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Getting the Green Light on an Added Value Venture

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Is your agricultural organization considering a start-up venture that can add value to the company's business operations?

You're not alone if you are. Over the past 10 years, hundreds of agricultural businesses across the United States have ventured into value-added operations, from food-producing enterprises to renewable fuel operations derived from soybeans and corn. Some have been successful, some have not.

As a major provider of financial solutions to rural America, CoBank has looked at many value-added ventures in the last decade. We've been involved in financing ethanol and diesel, pasta, corn-milling, turkey- and beef-processing plants. We know what steps must be taken to ensure that these value-added ventures succeed. Using ethanol as an example, here is a road map to launching an added-value venture.

The First Steps

The first step in determining whether the project has merit involves the added-value equation, or balancing the elements of the proposed venture. To calculate the equation, a lender lines up the project's strengths, weaknesses and uncertainties in a column format. In order for the project to proceed, its strengths minus its weaknesses must be greater than its uncertainties. If that equation holds true, the project can proceed to the next step -- attracting financing.

Lenders look at five credit factors:

- Capacity -- the repayment capability.
- Capital -- the financial condition or the balance sheet of the business.
- Character -- the management.
- Collateral -- the quality and value of the secondary repayment source. The

collateral in most added-value propositions may only be used for the designated purpose and therefore, is considered a special-use asset.

- Conditions -- the purpose, amount and requirements to operate the business. Lenders look at this credit factor from two perspectives: the external and the internal. External conditions cover such areas as the economy, whether there is enough production in the area to support the venture, demand for the output, and government regulations. Internal conditions include the loan covenants and the business's ability to meet a minimum set of financial standards.

Start-Up Stage: A Step at a Time

Once these credit factors are known, you can move to the start-up stage for your added-value project. You must follow each stage in order. If you jump ahead, you'll have problems and you'll end up backtracking.

You should start with an initial meeting, which is the official formation of the venture. Several questions must be answered at this meeting:

- Is there a group of producers willing to invest in, or to be part of, this business?
- If so, have you formed your organization? Will it be structured as a not-for-profit organization, a co-op, a C or S corporation, a limited liability corporation (LLC), or maybe the new Wyoming Co-op?
- Have you secured seed money? This means more than just applying for a state or federal grant or finding an economic development person to do some work for you. It means the owners must make an initial cash investment that the venture can apply towards research and development.

Moving on to a Feasibility Study and a Business Plan

Once the seed money is secure, you must conduct a feasibility study. This outlines the global picture, which doesn't necessarily refer to an international scenario. It may be local, regional or national, depending on your targeted market and the proximity of your competition. The feasibility study addresses such issues as how your organization will fit into the global picture and what you must do to be competitive. There are five components of a feasibility study:

- Technology
- Management
- Markets
- Economic conditions
- Your financial projections

<u>Start-up stages for added-value ventures</u>	
✓	Hold initial meeting
✓	Form organization
✓	Secure seed money
✓	Conduct feasibility study:
	- Economic
	- Market
	- Technical
	- Financial
	- Management
✓	Develop business plan:
	- Operation plan
	- Marketing plan
	- Management plan
	- Financial plan
✓	Develop prospectus
✓	Hold membership drive
✓	Hold annual meeting
✓	Finance project
✓	Hire manager
✓	Construct project
✓	Begin operation

These five components are basically what USDA requires for an analysis for its Business and Industry Loan Guarantee Program.

The feasibility study addresses supply and demand characteristics. It discusses the importance of a steady supply of raw materials and reviews market share, pricing trends and sensitivities. It outlines your cost competitiveness, and determines if you will be a high-cost or a low-cost producer. It answers such questions as: Can you get into the market? Can you enter into contracts? Are your financial projections realistic? It also outlines scenarios for worst-case, best-case and what-if situations. Finally, it details your capitalization structure.

The feasibility study is one of the most important steps you can take on your way to a successful added-value venture. Yet, some organizations that are willing to spend \$15 million on a new plant skip this step because they are reluctant to spend the \$20,000 to \$40,000 required for a feasibility study. Still others rely on people who will gain from their involvement in the added-value venture to conduct their feasibility studies. Instead, use unbiased, third party assistance; an impartial feasibility study should be your goal.

