Options for Financing Agricultural Value-Adding Businesses

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Introduction

Financing can make all the difference between success and failure in business. The different dimensions of financing contribute to its effects on the ability of businesses to succeed. For example, while inadequate financing has been identified as a major contributor to business failure, the nature of financing and its timeliness both have significant impact on the success probability of a firm. For most new businesses, the nature and structure of financing not only affects the firm's ability to seize opportunities and grow, but its ability to attract and retain other resources necessary for its long-term sustainability and profitability.

Interest in value-adding initiatives by agricultural producers has been increasing in recent years. For the purpose of this document, agricultural value-adding initiatives are those that reward producers for performing any activity that has *traditionally* been performed at another stage further down the supply chain, or for performing activities that are *discovered to be necessary* but had never been performed in the supply chain. The reward from value-adding initiatives may be in the form of an increase the net price received and/or growth in the value of initial investment made to extract the reward.

Some value-adding initiatives require significant capital outlays from producers. For example, ethanol projects require several hundreds of thousand dollars in investment in distillery equipment and other hard assets. In most cases, producers have focused on traditional financing instruments in participating in these value-adding ventures, i.e., from their savings or by borrowing. Thus, they have not taken full advantage of all the financing instruments available in the marketplace. With the changes in the value-adding opportunities in the industry, it is imperative that its entrepreneurs access the full range of financing opportunities.

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The purpose of this paper, therefore, is to provide a typology and description of the various financing instruments and help producers understand how they may be used to facilitate their value-adding initiatives. There is a strong relationship between the organizational type that is developed to seize value-adding opportunities and the range of available financing options. To that end, this paper will also present a description of the various types of organizations, focusing on their effect on ability to use different financing instruments. While the information presented in this document is available in bits and pieces and in different forms at different places, we have attempted to provide a "one-stop shopping" experience for producers and ranchers seeking to find out how to take advantage of innovative financing options for their value-adding initiatives.

Business Stage and Financing

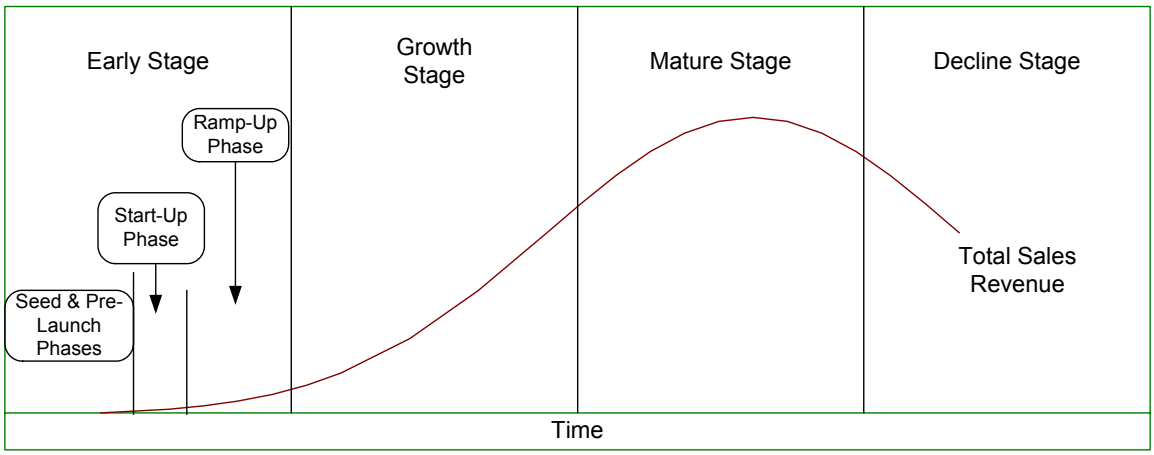
Businesses go through life cycles (Figure 1) and each life cycles creates it own financing issues and concerns. We can divide the life cycle of a business into four broad segments: early stage, growth stage, mature stage and decline stage. A company in the early stage will present a higher risk regardless of the financing vehicle relative to a company in the mature stage. For one, the latter has assets and a known cash flow trend that allows financiers to assess risk profile using historical data and projecting on well-defined assumptions about management, markets and customers.

Although each of the other stages requires careful attention in undertaking financing decisions, we limit our discussion to early stage companies because most value-adding businesses requiring financing will be in this stage. The early stage may be divided into four different phases: seed phase, pre-launch phase, start-up phase and ramp-up phase. The importance of focusing on these distinct phases is to enhance producer-investors' understanding of the business characteristics at the different phases so that they can assess the associated risks as well as ask the pertinent questions necessary to enhance their confidence in their investment decisions. The seed phase, also known as the pre-commercialization stage, is really the proof-of-concept stage when an idea is being tested for its credibility as a product or service. At this stage, the basic research has been completed but the commercial capabilities are not yet proven. In most cases, there is no

formal company formed at the seed stage because the commercial capabilities are not proven.

During the seed stage, the entrepreneur generally requires small amounts of financing to conduct further research and development activities to prove the concept by developing prototypes, evaluating market potential, protecting intellectual property, and developing business plans. The entrepreneur may have to complete a comprehensive market testing using various focus groups, as well as conduct comprehensive industry analysis and market feasibility study to ensure that the product or service it is planning to present has the credibility to gain and sustain market share in the face of incumbent competitors.

Figure 1: Stages in the Evolution of the Firm



The pre-launch phase is typically characterized by activities that have no immediate direct connection to generating revenues. For example, the entrepreneur may need to acquire or secure access to a piece of land to build production facilities or make arrangements to rent a building for such activities. There may also be need for the acquisition of equipment in preparation for production and the preparation of hiring management, production and other employees. This is also the stage where the company is undertaking regulatory requirements such as environmental impact assessments to ensure its activities are in compliance with local, state and federal regulations as well as securing the appropriate licenses from the different levels of government. Many companies will also complete the business structure during the pre-launch stage, working with attorneys to determine the best business form for the venture. The assembled

management needs to also initiate the development of distribution and marketing relationships along the business' supply chain in anticipation of the launch.

