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# AGRIBUSINESS MANAGEMENT

## MANAGEMENT STRATEGIES FOR SMALL AGRIBUSINESS FIRMS

Most agribusiness firms are small. Regardless of the measurements or standards employed, this assertion remains valid. It is perhaps, the natural end product of our free enterprise economy, where entrepreneurial spirit remains more pervasive than the economies of size. Or perhaps this characterization of the agribusiness industry is linked inseparably to the very atomistic nature of our total agricultural economy. This is not to suggest that large corporate conglomerates fulfill a minor role. In fact, their presence and influence may be more apparent now than was the case a decade or more ago. However, as one travels regularly through rural areas of this country, one can't help but realize that relatively small agribusiness entities retain a dominant foothold in the economy and continue to outnumber their corporate competitors in almost every market or rural community.

Over the years, I have observed hundreds of small agribusiness firms and even worked with a number of them as they struggled with the economic stresses of a day-to-day operational existence. I have witnessed phenomenal successes and observed countless failures. One would hope that the experiences thereby gained would equip me with the wisdom to differentiate between success and failure on the basis of management strategies employed. Unfortunately, the world of the small agribusiness entity is rarely so simple and seldom lends itself to distinctive classification. Despite my most ardent efforts, I've found few distinctive management strategies, which, if employed, will assure either success

or failure for the small business. In fact, the only astute observation I might offer is that "Lady Luck" rarely fulfills a major role. While "luck", alone, may bolster the position of a small agribusiness firm, it will not long sustain it. And if a business is pending failure, it is rarely the result of "bad luck", despite the lamentations of those persons affected.

The failure rate for new agribusiness firms remains high; i.e., it is estimated that 70% of such businesses will cease to function beyond five years. In such cases, the contributing factors are more readily apparent, as management inexperience, insufficient financing, marketing deficiencies, and competitive forces too often interact to defeat the new venture. More troublesome, however, is the post mortem of a small business which survives for many years, perhaps over two or more generations of ownership, but then suddenly falls on hard times. In such cases, contributing factors are much less apparent and in their absence, we too often point the finger of guilt at such fickle phenomenon as advancing technology, marketing dynamics, and a deterioration of the general U.S. economy. I suspect these are little more than convenient excuses and socially acceptable scapegoats.

In my opinion, the pending failure of a small, but long-established, agribusiness firm means that a valuable core of management talent remains somewhere within the firm, but that a series of persistent management deficiencies have slowly eroded the basic strengths of the business and left it vulnerable to those adversities normally encountered by all businesses in all markets.

## **Management Deficiencies**

What are these persistent deficiencies and how do they manifest themselves in small agribusiness firms?

First, they evolve from a faulty management strategy, which perceives a growth in sales as the common solution to all problems. Because of the sharp seasonal patterns of the agribusiness industry, small business managers possess an acute lack of awareness of the fact that, except in the short run, there is no such thing as fixed overhead costs.

Second, product cost analyses are overlooked entirely or poorly conducted. As a result, even the more experienced management is left blind to those losses incurred largely through the rapid-fire addition of new products/services.

Third, agribusiness firms, particularly those governed by local boards of directors, cling tenaciously to the practice of managing operations on the sole basis of income statement analyses, while ignoring completely the value of balance sheet impacts or position. This general lack of concern for the relationship between cash flow (income statement) and the productivity of capital employed (balance sheet) can prove devastating as agribusiness firms search wildly for new pools of investment capital rather than attempting to make better use of that capital already employed.

In the discussion that follows, I shall attempt to further expand on the management deficiencies noted above. Where possible, specific industry examples will be cited. Finally, some attempt shall be made to describe those management strategies, which, if employed by small agribusiness firms, will address the deficiencies, and reduce their current rate of failure.

## **Marginal Income Policies**

Trained as an agricultural economist, I have long extolled the virtues of marginal income

analysis. I have often urged managers, when confronting conditions of economic stress, to approach short-run, pricing decisions with the knowledge that variable costs, alone, need to be covered. Theoretical support for this approach rests on the fact that, for a short period, added sales can accrue to existing volume profitably even when prices are insufficient to cover a proportionate share of fixed overhead costs. The mania for growth in sales volume is thereby created. Moreover, standard accounting procedures encourage management's belief that higher profits automatically follow higher sales.

However, product, pricing decisions made within the context that the marginal income thereby created need only compensate for the marginal variable costs incurred may prove dangerous. For many small businesses, additional sales can only be generated via new products or services. The added complexity of operations resulting from this sales expansion often entails overhead costs not normally a part of the regular business.

