices.

Conclusions

Sound strategic planning requires assessing strategic risk, which involves the sensitivity of a farm's strategic direction, and the ultimate vulnerability and sustainability of the farm to uncertainties in the business climate. In uncertain environments, the natural tendency is to continue down the same path we have been on and not spend much time evaluating alternatives. However, during uncertain times, opportunities often arise. This article discussed a framework that can be used to evaluate a farm's options during uncertain times.

References

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