The start-up phase, also known as the launch stage, is characterized by hiring the appropriate employees to undertake production, marketing and other business functions within the company. The firm focuses on establishing itself in its marketplace by developing customers, building a presence through trade shows and other marketing and promotion activities. The start-up stage allows the firm to develop credible traction in the marketplace without unduly attracting attention from incumbent competitors (unless it is positioned to successfully compete at this stage). During the start-up stage, production is under way, marketing is developing product and service tools and building customers, sale orders are coming in and the company is sending out invoices.[2]

The ramp-up phase is the final phase in the early stage and is characterized by the company ramping up production and sales. At this stage, the company's business model has been validated by the target market, exemplified by the number customers and the volume of products being purchased. Its revenue model is also validated exemplified by the fact that revenues are approaching break-even and profitability is only a matter of time.[3] Therefore, ramping up – increasing sales and revenues – is a clear indication of success in the early stage. From a strategic perspective, the ability to accelerate the ramp-up momentum into growth catapults the company into its growth stage where it established profitability and it is able to finance all its operations from internal resources.

Types and Sources of Financing

There are two major sources of financing: debt and equity. It is possible for some entrepreneurs to secure governments grants to finance certain aspects of their businesses or as incentives to locate in certain communities and/or encourage entrepreneurial activities in particular industries. However, because these government grants are sporadic and subject to termination and change to meet particular budgetary and/or policy

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[2] Prior to successfully selling products and generating credible invoices, the company is technically still in the pre-launch stage. Therefore, customers and invoices make the difference between the pre-launch and start-up stages even if production is taking place.

[3] It is expected that a faulty business and revenue model will become apparent prior to the ramp-up stage and the company will fail before its ramp-up stage is over.

initiatives, we have chosen to focus on non-government sources of business financing. These include individuals, financial institutions, venture capital firms and others who provide either equity or debt financing to the company.

Equity Financing

We define equity financing as the contribution of resources to the company in exchange for an ownership stake. The resources may be cash or non-cash; they may be tangible or intangible. Equity capital is permanently invested in the company and does not have to be repaid by the company. The ownership stake resulting from equity investments allows the investor to share in the company's profits when dividends are distributed as well as in the growth of the company's market value. Equity stake in a company can be in the form of common or preferred stock. Common stockholders can vote while preferred stockholders generally cannot, but common stockholders are last in line to the company's assets in case of financial problems or bankruptcy. Preferred stockholders also get paid a stated dividend before common stockholders are paid any dividends.

Companies may establish different classes of common stock to control voting rights among common stockholders. For example, while the majority of shareholders will have one vote per share, a small group of common stockholders may hold a class of common shares that allows them 10 votes per share. Similarly, companies may use different types of preferred shares, defined by the option underlying the preferential terms. The three commonly used options are: (1) callable option which permits the company to repurchase the stock under certain predefined conditions; (2) redeemable option which allows the shareholder to sell to the company under predefined conditions; and (3) convertible option which allows the shareholder to convert the preferred shares to common shares under predefined conditions and rules.

Debt Financing

Debt financing involves the borrowing of resources from creditors with the explicit stipulation of repayment of the principal and interest at a specified future time.

Like equity financing, the resources borrowed can be tangible or non-tangible; cash or non-cash. For the creditors (those lending the resources to the company), the reward for providing the debt financing is the interest on the principal. There are two main types of debt financing: secured and unsecured. Secured debt has collateral (a tangible valuable asset) against it while an unsecured debt does not have any collateral, or more appropriately is collateralized will the creditworthiness of the borrower and the lender's trust in the borrower's ability to repay. Therefore, unsecured debt is often obtained from sources that have a strong affinity, or are familiar with the borrower. Debt financing or loans may also be short-term or long-term in their repayment schedules. Generally, short-term debt is used to finance current activities such as operations while long-term debt is used to finance assets such as buildings and equipment.

Other debt instruments are warrants, leases and bonds. A warrant is a security that grants to its owner the right to buy a stock from the issuer at a pre-determined (exercise) price at a future date with a specified expiration date. In general, the warrant expires if it is not exercised by the expiration date. Warrants are long-term financing instruments, and thus have value relative to the price of the stock purchase right they represent. If the stock price is expected to rise, then the warrant holder can exercise the right to purchase at the pre-determined price before the warrants expire, thereby profiting from the price spread if it is above the pre-determined price. On the other hand, if the price of the stock is below, or falls below the pre-determined price before expiration, then the warrant becomes worthless. When a warrant is exercised, the shares come from the issuing company and not from the marketplace. Warrants are a useful by for early-stage companies seeking to reduce investor resistance by providing some downside risks "insurance" while offering an opportunity to benefit from the company's growth.

Technically, a lease is a legal agreement between two parties that specifies the terms and conditions for the rental use of a tangible resource, such as a building, equipment, vehicles, etc. The agreement is usually between the company and a leasing or financing organization and not directly between the company and the organization providing the leased resource. What usually happens in a leasing agreement is that the leasing company (lessor) pays the vendor for the asset and then "rents" it to the lessee under clearly defined terms. Once the lease term has expired and providing the lessee has

performed their obligations as defined under the lease terms, there are generally three options: return the asset to the lessor in good working condition; with the lessor's consent, renew the lease for another specific time period; or purchase the asset for a pre-determined amount, a negotiated amount or the fair market value at that time. A lease may offer some special advantages to a company, such as not tying up capital in a depreciating asset, incurring fixed regular payments over time instead of one lump payment upfront, potential tax advantage, and minimizing the risk of obsolescence. It may also free up collateral for use in securing other financing.

Bonds may be issued by a company to raise financing for particular activities. Bonds are different from other debt financing instruments because the issuing entity specifies the interest rate (or coupon) and when the issuing entity will pay back the principal (maturity date). Also, the issuing entity does not have to make any payments on the principal (and may not make any interest payments) until the specified maturity date. When a bond is issued, the price one pays to acquire it is known as its "face value." When a company issues a bond, however, it guarantees to pay back the principal (the face value) plus interest. From a financing perspective, issuing a bond offers the company the opportunity to access financing without having to pay back until it has successfully applied the funds. The risk for the investor is that the company can go bankrupt before the maturity date, in which case bond holders are in line ahead of stockholders.