Consider this example. A small fertilizer and chemical retailer had operated successfully for years in a rural community and had just completed an addition to its existing warehouse. Some extra space was now available and in an attempt to make use of that space, the retailer decided to add a full line of lawn and garden products. The owner reasoned that since the space was "free", with costs charged against the fertilizer and chemical sales, he could price the new products at a level just above his variable costs (cost of goods plus some labor). Up to this point his logic was consistent with marginal income theory. What he failed to realize, of course, was that new overhead costs would soon accrue to the new product line. Large inventories of lawn and garden products soon developed. A small engine (lawn mower) repair shop was needed to serve his new customers and his accounts receivable grew rapidly. Had he realized that in the long run all such costs were variable, not fixed as overhead, his marginal income

pricing strategy would have been quite different.

Amongst small businesses, there exists this common belief that the only road to success is that which leads to a continuous growth in sales. Managers too often fail to realize that growth is not synonymous with capitalistic success. As noted earlier, some standard accounting procedures even perpetuate this fallacy. For example, break-even accounting procedures suggest that when sales are high enough in a given period to absorb all variable costs as well as all fixed overhead costs, the break-even point has been reached. If this is the case, it can be shown that the margin above variable costs alone, on additional sales, contributes exclusively to profit. This general relationship provides the basis for stimulating classroom lectures and industry seminars. Agribusiness managers are also captured by the concept as they often observe that they may be 10 months into their fiscal year before the break-even point is reached and true profits begin to emerge.

While I remain a strong proponent of this strategy, its fallacy rests with the assumption that all expenses are easily divisible as fixed or variable. If you lease space or equipment, for example, cost accountants will treat rent as a fixed expense. Is it really? It may be possible to sublease unused space or rent additional space as needed. Within this context, rent is no longer fixed. Agribusiness firms often generate profits only at the tail end of a season, absorbing all overhead first before a profit is reported in their monthly profit and loss statements. The danger of this practice is that it focuses management's attention on sales volume rather than margin on sales. As a result, the burden rests on skills employed in a successful marketing program, while inadequate attention is devoted to those skills needed in effective cost control programs.

### **Insufficient Product Cost Analysis**

A second major management deficiency is tied to those methods of cost analysis employed in small agribusiness firms. To be honest, all cost accounting efforts are plagued with estimates, assumptions, and the lack of exact measures. Most methods are capable of accurately assigning direct costs to the appropriate commodities, functions, product lines and/or services provided. The assignment of indirect costs, however, remains an inexact science. Old and new product lines, for example, are typically charged the same proportionate amounts for overhead, although it can often be shown that start-up costs for new items or functions are high. The apportionment process, itself, may be based on physical volume, sales volume, margin, or other measures.

Expanding sales through new products or functions will result in the subsidization of the new by the pre-existing old. Small business managers are often totally unaware of this accounting bias and resultant underestimation of the true cost of sales volume increases. Management strategy should call for the thorough examination of the cost accounting methods and a detailed search for the old vs. new product profitability. Managers should remember that as new products are added and sales volume increases, the complexity of their small business may grow beyond management's skills. When this is judged to be the case, pre-existing products/services may need to be dropped so that a state of relative simplicity returns.

For example, I once worked with a small business operator who had long prospered as a wholesaler-distributor of fresh vegetables. In an attempt to extend the length of seasonal operations, the manager decided to expand into the processing-canning of a specialized line of asparagus. The new endeavor proved to be highly profitable, but the company simply lacked the manpower and skill to manage well the expanded, more complex, business.

It finally became obvious to all that continued handling of fresh produce would have to be discontinued. This was a painful decision for all concerned, but the beneficial effects were both substantial and instantaneous. Product cost analysis, alone, was not adequate in this case, as there existed no means for measuring the cost of the operational complexity resulting from the multiple activities.

When cost accounting procedures fail, as was the case in this example, management has little choice but to fall back to certain basics and ask some simple questions such as:

1. Are sales, on a product-line basis, falling or rising over time? Some products/services have natural life cycles and small businesses are generally ill equipped to spend large sums of money attempting to avoid a pre-ordained product demise.
2. Is a real profit being generated? Managers are often reluctant to admit that a long-standing product/service/function is no longer carrying its fair share of the total cost burden. They refuse to accept what the financial data show. Their sense of security is tied to the old, and acknowledging the profit superiority of a new venture is difficult. Don't waste money attempting to revive an old operation; let it die quietly and quickly.
3. What are the comparative gross margins by product line? A retailer of chemical products once asked me to evaluate his multi product line. While most products were generating 40% gross margins, one showed only 10%. The manager expected me to recommend that this product be dropped; yet I suggested the opposite. My analysis had shown that while gross margins were low, little inventory was required. The product was purchased in large volume by a few large growers, and handling costs were minimal. Finally, I discovered that most

sales were for cash; i.e., few if any credit losses were reported. Consequently, almost all of the 10% gross margin became a net contribution to the firm's profit. On a comparative basis, it was one of the firm's most profitable products. Further, it was found to enhance the sale of other high gross margin products.