Once the feasibility study is done and you've outlined the global picture, you will know against whom you're competing. For example, if you're building a plant in Missouri, you may be competing with southern Minnesota, western Iowa or South Dakota. How will your operation fit into that region?

To answer that question, you must move to the next step — the business plan.

On to the Business Plan

The business plan offers a different point of view from the global perspective of the feasibility study. It extrapolates the information to the local level. The business plan provides details about the operation, the market, management and the organization's financials. It also addresses how to create a profitable income stream for investors.

The business plan covers:

- **Markets.** This will tell you who you'll be selling to, how much of the market share you want, and the quantity of product you can expect to sell. That "who" is a critical element. It covers your customers and competitors.
- **Management.** This details the players, and consists of profiles on the board members as well as the general manager, who will run the daily operations.
- **Money.** This covers capital and cash flow.

Included in the business plan is the marketing element. That marketing plan should outline how you'll create wealth for the investors and owners. It should provide details on your customer base and on the competition. It should include specific tactics for executing the marketing strategy. It should also include whether there is a distribution channel in place. You need to know if there are existing railroads you can use to move the ethanol or if you will need to transport it by truck or barge.

A business plan also answers such questions as: Are there alliances or marketing firms you can partner with? Are there marketing contracts you can enter into? A business plan also should provide for market contingencies or backups. Backup plans should not only cover markets but also the operations. One contingency that should always be covered is when to end your investment. For example, if you've been losing money for three years, you need to know if it's time to pull the plug.

Delving into the Operating Plan

One management element of the business plan is the operating plan. For this, you'll need to look at who's going to build the facilities and select the engineers and technology experts. Today's ethanol industry is a mature one, which means there are proven engineers and builders who have successfully built and run ethanol plants.

Selecting management is an important component of the operating plan. Management is a key to the feasibility of an ethanol or biomass venture. Therefore, you need to know which individuals have the expertise you need. This is a particularly big issue in ethanol when you consider all the ethanol plants being discussed in the Corn Belt.

Before you begin your management selection, you must answer some basic questions. Are you going to do a broad-based search for a manager? At what stage will you employ a manager? Hiring the management during the early stages of start-up could be beneficial to help implement the plans and membership drives -- if you have the right seed money to support him or her. You must first determine the compensation package. And that package must compare favorably with what your competition is offering. You also need to decide if you're willing to reward your management based upon long-term results.

Focusing on Financials

After you've selected your manager, start looking at the financial or money elements. The financials in the business plan basically focus on three key items: return on investment, equity strategy and debt strategy. We also add a fourth element: guarantees. In most added-value ventures, looking at a USDA Business and Industry Loan guarantee is an important element for future success as it minimizes some of the future risk in case something should happen with your business.

What is the risk of return, and what's the right return on investment? The right return is specific to your organization and depends on your venture's goals. A common expected rate of return is 15%. That figure is derived by assuming the investor will take money out of his existing business, or farmer operation, to invest in an added-value project, such as ethanol. If he invests that money in the stock market, he can expect an average 10 percent return. On the other hand, if that investor wanted to get into ethanol, he could also invest the money in Archer Daniels Midland (ADM) or Williams Energy stock. Therefore, if he's going to invest in your business, his return should be greater than the stock market's average 10 percent return.

On the other hand, if you would like to bring in venture capital for your added-value project, those investors will look for a 20 to 25 percent return. Yes, venture capital is coming back to agriculture as a result of the beating it's taken in the technology sector in recent years.

Or, your venture may just need to have a return high enough to cover the additional expense that you're going to incur to stay operational.

Risk and Return

When you're determining the right rate return on investment for your operation, you must make sure you don't include the return from the sale of your raw material. If you're going to deliver corn to the ethanol plant, that corn has a market price. An increase in the market price will have a negative effect on your business. It's fine to take your stock appreciation and your dividend and add that back to just the corn bushels delivered – there's your premium. But if you build your premium upfront, the chance of your business showing a profit or paying a dividend is unlikely.

There have been many instances in which an ethanol plant has increased the basis of corn in an area by 10 cents or more. Obviously, this is beneficial to the farmers who did not invest in the value-added project, because they're receiving a higher corn price with no additional investment. However, while the producer members of the co-op are also getting a higher price for their corn, their return on investment from the ethanol plant is lower than expected. Therefore, you don't want to raise the market for the price of your commodity. What you want to do is increase the return on your investment.