Sources of Financing

Table 1 illustrates the potential sources of different financing options described in the foregoing section. The founders (entrepreneurs) of the company are also its first investors, providing both cash to which is used to fund their equity (usually common shares) in the company. They may also provide loans to the company from time to time and transform some of those loans into preferred stock and/or common stock. The first port of call for financing after entrepreneurs have exhausted their own resources is friends and family. The cash resources from family and friends have often been referred to as love money. Like the investments of the entrepreneurs themselves, the investments from friends and family often come in as equity financing or unsecured loans. It is

possible for the entrepreneurs to develop both common and preferred share status for their friends and family during the early stages of the business. They may also issue them warrants to provide them with an opportunity to ride the growth while minimizing the downside risks.[4]

Table 1: Types of Early Stage Financing by their Primary Sources

Source	Financing Type					
	Debt				Equity	
	Loans	Warrants	Bonds	Lease	Common Stock	Preferred Stock
Founders	•				•	•
Friends & Family	•	•			•	•
Business Angels	•	•			•	•
Community Development Financing	•					
Business Associates	•	•		•	•	•
Venture Capitalist	•	•			•	•
Financial Institutions	•	•	•		•	
Financing Companies	•	•	•	•	•	
Government	•		•		•	
Public			•		•	

Business angels are high net worth individuals within the community whose strong business objectives are tempered with an equally strong desire to support up and coming entrepreneurs. They are often willing to provide financing during the early stages in exchange for equity if the value proposition of the business is compelling and resonates with their own values. Business angels may sometimes provide loans to and purchase warrants from an early-stage company as well as offer management and technical expertise to help the company's management and technical staff navigate the market place or product scope. Business angels are generally difficult to find because they do not advertise their activities and usually maintain low profiles. However, they can offer tremendous tangible and intangible resources if they are found and engaged.

The entrepreneurs' associates, made up of employees, suppliers and customers, are another equity financing source. Depending on the business and its products/services,

[4] Family and friends can have a higher cost than other investors because of their emotional dimensions. For this reason, it is strongly recommended that entrepreneurs ensure that their family and friends understand the risks involved with the financing.

these associates may want to ride the upside growth opportunity by providing financing to the company and taking equity positions in exchange. This tends to work best for companies that have already proven their business model and have suppliers or customers who believe their services/products offer it significant growing and sustainable competitive advantage. Thus, it is a useful source for companies that are in the ramp-up phase in their development. Associates have access to the same financing vehicles available to business angels and family and friends. Supplier associates, however, can also provide access to leases to enhance the company's access to equipment, real estate and other resources.

Venture capital provides companies with committed, risk-sharing capital, usually in return for an equity position in the firm. However, venture capitalists are usually only interested in high growth companies, e.g., in excess of 20 percent. Venture capitalists usually invest managerial and technical expertise in the companies they make financial investment in, and often demand positions on its board. They also tend to negotiate significantly higher equity stakes in comparison to financial and non-financial investments from other sources. Venture capital can be used at any stage of the company, but most of them tend to like the early phase so they can ride the fastest growth segment of the company's life cycle.

Venture capital may originate from private institutional sources or from government-licensed companies. Private venture capital is often organized by pooling the money of rich investors into a single fund to provide a critical mass of capital to undertake multiple projects, reduce their risks and increase the probability of generating a significant return on investment. On the other hand, government venture capital is indirect venture capital that results from licensing special firms, such as the Small Business Investment Companies (SBICs), to provide venture capital to small businesses with government guarantees. The SBICs are licensed by the federal government's Small Business Administration (SBA) but they use their own venture capital, plus other venture capital funds acquired with SBA guarantees, to make venture capital investments in businesses that meet the SBA definition of small business.

In general, venture capitalists tend to be organized by industry as well as deal size. For example, the SBICs focus on small companies and therefore small financing deals while some private venture capital funds will not consider deals less than a few million dollars. There are also venture capital firms that focus almost entirely on particular industries because of their need to bring management and technical expertise to the company in addition to cash. For these reasons, it is important to ensure that a venture capital firm fits the company's profile before initiating contact in order to minimize time and other costs.

In addition to government agencies such as SBA providing guarantees to financing sources for certain companies, governments may also participate by purchasing corporate bonds and stocks. For many early stage companies, government also participates with grants which are financial offerings that do not have to be repaid but the companies receiving them must meet certain specific criteria. For example, ethanol plants may qualify for a certain government grant if they are owned by certain class of citizens (e.g., grain producers) whose agricultural products are used as inputs in the distillation process.

The general public can participate directly in a company through purchasing its bonds or its stock. Companies can only make their stock available to the general public if they make an initial public offering (IPO), file the necessary regulatory documentation with the Securities and Exchange Commission (SEC) and register on a stock exchange. The IPO process involves hiring an underwriter (usually a brokerage firm or a bank) coordinate the preparation of all the required information and documents, including securing the services of a certified public accounting firm to conduct the necessary due diligence as well as prepare the prospectus or offering documents. The underwriter will also file the appropriate documents with the SEC and position the company to register on a recognized stock exchange as well as preparing it to sell its stock to the general public. Although the process can be very expensive, an IPO does not guarantee that the required funds will be secured. For this reason, it is important for the early stage company to assess its business and revenue models carefully to ensure its success in an IPO as a financing vehicle. Good underwriters will usually assess the firm's readiness before initiating the IPO process.

Another approach to "going public", but only limited to the company's community of affiliation (customers, suppliers, neighbors, etc.) is through a direct public offering (DPO). This approach allows the company to issue and sell shares directly to the community members without using an exchange, and therefore not needing to satisfy the regulatory requirements of an IPO. However, the investors are not able to trade it publicly unless the company is already traded on the stock market. They can, however, trade internally among themselves. A company using DPO controls its shareowner mix by targeting the specific affinity groups that place the highest value on its products and future prospects. DPO is particularly important to companies that have strong ethical or other values and do not want to be pressured to compromise these values in their business operations. They are useful after the start-up phase since that is the time when customers and suppliers are established and the potential role of the company in the success of customers, suppliers, employees and others are becoming clearer and compelling. They have the singular advantage of strengthening affine relationships, but this advantage could also be a source of disadvantage when such close investors become impatient. As an alternative to IPO, DPO tends to be less expensive but does not usually raise as much money as an IPO.

Financial institutions (banks, trust companies, etc.) and financing organizations (insurance companies, pension funds, institutional investors, underwriters, etc.) are the principal source of secured loans in addition to providing other financing vehicles such as bonds, warrants, leases as well as equity. They can help a company issue bonds or facilitate their IPO process. But for most early stage companies, these institutions and organizations are primarily sources of long-term and short-term loans to acquire facilities and finance day-to-day operations until cash flow levels are high enough to provide such financing.

