Diversification: Business Planning Tools to Achieve Your Goals
Chris Laughton – Farm Credit East
Harvest New England Conference
Agenda

- What is “Diversification”
- Pros & Cons
- The Diversification Matrix
- Steps to Diversifying Successfully
- Partial Budgeting
- Examples
- Q&A / Discussion

What is “Diversification”?:

- Adding additional revenue streams to your enterprise
- Can mean:
  - Adding additional products or services
  - Expanding into additional markets
  - …or a combination of both
Example:

- Dairy producer selling milk to a cooperative or processor
  - Adding:
    - Direct-to-consumer milk sales
    - Cheese production for wholesale or retail
    - Maple sap sales
    - Often means moving from producing a commodity to adding a value-added product or new specialty markets

Example:

- Wholesale Fruit Grower
  - Adding:
    - Direct-to-consumer fruit sales
    - Pick-your-own or agri-tourism activities
    - Additional crops
    - Value-added products (i.e. jams & jellies, pies, etc)
Pros:

- Adds new revenue stream
- Hedges market risk
- Can add higher margin sales
- Further leverage existing facilities and production
- Can extend marketing season – improve seasonal cash flow

Cons:

- Adds management complexity
- May require new equipment, facilities, or staff
- Makes accounting more complex
- Can divert attention and capital from core business
- Risks to existing operations
  - Will this affect core business in a negative way?
Enterprise Accounting

- Separates Revenues and Expenses according to divisions, or enterprises, in your business
- Enables profit and loss measurement for each part of your business
- Revenue usually easy; Costs harder
- Labor allocation usually the biggest challenge
- Inventory costing can also be difficult

The Diversification Matrix

<table>
<thead>
<tr>
<th>New Products / Same Markets</th>
<th>New Products / New Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Same Products / Same Markets</td>
<td>Same Products / New Markets</td>
</tr>
</tbody>
</table>

(This is where you are now)
The Diversification Matrix

<table>
<thead>
<tr>
<th>New Products / Same Markets</th>
<th>New Products / New Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Existing Customer Relationships</td>
<td>• Need to Develop New Markets</td>
</tr>
<tr>
<td>• Need to Develop New Products</td>
<td>• Need to Develop New Products</td>
</tr>
<tr>
<td>Same Products / Same Markets</td>
<td>Same Products / New Markets</td>
</tr>
<tr>
<td>• Predictable, Tried-and-True</td>
<td>• Existing Products</td>
</tr>
<tr>
<td></td>
<td>• Need to Develop New Markets</td>
</tr>
</tbody>
</table>

The Diversification Matrix – Dairy Farm Example

<table>
<thead>
<tr>
<th>New Products / Same Markets</th>
<th>New Products / New Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>A2 Milk</td>
<td>Cheese via On-farm Sales</td>
</tr>
<tr>
<td>Organic</td>
<td>Maple Syrup</td>
</tr>
<tr>
<td>Grass-fed</td>
<td></td>
</tr>
<tr>
<td>Same Products / Same Markets</td>
<td>Same Products / New Markets</td>
</tr>
<tr>
<td>Wholesale Milk to Coop</td>
<td>Retail Milk to Consumers</td>
</tr>
</tbody>
</table>
The Diversification Matrix – Orchard Example

<table>
<thead>
<tr>
<th>New Products / Same Markets</th>
<th>New Products / New Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Different Fruits or Cider to Wholesale Markets</td>
<td>New Types of Fruits to Consumers Pies to Retail Markets</td>
</tr>
<tr>
<td>Same Products / Same Markets</td>
<td>Same Products / New Markets</td>
</tr>
<tr>
<td>Wholesale Apples to Packer or Retailer</td>
<td>Retail Apples to Consumers</td>
</tr>
</tbody>
</table>

Steps to Diversifying Successfully

- 1. Self-analysis
- 2. Recognize a need or a market
- 3. Talk and Listen to others – producers, customers
- 4. Regulatory review
- 5. Put appropriate recordkeeping systems in place
  - What are metrics for success?
- 6. Enterprise budget – secure resources
- 7. Be prepared for mistakes – and adjust accordingly
Steps to Diversifying Successfully

1. **Self-analysis** – look at your business and yourself:
   - Do you have unused capacity or resources?
   - Facilities, equipment, *time*?
   - If pursuing retail markets – are you “retail-friendly”?
   - Are you ready to take on an additional venture?
     - Is your existing business operating efficiently?
     - A new venture can consume a lot of management time
     - Can distract from your core business
     - Can divert resources from your core business

Steps to Diversifying Successfully

2. **Recognize a need or a market**
   - Is there an unmet need you can serve?
   - Are there additional markets for your types of products?
   - Is there an additional product line you think you can supply profitably?
Steps to Diversifying Successfully

3. **Talk and Listen to others** – producers, customers
   - Research the competitive market – how to gain market share
   - Why should a customer choose you?
   - **Unique Selling Proposition**
     - Are you: Better?
     - Cheaper?
     - Different?
   - Talk to buyers or consumers to see what they want
   - **What story** are you going to tell with your marketing?

4. **Regulatory review**
   - Value-added products may require additional labeling and permitting
   - Many states have “cottage food laws” allowing production in non-commercial kitchens, but they still typically require inspections and permits. State dept of ag can help
   - Labeling requirements vary.
   - Other permits and zoning bylaws may apply. – particularly if converting a wholesale facility to retail
   - **Labor for processing might not be considered “ag labor”**
   - Review insurance coverages
Steps to Diversifying Successfully

5. **Put appropriate recordkeeping systems in place**
   - Account for revenues and expenses separately from your other activities
   - Allocating shared labor can be a challenge
   - Develop system to track and cost inventory
   - What are the metrics for success? For exiting?