4. What are your customers' perceptions? "Loss leaders" are uncommon in the agribusiness industry. However, low-margin items are found in the farm supply sector and are used to retain customer loyalty. It's difficult to attack this management strategy, particularly where low-margin items are used intelligently within the context of a larger marketing program. Yet small agribusiness firms are generally less well equipped to exploit such measures. Customers may be attracted to low-margin items, but as such items comprise an ever increasing share of the firm's total sales, the small business finds itself in a precarious position. What the customer perceives is the low price, not the lower margin. His/her concerns do not typically focus on the long run viability of the enterprise. Small business managers, therefore, are advised to take a very cautious attitude regarding any attempt to expand their sales on the basis of customer price appeal alone. My analysis suggests that many small businesses continue to survive, not on the basis of price alone, but on the customer's perception of quality, service, and the long-established personal integrity of the firm's management.
5. Are you intent on maintaining full service and a full product line? The concept of one-stop shopping emerged decades ago and has proven successful in many forms of retailing. The idea of one-stop farm service centers was all the rage in the early 1970s, but progress has been slow and success has been elusive, particularly for those farm equipment dealerships that served as proponents.

The very nature of small agricultural enterprises places restrictions on the number and breadth of product/services offered. To catalog and stockpile vast inventories of products is neither wise nor feasible for rural area merchants. Full-service and full-product lines retain their conceptual appeal, but clearly they are not solutions to most problems. Once again the small agribusiness manager must select a strategy that is consistent with the firm's capabilities. Despite some customer grumbling, the best policy is to concentrate on those products/services, which are in greatest demand and which are capable of generating those profits required to sustain the business. Heavy investment in slow-moving inventories can prove disastrous.

### **Focus on Balance Sheet Performance**

It is not by accident that small agribusiness managers elect to measure performance on the basis of "P and L" statement parameters. After all, profits and/or losses are the most visible standards by which to judge success or failure. Managers are generally familiar with those basic factors contributing to profits and/or losses. Unfortunately, a manager who concentrates only on these measures and standards is ignoring two other important indicators; i.e., cash flow and the productivity of capital.

A large regional cooperative grain warehouse held regular monthly meetings of its board of directors. Each month the board was presented with a monthly and year-to-date copy of an income statement. As the board regularly monitored costs and revenues, it grew increasingly perplexed over the cooperative's need to borrow for its working capital needs. The board simply could not understand how working capital shortages and monthly profits on operations could occur simultaneously. The reason, of course, was that the board was not provided with monthly trial balances and was, therefore, unable to see that variations in current liabilities were

commensurate with large inventories of grain, most of which remained unsold.

Small business managers must pay equal attention to balance sheet measures. This is particularly critical when the business is susceptible to rapid growth in accounts receivable. Failure to keep these accounts current adversely impacts cash flow and the business soon starves from a lack of working capital. Inventory must also be closely monitored and requires balance sheet study. Small agribusiness firms seem particularly susceptible to the practice of accumulating an extensive, but obsolete and worthless inventory. The stockrooms and storage yards provide ample evidence of the manager's reluctance to remove or throw away obsolete items. A good housecleaning is necessary. Even if such items have little current market value, their disposal requires that the business reflect a reduced inventory valuation.

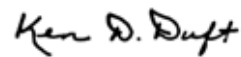
Small business managers, particularly those who ignore their balance sheet entries, neglect to review their fixed assets for hidden capital. For some reason, managers view land, buildings, machinery and equipment as sacred. They recall vividly the financial stresses incurred in acquiring these assets and their possible disposal simply tears at their heartstrings. I share with managers this common malady as I simply refuse to dispose of the many automobiles I've owned. Each was purchased under conditions of serious personal financial stress and the thought of parting with these now-worthless hulks is hard to accept. Yet I must remember that the value of capital employed in my personal business is not measured in intrinsic terms nor in the net book value of these long-depreciated assets. Rather, their current market value is important and if there exists any way to convert these hulks to cash, I would be foolish to bypass the opportunity. Hence whenever possible, do as I say (not as I do) and sell off unused assets for cash and free up this capital for investment elsewhere in your small agribusiness firm.

## Summary

Our agribusiness industry is still characterized by a large number of relatively small businesses. Their continued viability is very important, particularly to those rural communities where few alternative suppliers can be found. The failure rate of newly formed small agribusiness firms remains high and even those businesses that have operated successfully for years are now confronting difficult times. As small business managers strive to retain their economic viability, the choice of an appropriate and effective management strategy becomes critical. Management deficiencies, not bad luck, are contributing to these difficulties. First, many managers mistakenly view a growth in sales volume as the common

solution to all problems. This paper uncovers the fallacies of this misconception. Second, small business managers are plagued by the inadequacies of their own product cost analyses. Marginal cost pricing decisions and break-even analyses too often provide distorted results. Finally, too often small agribusiness managers fail to make effective use of balance sheet performance standards. Decisions not based on cash flows, working capital, and return-on-investment suffer from this lack of management review.

Sincerely,



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