Long-term loans may be classified into two groups: senior term debt and subordinate term debt or mezzanine financing. Senior term debt, provided by financial institutions and financing organizations is collateralized by a first lien on the current and long-term assets of the company. Senior debt lenders usually consider the company's earnings before interest, taxes, depreciation and amortization (EBITDA) as a proxy for the company's cash flow, and will lend up to a certain multiple of EBITDA. This

multiple varies by industries and is dependent on both the company's financial health and competitive position. When senior debt is to be repaid from cash flow, it is not unusual for the lender to use covenants to exert control over the borrower in order to protect the loan. These covenants are designed to keep the company within certain financial parameters, e.g., the lender may want the company to stay below a certain ratio of debt to cash flow and to stay above a certain ratio of cash flow to interest. Breaking a covenant may put the company in default and lead to a demand of the loan.

Creditors with subordinated debt are paid only after senior debt is retired in full. Subordinated debt is therefore more risky than senior debt, and as a result it extracts a higher interest rate (anywhere from two to eight percentage points more than senior debt). Subordinated debt financing is generally provided by insurance companies, finance companies and subordinated debt funds. It may also be raised with public offerings of high-yielding bonds sold to institutional investors such as insurance companies and pension funds. Governments or other public entities may also provide subordinated debt, usually on much better terms than capital market sources.

Secured short-term loans are usually collateralized with accounts receivable or inventory. They tend to extract higher interest rates and take many more forms than long-term loans. At the minimum, four types of secured short-term loans can be identified: demand loan, line of credit, supplier credit and account receivable loans. Demand loan usually carries a floating rate of interest (it varies according to the prime rate) and is characterized by the fact that it must be repaid in full when the creditor demands it. Line of credit, also called operating loan, provides a business with the money to cover day-to-day expenses. As funds are used, the established credit line is reduced and it is replenished by making payments towards what has been used. There is a limit to the amount the company can draw on and interest is calculated only on the amount outstanding. Supplier credit is when a company's suppliers provide products or services and allow the company to pay for them with interest after a specified time period. Some suppliers will offer discounts if the loans are paid off before they are due.

Often early stage companies do not have the resources to collateralize their loans, making it difficult for them to have access to such financing vehicles. Sometimes, the

entrepreneurs' personal assets will be used as collateral for the loans they raise for their companies. However, there are private and government guarantees that can help them over the collateral hurdle by reducing the lender's risks through an agreement to pay or all part of the loan in case of default. Government guarantees are often made available to companies that meet specific public policy objectives such as increasing trade in certain industries, increasing employment in certain locations and promoting innovation by certain citizens. Thus, government guarantees are not de facto available to any entrepreneur who is seeking a loan but does not have the requisite collateral. The Small Business Administration (SBA) may guarantee term loans from a bank or commercial lending institution of up to 10 years by up to 80 percent of the loan principal. While the SBA-guaranteed loans are comparatively inexpensive, they can be difficult to access because of the application procedures and requirement hurdles. The maximum allowed interest rates range from highs of prime plus 4.75 percentage points to prime plus 2.75 percentage points, although lenders may charge less. Another advantage of SBA-guaranteed loans, if they can be accessed is that the lending organization cannot charge fees (known as commitment fees) for agreeing to make a loan, or repayment fees, which means the effective rates for SBA loans may be, in some instances, superior to those for conventional loans. The SBA guarantees $50,000 to $750,000 of loan principal.

Rural Business and Industry (B&I) Program at USDA provides loan guarantees specifically for cooperatives undertaking value-adding initiatives. The guarantees are capped at $40,000 for value-adding cooperatives located in rural areas and up to $25,000 for those headquartered in metropolitan areas, provided they are within 80 miles of the agricultural producers involved in the operation.

To avoid the hurdles of government guaranteed loans, entrepreneurs can seek private guarantees from individuals or organizations that are prepared to take the risk. Private guarantors are often people, such as business angels, who have already made equity investments in the company but are unwilling to make further equity investments or understand the company's business model and are willing to take a risk on them. The guarantor does not have to turn over any funds unless there is a default. This makes guaranteeing a less risky proposition than equity or debt financing, and therefore, sometimes easier to secure. At the end of the guarantee period, it is expected that the

company will be able to raise equity capital to pay off the guaranteed loan and be in a position to secure any necessary loans on its own merit.

There are certain loans that are specially directed towards certain purchases and have the backing of legislation. One of such is the 504 Loan Program which was established in 1980 to provide long-term, fixed-rate financing for major fixed assets, such as real estate, facilities construction or expansion, or other fixed-asset needs. Certified Development Companies (CDCs) are responsible for making 504 loans and their interest rates are tied to an increment above the current market rate for five- and 10-year U.S. Treasury issues. CDCs fees are approximately 3 percent of the loan amount and borrowers are allowed to finance the fee through the loan. The loan is collateralized by the project assets and personal guarantees from the principal owners and the range of funds is typically $50,000 to $750,000 for up to 10 years on equipment and 20 years for real estate but it is possible to borrow up to $1 million under certain circumstances. Accessing 504 loans and other legislated loans can be cumbersome because of the application requirements and the number of parties often involved in the transaction.

Other such programs are available at the state level. For example, Iowa State's LIFT (Linked Investment For Tomorrow) program, offered through the State of Iowa Treasurer's Office, allows many small businesses to apply for loans at interest rates substantially less than current market rates. It targets, among other segments, minority- and women-owned businesses as well as value-adding agricultural and horticultural businesses. Similarly, Minnesota State passed a 1994 legislation establishing the Value-Added Stock Loan Program to provide loans for producers and ranchers who want to buy stock in a Minnesota value-added farmer-owned cooperative, limited liability company or limited liability partnership. These state level programs require, among other things that the applicants be residents and have net worth not exceeding some threshold. They also require the loan to be collateralized.

A special source of loan financing is Community Development Financial Institutions (CDFIs). They primarily provide loan financing to businesses in areas that need economic development when such loans are generally "unbankable" by traditional industry standards. The base qualification for this type of financing source is that the

business must be contributing to local employment or enhancing the local economic conditions in a tangible and measurable way. The fact that qualifying companies are not bankable implies that CDFI loans are generally riskier than bank loans, and therefore, tend to cost more. Typical pricing may be anywhere from 0.5 to 3 percentage points higher than conventional loan rates and the range of funds typically available is usually no more than $500,000. Because these institutions usually have very narrow focus, it is of difficult to meet their criteria to secure CDFI financing.