Steps to Diversifying Successfully

6. **Enterprise budget** – secure resources if needed
   - Develop a *realistic* budget for this new venture – cash flow for first 2-3 years
   - Are resources needed? Facilities, equipment, hired labor?
   - Are new skills needed? – can you learn or hire expertise?
   - Does the venture “pencil out?” – is it the best use of time & money?
   - Is there a way to test the market before making a big investment?
   - Cheaper to make mistakes at the drawing board
Steps to Diversifying Successfully

7. Be prepared for mistakes – and adjust accordingly
- Missteps will happen! Accept them but learn from them
- Define goalposts for success
- Consider under what circumstances will you “pull the plug”?  
- Understand that there are things you don’t know

Dairy Farm Scenario

- Farm owns wooded acreage that could be a decent sugarbush
- Hire consultant (experienced maple producer) to evaluate
- Develop marketing plan
- Maybe try selling sap first, before investing in evaporation equip.
- Develop budget for equipment and labor needed – secure capital
- Hire worker with experience in sugaring
- Develop recordkeeping system to allocate labor
- Evaluate and make improvements – or cease
Orchard Scenario

- Wholesale apple orchard with declining returns
- Evaluate and prioritize investment needs:
  - New plantings – new varieties, orchard renovation
  - New retail venture
- Pivot to retail
  - How to market – PYO & stand
  - Budget for needed investment – does it “pencil out”?  
  - How to “enterprise” retail vs. orchard operations

Greenhouse Scenario

- Retail Greenhouse has excess capacity
- Feels their retail sales are hard to increase
- Looking toward wholesale markets for growth
- Develop wholesale buyers and markets
- Budget needed investment
- Pencil out venture
- Crop budgets
Diversification for Risk Management

**Pros:**
- Not “all eggs in one basket” – insurance policy of sorts
- If one venture does poorly another may do well
- Can add additional revenue beyond core business
- Offers an alternative to the commodity roller-coaster

**Cons:**
- Adds management complexity
- Can distract from core business
- Can be hard to achieve economies of scale with multiple ventures

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The Partial Budgeting Process

For any change in your business....

<table>
<thead>
<tr>
<th>Things that <em>increase</em> net income</th>
<th>Things that <em>reduce</em> net income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Added Returns</td>
<td>Reduced Returns</td>
</tr>
<tr>
<td>Reduced Costs</td>
<td>Added Costs</td>
</tr>
</tbody>
</table>
The Partial Budgeting Process

Greenhouse example:

<table>
<thead>
<tr>
<th>Added Returns:</th>
<th>Reduced Returns:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hanging Baskets – Wholesale</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Reduced Costs:</th>
<th>Added Costs:</th>
</tr>
</thead>
<tbody>
<tr>
<td>N/A</td>
<td>Greenhouse Modifications - 5 yr Amortization</td>
</tr>
<tr>
<td></td>
<td>Production Labor</td>
</tr>
<tr>
<td></td>
<td>Materials</td>
</tr>
<tr>
<td></td>
<td>Sales (prep &amp; delivery) Labor</td>
</tr>
</tbody>
</table>

| Increased Net Income: | $25,000 |
| Reduced Net Income:   | $19,500 |

Marginal Return: $5,500
Marginal ROI: 28%

The DIRT-5 of Capital Investments

- **Depreciation**: Depreciation is the cost of the item spread out over its useful life.
- **Interest**: Interest is the cost of financing the item or opportunity cost of investment.
- **Repairs**: Repairs are the anticipated maintenance costs of the item.
- **Taxes**: Taxes could be property taxes, excise taxes, etc.
- **Insurance**: Insurance is the cost of insuring the item.
# The DIRTI-5 of Capital Investments

Farm stand construction – (existing land, construction = $100,000)

<table>
<thead>
<tr>
<th>Item</th>
<th>Annual Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Payments (10-year note) (covers “D + I”)</td>
<td>$13,000</td>
</tr>
<tr>
<td>“R” – Repairs</td>
<td>$2,000</td>
</tr>
<tr>
<td>“T” – Taxes – Marginal increase in property taxes</td>
<td>$2,000</td>
</tr>
<tr>
<td>“I” – Insurance costs</td>
<td>$1,000</td>
</tr>
<tr>
<td><strong>Total Annual Estimated Cost of Building</strong></td>
<td><strong>$18,000</strong></td>
</tr>
</tbody>
</table>

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# How Much Will I Need in Sales?

Adding a Farm Stand – (Marginal Costs)

<table>
<thead>
<tr>
<th>Item</th>
<th>Annual Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>DIRTI-5 Costs of Building</td>
<td>$18,000</td>
</tr>
<tr>
<td>Labor Costs to Staff Store (roughly 2 FTEs)</td>
<td>$75,000</td>
</tr>
<tr>
<td><strong>Subtotal – Margin Needed:</strong></td>
<td><strong>$93,000</strong></td>
</tr>
<tr>
<td>If goods sell @ 40% Margin: Gross Sales Needed:</td>
<td>$232,500</td>
</tr>
<tr>
<td>If open April-December, Sales per week Needed – for break-even:</td>
<td>$5,813</td>
</tr>
</tbody>
</table>
Reasons for Low Gross Margin

- Pricing is too low
- COGS is too high
- Shrink is too high

Shrink is any product grown or made (or purchased) but not able to be sold, due to:
  - Lack of demand / seasonality
  - Poor quality
  - Spoilage
  - Theft
  - Or other factors…

Key Takeaways

- Time and Money are limiting factors for most businesses – use them where they make the most sense!
- Get “better” before “bigger” – optimize your core business first
- Don’t neglect your core business when diversifying
- Plan ahead and research – saves costs later
- Learn from others
- Don’t stretch yourself too thin
Questions?

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