Ag Decision Maker

File C4-10
May 2016
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Understanding Farm Business Transfers

Below are factors you should consider before selecting and developing a business transfer agreement. By carefully evaluating these factors, you increase your chances of successfully creating a two-generation business agreement.

Dynamic Industry

Farming is changing rapidly. Farms are not only getting larger but more specialized. Farms of the future will be producing products for specialized markets and using technologies not yet developed.

Business transfer arrangements serve two roles:

• **Business Transfer Between Generations -** Business transfer arrangements have traditionally been used to transfer the business from one generation to the next. The business agreement is the vehicle for transferring ownership, management, and income between generations. This is extremely important for successful two-generation farming arrangements.

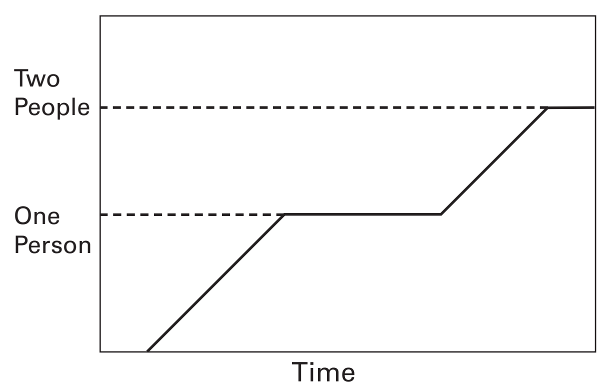
• **Strategic and Business Plans -** Astute managers try to anticipate future directions of the agricultural industry. To take advantage of these new directions, managers must make changes in their businesses. This is called a strategic plan. These business changes (strategic plan) are implemented with the use of a business plan. Put a different way, a strategic plan addresses, "*Where is the business going?*," and the business plan addresses, "*How will the business get there.*" To be successful, the business transfer arrangement should be coordinated with and become an integral part of the overall strategic plan and business plan.

Business Expansion

Most farm businesses were developed to be one-person operations. Farm businesses were expanded until the farmer was fully employed or until management skills were fully utilized. Farmers usually would not consider expanding further by employing full-time hired labor. Farmers would often say, "*I've got about as much as I can handle now.*"

Because most farm businesses are one-person operations, they need to be expanded when a young person returns to the business as shown in Figure 1. The farm must be large enough to utilize the labor and management of both generations and provide sufficient income for them.

Figure 1. Business Growth Curve



The expansion can occur quickly and easily if the young person brings sufficient assets for expansion. However, the younger generation often has limited assets. So, business expansion requires utilizing the older party's assets. If the older party does not have sufficient assets, expansion must occur by borrowing or renting.

After years of reducing business debt, the older party may be thrust back into high debt levels when a young person returns to the farm. The older party should carefully consider whether they want to financially jeopardize the farm business

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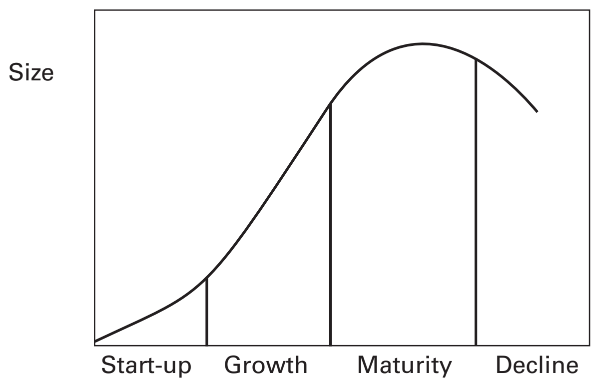
and their retirement income by expanding with borrowed money. Even if the expansion and debt repayment go as planned, it may add stress and worry to the older party's life.

Business Life Cycle

Farm businesses go through a relatively predictable life cycle. The business life cycle often parallels the manager's life cycle as shown in Figure 2. Below are the stages of the business cycle.

Figure 2. Business Life Cycle



• **Start-up -** In this stage the manager attempts to assemble sufficient assets to start a viable business. During this period the fledgling business is vulnerable to failure and income is tight. The manager is often short of capital and know-how but possesses lots of enthusiasm.

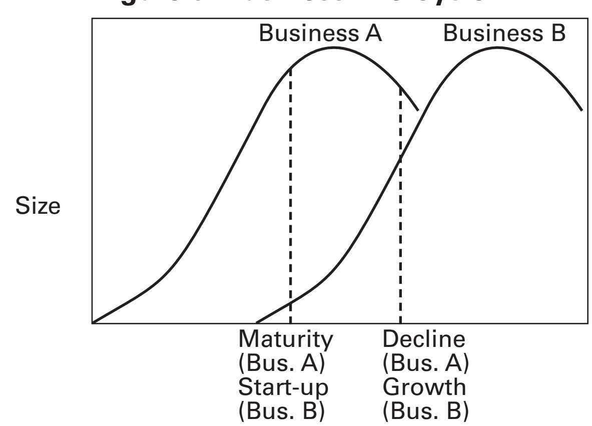
• **Growth -** During this period the business tends to expand rapidly in terms of acres of crops, head of livestock, or number of enterprises. The manager's skills develop. However, lack of capital may limit growth during this period.

• **Maturity -** During the maturity stage the manager has reached full employment and the size of the business stabilizes. This is often a period of good profits and excess capital. Also, the manager often has highly developed management skills, and concentrates on improving efficiency.

• **Decline -** During this period the manager begins to wind-down the business. Rather than making new investments, the manager utilizes current machinery and facilities until retirement. Surplus capital often exists but labor may be in short supply. Non-business goals receive higher priority.

By working together, both the older party and the younger party can complement each other and maintain each of the businesses at a higher level of productivity and income generation. As shown in the Figure 3 chart, when the older party's business is in the maturity stage, the younger party's business is often in the start-up stage. Also, when the older party's business is in the decline stage, the younger party's business is often in the growth stage.

Figure 3. Business Life Cycle



By working together, the older party's business during the maturity and decline stages can provide capital and management skill for the younger party's business during the start-up and growth stages. Likewise, the younger party during the start-up and growth stages can provide labor for the older party's business during the maturity and decline stages.

In addition to having a separate business for each party, the two parties can work together in one multi-family business.

Specialization with Diversification

Working together can allow for specialized management while capturing the synergistic advantages of diversification. An example is an operation with crop production, hog production, and beef production. One manager specializes in crop production, another in hog production, while the third specializes in beef production. Under this arrangement, there is a tendency to expand each enterprise or business to the level that one manager can effectively handle. Synergies are obtained, and the advantages of specialization, as well as diversification, are achieved.

The operation can be organized as one multi-family business with three separate enterprises or three single family and single enterprise businesses.

Some arrangements are designed to coordinate activities. For example, one family manages a farrowing operation that provides feeder pigs to another family that manages a finishing operation. This may be preferable and more profitable than both families co-managing one large farrow-to-finish operation. Under this arrangement, the two operations could be located in different parts of the county, or even different parts of the state.

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Cathann A. Kress, director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.