Business Structure and Financing Sources

The foregoing subsections have provided the principal sources of debt and equity financing for businesses, including early stage ones. In this section, we turn our attention to the relationship between organizational structure and the applicability of the different financing sources. The objective is to help agricultural producers seeking to undertake value-adding initiatives determine the most effective business structures to facilitate the financing of the business. We provide a broad overview of group-action business structures and then show the business structure influences the financing source.

Business Structures

There are four principal group-action business structures: partnerships, limited liability companies, corporations and cooperatives. Partnerships are business arrangements in which two or more individuals manage and operate the business and as owners, are personally responsible for all of the business' debts and liabilities. General partners have joint and several liability, i.e., partners are jointly and individually responsible for the entire liability. When there is a claim against the partnership, one or all partners may be sued and if one partner pays more than their share of a liability, they may recover the excess from the other partners. Thus, in general partnership, partners are liable for the business acts of other partners. If the partnership goes bankrupt, partners' personal assets will be involved in the bankruptcy.

To minimize the risks of general partnerships, two other forms of partnerships may be structured: limited partnership and limited liability partnership. A limited partnership is similar to a general partnership except that there is at least one general partner and one or more partners with limited liability and no rights of management. The limited partners, therefore, if they work for the business, are employees without management decision-making responsibilities. Limited partners' liabilities are limited to the extent of their investment in the business, and are therefore not personally liable for business debts and liabilities (except those they personally guarantee). In a limited liability partnership, partners are only liable for their own and their direct reports' negligence. The partners are, however, jointly and severally liable for the acts and obligations of the partnership.

Unlike partnerships, a corporation is an artificial entity legally separate from its owners (shareholders), formed under state or federal law. Although only one shareholder is required to form a corporation, it is a great tool to bring significant number of people into a business through ownership. The percentage of stock owned by a shareholder determines how much control that shareholder has in the corporation. Corporations are more complex to set up than partnerships because of the possibility of opening it up for public participation through initial public offering, but it is also one of the easiest structures to provide an exit for investors. US law allows for the establishment of two types of corporations: a C corporation and an S corporation. The income of the former is taxed at prevailing corporate tax rates and when its shareholders receive dividends from its after tax earnings, those dividends may also be subject to tax at the personal income tax rates of those shareholders. Contrarily, S corporations are not subject to corporate taxation, but their net incomes are allowed to pass through to their shareholders to be taxed at their personal income tax rates, i.e., taxed like a partnership but with the separate entity advantage. As a result of their special status, S corporations can have no more than 75 shareholders who must all be residents of the United States. They can also have only one class of common stock and no preferred stock.

Limited liability companies (LLCs) lie between partnerships and corporations in their ownership structure and tax treatment. Their owners are referred to as members and unless specific agreement designates one or more of them as managers, all members are

considered managers of the LLC unless specifically excluded. They are not subject to corporate tax but profits are passed through to members to be taxed at their personal income tax rate. Like a corporation's shareholders, the liability of the members of an LLC is limited to their investments in the company unless they personally have guaranteed loans and other liabilities of the company. They do not have the limitations of the S corporation with respect to membership size and are therefore more attractive when more than 75 members is an advantage and the regulatory hurdles of corporations are necessarily avoidable.

Cooperatives have long been used in all facets of the agricultural industry. They have been used to market produce as well as undertake processing of agricultural outputs to increase their value. They have also been used to purchase inputs for producers to minimize production costs. Agricultural cooperatives enjoy a number of special legal benefits; from protection from anti-competitive behavior under the Capper-Volstead Act (1927) to special discounts on interest rates. It is also the only business form that has a special service unit devoted to its support at the USDA – the Rural Business Cooperative Service, which has a mandate to enhance rural American's quality of life through, among other things, providing leadership in building sustainable cooperatives that can prosper in the global marketplace.

Cooperatives are special business structures because they are the only one in which ownership, governance and user benefits are embedded in the same group of people. To qualify for agricultural cooperative status, therefore, the organization must have agricultural producers as its members, and these members must have democratic control over the business and benefit from the business in accordance with their patronage of the business. In other words, the more a member used the services of the cooperative, the higher that member's patronage rewards and vice-versa.

Unlike other business structures in which equity can be purchased, equity in cooperatives is earned through patronage. Also, unlike other business structures in which stock value determines the capital gains from an investment, cooperative stocks typically have fixed face values and are redeemed at that face value. They are usually not transferable and can only be redeemed at the discretion of the cooperative's board. In

other words, there is no easy mechanism to recoup growth in one's equity in the cooperative. This is the subject of much research and the foundation of some of the modifications that are emerging in the cooperative world.

One of such modifications is what is being referred to as new generation cooperative. For these business structures, the democratic control by members is modified to reflect their stockholding which is itself determined by the patronage commitment they have made to the cooperative. Thus, new generation cooperative members enter into binding contracts with their cooperative to supply (or purchase) a specific quantity of products within specific time periods. Additionally, equity investment is a prerequisite to entering into a supply contract. New generation cooperatives also attempt to overcome the equity transfer constraints in traditional cooperatives by allowing the sale of currently owned stock to other eligible producers at prices agreed to by the buyers and sellers. The equity shares of new generation cooperatives appreciate or depreciate in value based on the earnings potential they represent, just like that of corporations. And although the cooperative's board of directors doesn't set prices, they approve all stock transfers to ensure that only eligible producers get access to available shares. Again, unlike traditional cooperatives that build equity through retained earnings, new generation cooperatives tend to have high levels of cash patronage refunds to members since equity is achieved in advance of business startup. In other words, members benefit from the current success of the business and take control of how they invest or grow the resulting benefits. But not many farmers have the necessary cash to purchase equity in emerging new generation cooperatives that could significantly change their financial and economic futures. As noted by Jack Cassidy, Vice President of the Cooperative Bank in August 2001 before the US Senate Committee on Agriculture, Nutrition and Forestry,

> "The reality is that cooperatives often are unable to go to financially stressed farmers to seek equity capital for projects that would open new markets and create economic opportunities in rural areas. New and improved approaches involving public-private sector partnerships are needed to foster the flow of equity capital to rural America."