Finally, if you're considering this added-value venture because it provides the ability to stay on the farm, you'll need to look at the project differently. Basically, you're going to break even or even lose some money.

How Much Capital?

Moving forward in the money segment of your business plan, there are other items to consider when financing or planning a value-added project. Lenders look at financing the entire business and not just different components of the business. The entire business has three primary components to consider: the total cost of plant, property and equipment; start-up expenses from the planning stage through full capacity; and beginning working capital.

Groups often wonder how much capital they need to raise. Unless your feasibility study outlines differently, you should plan on raising between 40 percent and 60 percent through your membership. However, for some projects, it may be necessary to raise 125 percent of the total needs. The extra 25 percent is necessary to help carry the new venture as it begins to establish its brand.

The final monetary component of a comprehensive business plan is the cash flow, or capacity.

Capacity depends on several factors:

- What are the economic conditions?
- What does the competitive marketplace look like?
- What's the need or demand for the goods and services sold?
- Are there, or are there going to be, technology changes?
- What's the government going to do?
- What's the cycle of the industry?
- And, are there any environmental effects?

As we look at ethanol today, every one of these components is critical in determining whether or not to enter into a biomass or ethanol project. In today's economy, ethanol is only worth 95 cents to \$1 per gallon. This illustrates why producing competitively is so important. As more and more plants come on-line, and as existing plants expand, production increases. So, in the long run, it will be the least-cost provider who will survive these periods.

Basically, the need for goods and services is the same thing as supply and demand. The big questions in ethanol are, "Will California continue to use MTBEs? Or will it have to use ethanol? If California has to use ethanol, will a foreign country produce it, or will it buy it here in the United States from U.S. production?"

Some of the technology changes that should be reviewed, if you're considering starting an ethanol plant today, are:

- How fuel sales will impact the industry and the future of ethanol.
- What the government will do when the incentives run out.
- Whether or not there will be any environmental threats that could change ethanol.

Final Steps

Once the in-depth steps of the feasibility study and business plan are completed, you need to find an attorney who will prepare a prospectus. This statement outlines the main features of the new business, and is necessary whenever a company issues stock. Its primary objective is to disclose all risks associated with that investment.

After the prospectus has been prepared, you can begin your membership drive. Then you can hold your annual meeting.

You should not seek financing for the project until all these stages are complete. Groups often feel they need to talk to a lender about financing request before completing the feasibility study. However, a good and true feasibility study will outline the capitalization or equity you need to raise to be competitive.

Once the financing is in place, you may need to hire a manager, if you have not done so already. Hiring a manager is one step you can do before the others, as long as you have enough seed money to pay him or her.

What a co-op needs to be a player in capital markets:

- **Strategic vision and a sound business plan -- Where you're going, how you're going to get there and how it compares with past performance.**
- **Financial size.**
- **Consistent financial performance. This provides any organization with flexibility and alternatives. It positions an organization as an attractive business partner. All of which are key to increasing your financial capacity.**
- **Appropriate management skill set.**
- **Capable board and management that understand governance implications, exit strategies of debt/equity tools.**
- **Established regional or national brands help.**

Finally, you will construct your plant and begin the operation.

Keys to Success

During the past decade of looking at value-added ventures, CoBank has come up with what we feel are the three most important keys to success -- leadership, communication and capacity.

Leadership should be local. It should consist of local producers who are willing to put their reputations and their money at risk. Leadership should not come from engineering firms, marketing companies or economic developers. In addition, an excellent management team that's capable of developing and implementing sound business and marketing plans is critical, as is a well-thought-out risk management plan.

Successful added-value ventures also are well capitalized and able to cushion for unplanned adversities. They have 40 percent to 60 percent equity that's been raised by their investors.

The final essential key to success is communication. This means frequent, open and honest communication with the investors. It means communication that focuses on the value of their stock or their investment, not just the production statistics. And it means communication that is developed from the perspective of an added-value processor, not a commodity or livestock producer.

There's an old saying, "Nothing ventured, nothing gained." Following all of these steps carefully, accurately and in proper order can make all difference in determining whether your added-value venture achieves success.

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