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Capital Budgeting; A Tool for the Ranch Business Plan

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With the current state of business in the beef industry, now is a good time to begin thinking about the overall business plan of the cow-calf ranch. Profitability is at levels seldom seen, and this provides an opportunity to develop contingency plans for the downside of the market. Strong profits provide a good time for paying off debt and/or making investments that help minimize or eliminate market downside impacts. One tool to help make the decisions that will fulfill a rancher's business plan is capital budgeting.

Capital budgeting is a 5-step process: 1) identifying investment opportunities, 2) determining a method of analysis, 3) securing the necessary information, 4) analyzing the information, and 5) formulating a decision. Capital budgeting not only can help make wise investment choices, but it can help in determining the financing mix of the investment decision. Investments can be financed by one or a combination of three methods; equity (cash or retained earnings), debt, and leasing.

Before initiating a capital budgeting exercise, it is important to develop an overall business plan for the ranch. If the ranch business plan calls for herd reduction, then purchasing or leasing additional land would not be an investment opportunity worth evaluating. A clear definition where the business is heading is needed before one can effectively evaluate any investment opportunity.

The first step in the capital budgeting process is to identify the investment alternatives. If you want to expand pasture acreage, do you buy or lease land? If you want to expand your herd, do you purchase or raise replacement heifers? The investment opportunities can fall in to any or a combination of three categories; depreciable assets (purchasing/leasing a tractor), cost-reducing technologies (Using automatic feeders to reduce labor hours), and revenue-increasing investments (Expansion of the herd or purchase of a stock portfolio).

Once the investment opportunities are identified, the second step is to determine the method to analyze the opportunities. There are five methods for analyzing investment opportunities. These are the simple rate-of-return, the payback period, the net present value, the internal rate-of-return, and the modified internal rate of return. The last three options are computationally intensive; however they do have one distinct advantage over the first two options in that they account for the time value of money. That is, the impact time has on what a dollar in some future period is worth today.

In the case of the simple rate of return, the information you need to gather is the amount of the initial investment for each alternative and the average added income generated by each investment over its expected lifespan. Average added income is divided by the initial investment to determine the simple rate-of-return. For the payback period, you need to know the initial investment of each opportunity and the expected added annual income generated from each investment until that investment is paid in full.

These two methods will rank investment opportunities by which one has the highest rate-of-return or the shortest payback period. As stated earlier, these two methods do not account for time in examining an investment. This will be particularly problematic when there are investment opportunities with different expected life spans. For instance, comparing a tractor purchase with investment in more land would not be comparable since the land is a much longer term asset.

After a capital budgeting analysis has been completed and the opportunities examined for their profit potential, the final steps of the business planning can be completed, and the business plan can be implemented. Using such capital budgeting tools can make the difference in profitability over the course of several years. Taking the opportunity to implement a sound business plan with good financial decisions while times are good can make t