Business Structures and Financing

The business structure adopted by producers will have a direct implication for the financing opportunities that are open to them (Table 2). Because of their flexibility, it is observed from the table that C corporations have the widest reach to financing, being able to access all the different types of financing with little or no regulatory or legal constraints.[5] Depending on the financial situation of the entrepreneurs and the status of the business, they may have to develop a business structure that minimizes constraints to their ability to access financing opportunities. For example, many early stage companies do not have the assets to collateralize their long-term loans, making financial institutions very difficult sources of loans. Also, if they are not already in business, with customers and generating cash flow, it is difficult for them to borrow short-term loans and collateralize them with accounts payable. If such companies are successful in securing loans from financial institutions, such loans tend to extract significantly higher interest rates to cover their inherent risks. Thus, if the early stage company is entering a market with strong incumbents, it runs the risk of exhibiting high operating costs which will adversely affect its competitive position. For this reason, such companies can only entrench their competitiveness through differentiation of their products or services. They have to do something that incumbents are incapable or unable to do for customers, reduce the switching cost of customers from incumbents by, among other things, constructing market confidence in their ability to consistently supply the products or services.

Table 2: Financing Type by Business Structure

Source	Financing Type					
	Debt				Equity	
	Loans	Warrants	Bonds	Lease	Common Stock	Preferred Stock
Partnership	•			•		
LLC	•			•	•	
S Corporation	•			•	•	
C Corporation	•	•	•	•	•	•
Cooperative	•		•	•	•	

[5] However, access opportunities should be weighed against regulatory requirements associated with registering and maintaining the particular business structure, taxation and other issues.

Superimposing Table 2 on Table 1 shows the influence of financing sources on business structures (Table 3). Early stage companies require significant access to equity financing to reduce loan servicing constraints on their competitiveness, and business structure is a major determinant of the ease with which equity financing can be accessed. Cooperatives tend to depend almost entirely on their membership for developing equity capital since non-members are legally prevented from participating if the cooperative is going to meet its requirements of user control and ownership. Similarly, because LLCs are focused on small businesses, they constrain the ability of entrepreneurs to solicit equity capital from many of the traditional sources of significant equity capital for early stage companies, such as business angels and venture capital. It is important to note that business structure can be changed any time, especially from a less formal structure such as partnership or LLC to a corporation. However, agricultural producers seeking to build value-adding businesses should review their long-term objectives and assess their full capital requirements in deciding their business structures.

Table 3: Business Structure and Financing Sources

Source	Partnership	LLC	Corporation	Cooperative
Founders	•	•	•	•
Friends & Family	•		•	
Business Angels			•	
Business Associates	•		•	
Community Development Financing	•	•	•	•
Venture Capitalist			•	
Financial Institutions	•	•	•	•
Financing Companies			•	
Government	•	•	•	•
Public			•	•

It is true that when equity investors are invited to participate in the business, the entrepreneurs lose some control as well as dilute their ownership positions. However, such concerns must be weighed against the objective of achieving the business' objectives. Control is neither a necessary nor sufficient condition for success but having the appropriate investors in the early stage of the company can make a lot of difference to the outcome. For this reason, it is important for entrepreneurs with early stage businesses to focus on attracting the *right* equity investors, i.e., "smart money" owners. These are

people who will bring their deep network of connections to the marketplace as well as management and other skills to the business, in addition to investing cash. They can enhance the success probability of the early stage business by enhancing its intangible resources, especially its human resources. As noted, business angels and venture capitalists are primary sources of "smart money."

The question that has dogged the agricultural industry is whether tested financing vehicles in other industries (e.g., business angels, venture capitalists, financing institutions, etc.) can be patient with the industry's slow growth opportunities. We believe this has to be taken on a case-by-case basis since not all value-adding initiatives in agriculture are necessarily slow-growing. Furthermore, with the changes in biotechnology and the emergence of new opportunities for value-adding initiatives, there is no saying when growth for certain initiatives will not be spectacular like those seen in pharmaceuticals or technology.

Since business plans for agricultural value-adding initiatives have focused almost completely on producer investments and government grants, we believe a challenging level of creativity has not been brought to developing business structures and operating models that exert the highest demands on capital. This lack of challenge may explain some of the failures that have occurred in the industry. However, by bringing the same level of challenge to the industry as exerted in other industries, and demanding performance that exceeds or compares to those in other industries, the agricultural value-adding entrepreneurs can develop business models that produce performances that stand tall among other industries.

For the foregoing reasons, it is important that agricultural value-adding entrepreneurs not write off non-producer equity and other financing sources simply because these sources have not participated in the industry in the past. They should rather be cultivating and nurturing them to see the immense opportunities in the industry. The industry's entrepreneurs should be identifying the strengths and differentiating characteristics of value-adding initiatives and positioning themselves to court the weary investors in high growth/high risk investments. Not only will building business models that seek the attention of business angels and venture capitalists increase the financing

opportunities for the industry, but it could engender projects that transform the business thinking in the industry as well as its inherent opportunities. This thinking can actually alter the way agricultural entrepreneurs think about themselves and their industry and open up new initiatives for the whole industry.

Getting Ready for Financing

Every financing source (with the probable exception of *some* friends and family) will demand a business plan before considering the financing.[6] Therefore, it is important to complete a thorough business plan before initiating conversations with financing sources. A well-developed business plan will provide information on the resource gap situation of the business and its desired growth expectations given its market environment conditions. Together, these will shed light on the business structure that will facilitate the easiest access to addressing resource gaps and achieving business objectives (Figure 2).

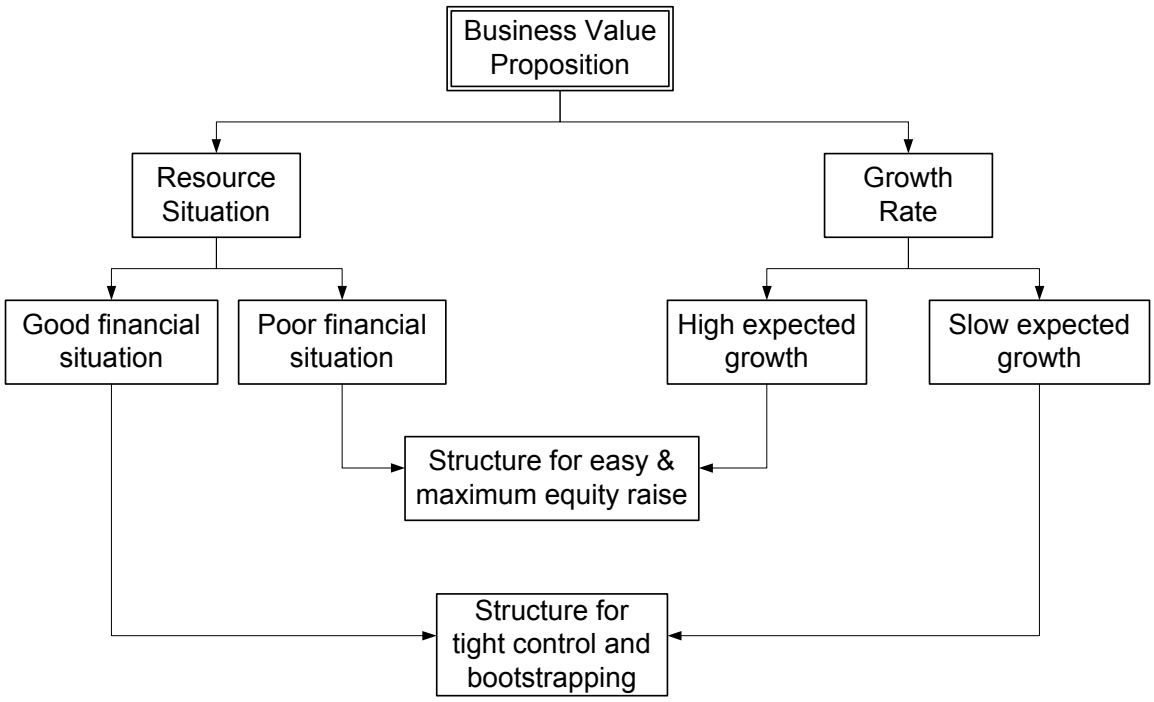
If the business value proposition is such that the market environment is stable and the competition diffuse, then the business may succeed through bootstrapping its growth with the net effect of the entrepreneurs maintaining significant control over their business. On the other hand, if the business environment is rapidly changing and incumbent competitors concentrated, then it may make strategic sense to grow rapidly in order to secure a credible market position. If the resource situation is such that the company does not have the financial and other resources to implement this strategy, then the sensible approach is to develop a business structure that allows for easy and maximum equity raise to finance the strategy.

The business plan should clearly specify the sources and uses of funds in the pro forma cash flow statement, showing how much financing is required at particular times (monthly, quarterly and annually) over at least the first three years of the business. These pro forma financial statements must be prepared using generally accepted accounting principles (GAAP), which in general are acceptable to most financing sources and presented in standard formats. The entrepreneurs should have a grounded understanding

[6] When friends and family do not ask for a business plan, it behooves the entrepreneur to provide it to them and encourage them to assess the merits to they enhance their understanding of the risks and opportunities. This is a way to minimize friends and family equity cost in the business.

of these financial statements to enable them prepare for the interviews with financing sources, negotiate favorable terms and obtain the desired financing to implement the defined strategy.

Figure 2: Effect of Resource Situation and Growth Expectation on Structure and Financing Options



Regardless of whether the entrepreneurs are approaching equity investors or lenders, the fundamental preparation requirements are the same, and include the following:

1. A well-written, clear, compelling and professionally bound business plan with a succinct executive summary that specifies[7]:

    a. The strategic direction of the business and its business structure, including value proposition, business and revenue models and the organization structure (management team and board of directors).[8]

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[7] See Exhibit 1 for a cautionary note on dealing with consultants when developing business plans.

[8] The business planning process is described in the document *Strategic Business Planning for Value-Adding Initiatives* by the author, available at www.AgMRC.com.

b. The market analysis showing the strategic advantages of the business and its identified challenges and how it plans to amplify the advantages and address the challenges

c. The functional analysis of the business, focusing on production and marketing strategies, resource organization and development to achieve business objectives. Strategies clearly link outcomes to actions and to resources in a concise, compelling and logical manner

d. Financial projections presented in GAAP formats, clearly specifying current financial situation and contributions to date, ownership structure with respect to equity distribution, allowances projected for management and others in compensation for performance, etc. The financial projections should also clearly indicate the required cash to execute the specific phase of the plan and the specific intended uses for the funds.[9]

e. A harvest and exit strategy to show potential financing sources that there is an opportunity for them to recoup their investments in reasonable time with projected return on investment clearly presented with accompanying assumptions.[10]

2. A 15 to 20-minute professional-looking slide presentation highlighting the principal components of the business plan: vision and mission, value proposition, business and revenue models, pro forma financials, required cash and intended uses of cash, and cash flow projections to show how debt will be repaid and equity built. The presentation should be burned onto CDs for distribution to potential investors and lenders with the hard copy of the full business plan.[11]

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[9] For early stage companies, it may be necessary for the founders to also prepare their personal financial statements in case lenders demand such documents.

[10] It is important to always present the caveat that all investments are risky, that the current projections are based on the underlying assumptions and the failure of any or all of the assumptions to hold may result in the projections being erroneous.

[11] Flash technology is now available and relatively cheap. If entrepreneurs can afford it, they should produce the presentation with audio and video components to enhance the experience for the potential investors and lenders. This is about marketing the business and its plan for success.

3. Professionally-prepared term sheets must be ready for presentation to potential investors in case they review the business plan and want to move quickly. (A term sheet is a summary of the terms based on which an investor makes investment into the company, a precursor to the investment agreement that both of the entrepreneur and the investor sign to formalize the investment. Although usually non-binding, it may impose some legal obligations on the investor and the company. It includes, at the minimum, the following:

   a. The value of the investment and its form (common or preferred stock, etc.)

   b. The ownership, rights and control acceded to the investor

   c. Effect of certain events (e.g., bankruptcy, sale or IPO) on the investor's shareholding.

   d. Since the term sheet specifies how the entrepreneur is selling part of the company, it is a very important piece of document that must be developed carefully and be prepared to negotiate with the investor. Since most professional investors have done these negotiations often, it is the responsibility of agricultural value-adding entrepreneurs to educate themselves on the salient dimensions of understanding the term sheet offerings and negotiating when the time comes. A financial or investment consultant and/or attorney must be retained to help if need be.

It is also prudent for the entrepreneurs to go over different scenarios from the perspectives of potential investors and lenders to make sure they have credible responses and answers to any questions or issues that may arise. Indeed, they should incorporate these questions and issues into their presentations so they become non-issues for the potential investors and/or lenders. Not only does this help them effectively *sell* their company to potential investors and/or lenders, it allows them to build a deeper understanding of their business environment and challenge their own sensibilities.

To maximize the effectiveness of time, entrepreneurs must research potential sources of financing before embarking on conversations with them. The research should seek to provide information on the following:

1. Make a list of potential investors and categorize them by source: friends and family, business associates, business angels and venture capitalists. Also make a list of potential lenders and categorize them: financial institutions, community development financial institutions, certified development companies, government agencies with mandate for the initiative, etc. Since familiarity with the entrepreneurs is a very important asset for any early stage company, it is important familiar investors and lenders are given higher priorities than unfamiliar ones. Additionally, entrepreneurs must dig into their network of associates and friends to use them to establish familiar connections.
2. Assess the ability of the source to provide the required funds, be it equity or debt. Some financing sources are specialized in the investments and loans they make – automobile, real estate, export, equipment leasing, etc. or biotechnology, energy, information technology, etc. Others may only finance companies that have sales of a certain value or only certain business structures or operations (e.g., Cooperative banks, Farm Credit, etc.).
3. Evaluate the cost of borrowed funds – interest rate, covenants and legal and accounting fees associated with securing the funds from the different sources. Other costs are embedded in the collateralizing process, e.g., using an asset as collateral may prevent it from becoming available as collateral for another loan even if the asset value increases. This can be a burden (cost) on the business. Some lenders have special interest rates and points for certain business types. There are benefits in dealing with local institutions because they tend to have greater ties to the community and hence are more understanding of the inherent costs that become burdensome to the business.
4. Evaluate the cost of equity funds carefully, measured by the equity the entrepreneurs have to give up in exchange for funds received from an equity source. Some investors are more comfortable with certain opportunities because they have a better knowledge of their inherent risks and benefits. This knowledge may influence their negotiations and the cost of equity they provide. But entrepreneurs should collect as much information on the cost of funds from the

different sources and build a comparison table before engaging sources for investment or debt financing opportunities. This will allow them to work through their negotiations and also know their next stop when the preferred stop fails to yield results. As a rule, entrepreneurs should be willing to pay a small premium for the opportunity to secure equity or debt from financing sources that understand the uniqueness of their business and are sympathetic to their industry situations.

5. Assess the ability of the financing source to provide ancillary resources – access to suppliers and customers, other financing sources, service providers, etc. Having people with your social networks that help the business achieve its objectives quickly is a bonus entrepreneurs should seek in all their relationships and financing sources are not exempt. In exchange for a few points on a loan or a few points on equity positions, if a particular financing source can help the business secure important customers or source good inputs, then it should be considered a fair price for a good outcome.

Summary and Conclusion

We set out to expand the knowledge of producer-entrepreneurs about how to raise financing for their value-adding businesses. The overriding purpose was to present the breadth of financing opportunities that is available and encourage producer-entrepreneurs to develop business models that allowed them to explore the full extent of the financing sphere. We showed that the early stage is often the most critical financing period of the business despite the fact that financing can be an issue at any stage in the business life cycle.

We indicated that there are two major financing sources, debt and equity, and that equity financing tends to be more successful than debt to all phases preceding when the business is generating sales. We identified and discussed several financing sources – founders, family and friends, business angels, associates, venture capitalists, community development financial institutes, certified development companies, financial institutions and financing organizations, government and the public through IPO. We also showed

that the business structure influenced the flexibility of accessing the different financing sources and suggested that entrepreneurs should assess their market environment, growth expectations and their resource gap situation to determine how much control they can afford and still transform their business dream into a reality. We indicated that when the market environment is stable and competitors are diffused, entrepreneurs may still succeed by bootstrapping, but when competition is concentrated and the market is changing rapidly, the window of opportunity suggests that the entrepreneurs find the right resources to accelerate growth in order to enhance the company's competitiveness.

In preparation for raising financing, we suggested that the entrepreneurs prepare a business plan and position the company to look attractive from an investment perspective. We suggested getting as much information of the different financing sources so that the entrepreneurs can identify their requirements to enhance the probability of financing success.

We noted that agricultural value-adding initiatives have been financed traditionally by producers who stand to benefit from the initiatives. This has constrained operational size and opportunities that can be seized. We then argued that agricultural value-adding entrepreneurs must set their eyes on some of the business angels and venture capitalists by developing business models that meet the litmus tests of their investments. By doing this, not only do these entrepreneurs secure the requisite financing for their businesses, but they elevate the industry's performance to its appropriate level and challenge long-held beliefs that competitive returns on investments are not possible in the agricultural industry. The emerging technological shifts make everything possible.

Suggested Reading

Amanor-Boadu, V. (2002). Preparing for Value-Adding Business Initiatives: First Things First, a paper prepared for Agricultural Marketing Resource Center (www.AgMRC.com).

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Van Osnabrugge, M. and R.J. Robinson (2000). *Angel Investing: Matching Startup Funds with Startup Companies: A Guide for Entrepreneurs, Individual Investors, and Venture Capitalists*, New York: Jossey-Bass.

Exhibit 1: Hiring Consultants for Business Plan Development

Entrepreneurs who lack the ability to write and produce a compelling business plan should employ the services of a consultant. However, it is important to remember that it is they, the entrepreneurs, who will be putting their money and reputation on the line. Therefore, the primary job of the consultants their hire is listening to what the entrepreneurs want to do, challenging them to sharpen their thoughts, bringing their knowledge of the market and industry and strategic options to educate the entrepreneurs and *writing* the entrepreneurs' plan for them. In other words, the business plan must be the entrepreneurs' plan and not the consultants. Many producer-entrepreneurs have found themselves with business plans that are completely foreign to their perceptions of their businesses primarily because a consultant decided to produce his/her plan for them.

It is very important to remember this: You don't pay a consultant to write you a business plan; you pay a consultant to <u>improve the business plan you have in your head and in your heart</u> and to *transform your thoughts and feelings onto paper*. Hiring a consultant does not offer entrepreneur an opportunity to abdicate their position as the engine of the business. Entrepreneurs who don't actively participate in the development of their business plans run the risk of getting a plan that is foreign to them, and therefore, difficult to market and implement.