

## **How to Effectively Underwrite Small & Emerging Farms**

Gray Harris & Denise Dukette

November 29, 2012

Winter Webinar Series

# Winter Webinar Series

- Nurture the growing healthy food financing sector
- Provide webinars to CDFIs and CDFI partners interested in healthy food financing
- Build strong networks of interested stakeholders



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# Today's Webinar Topic

- Understanding the unique nature of loans to food producers
- Redefining the 5 C's of credit for the food production sector
- Assist in understanding how underwriting factors may change as farm grows

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Nurturing Healthy Food Financing

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## **How to Effectively Underwrite Small & Emerging Farms**

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# Lending to Small Farms:

*This is a unique group to lend to!*

- Each farming situation will have unique characteristics
  - Products grown or raised
  - Climate and land conditions
  - Growing methods
  - Customer base
- The farming sector is evolving and changing rapidly, so farmers have to continually adapt

# Lending to Small Farms:

*This is a unique group to lend to!*

- No rule-book with cut and dried answers to business lending questions
- No standard financial ratios, metrics, or impact measures
  - The same type of farm will not have the same performance in different regions on the country
  - Two farms in the same region may have different growing methods, product mix, or customer base
  - Little statistical data capture



# Lending to Small Farms:

*This is a unique group to lend to!* Therefore:

- Requires solid lending skills and clear understanding of the sector
- Underwriting questions are often specific to the farm
- Active follow up with the borrower, especially during the growing season
- Critical to have strong partnerships to provide targeted knowledge

# What is a Small Farm?

There are different definitions but for this purpose we consider a small farm to be:

- Owned and operated by the farmer/farm family
- Fewer than 10 employees
- Does not have access to conventional (bank or FSA) financing, or access is insufficient for capital needs
- Does not have access to crop or income insurance
- Farming is a core business activity, although there may be off-farm income as well

# What is a Small Farm?

These are farms which may be:

- Reaching viability (profitability)
- Viable at current scale but are looking for new markets
- Adding new products
- Changing production or growing methods
- Adding value added processing of some sort

***Factor planned growth & change into underwriting***

# 5C's of Credit – Redefined!

- The 5 C's are common tools for lending
- Typically they are evenly weighted to make lending decisions

## ***We redefine them:***

*to reflect the realities of the small farm production sector and to better weight them to this sector's risks*

# The 5 C's Redefined:

- *Primary Factors*
  - Cash Flow Modeling
  - Capacity/Character:  
Farm Management Skills
  - Conditions: Know the Market
- *Secondary Factors*
  - Cash/Equity
  - Collateral

# Primary vs. Secondary

- Primary factors may be deal breakers. They are critical to success.
- Primary factors identify skill and knowledge gaps which may require TA.
- Secondary factors help fine tune a loan decision but do not “fix” issues with primary factors.

# Cash Flow Modeling

## Know the Cash Flow!

# Cash Flow Modeling

## *Cash Flow Repays Loans!*

- How will loan increase cash flow? – crop diversity, yield, growing season, acreage, access to new markets
- Viability is likely **not** based on historic performance or independent cash flow support
- Viability is based on taking agriculture experience to a new level (products, growing methods, scale, etc.)



# Cash Flow – Entering New Markets

## Entering new markets

*It is critical to:*

- Determine when to enter a new market
- Assess market demand, pricing, competition
- Find entry point into that market (varies by market)
- Analyze costs (time, fuel, packaging) to ensure that pricing targets/profits are achieved

# Cash Flow – Changing Farm Model

## Adding new products or changing growing methods

*It is critical to:*

- Determine timeframe to positive cash flow
- Capital expenditures required for change
- Analyze direct costs and target pricing
- Assess competition – current and potential
- Consider impact on farm model – complexity

# Cash Flow Tools

## **Combine products in cash flow model:**

- Overlay each new and existing product into cash flow
- Assess profitability of product lines and total farm
- Capital expenditures analysis and budget
- Unplanned expenses – disease control, weather, vet bills, repairs, equipment breakdown, increased utility costs
- Major variable costs – fuel to transport product, “raw materials”, fertilizers/feed
- What will loan accomplish? Pro forma cash flow model

# Cash Flow Tools

## Financial Measures:

- Typical to have negative cash flow in spring and off-season but should have positive cash flow for the complete season.
- New products may have negative cash flow until reaching scale or maturity. Overall farm needs to be able to support the shortfall.
- Farm with negative overall cash flow needs off-farm income to support it and clear plan to reach profitability.

# Cash Flow Tools

## Debt Service Coverage:

- Tailor loan repayment to projected monthly cash flow
  - Interest only or reduced payment in 'off' months
  - Working capital with draw period
  - Multi-year repayment for capital expenditures
- Build in payment flexibility if conditions change
- Debt service should be  $>1.0$  after all expenses including living expenses (include off-farm income)
- Working capital should be fully repaid within the season

# Capacity/Character: Farm Management Skills

# Farm Management Skills

*Range of critical skills is broad and highly specialized:*

- **Product Expertise** – raise/grow product, weather, disease/ illness, changing demand, product development
- **Marketing** - identify markets, determine accessibility, product and sale requirements, payment cycle and method
- **Practical Skills** - equipment maintenance, mechanical ability, resourcefulness
- **Logistics** - get to market, route density, accessible markets

# Farm Management Skills

*Range of critical skills is broad and highly specialized:*

- **Staffing** - seasonality, cost, housing, payroll processing
- **Financial Management** – cost controls, cash flow modeling, financial reporting, invoicing and receivable collection, budgeting
- **Capital Needs** – understanding equipment/facility needs
- **Regulation** - regulatory, zoning, land use requirements
- **Sector Knowledge** – changing requirements, regional and national trends, food habits



# Farm Management Skills

## **As farm grows, so does the needed skill set:**

- Production, crop rotation, land management
- Equipment needs, multi-year debt
- Fencing, irrigation, storage
- Delivery logistics – quality and quantity
- Larger cash seasonal demands
- Human resource management

# Farm Management Skills

## **As farm grows, so does the needed skill set:**

- Insurance/financial/legal resources
- May be difficult to keep all the balls in the air
- Individuals are still critical to success – illness or incapacitation can be big issue
- May not have time to access needed TA resources – too busy in the day to day
- Can over-extend physically, financially or to customers. Hard to retrench or regroup

# Farm Management Skills:

## *Some Considerations:*

- Business management skills are difficult to assess
- Young farmer is unlikely to have resume showing practical experience in skill areas
- Knowledge historically acquired from established farmers, prior generations
- Growth in small farm sector reflects new products, new demand, new methods
- Difficult to apply traditional knowledge relied on in the past

# Farm Management Skills

- No single skill will provide the basis for success but lack of a critical skill can be a recipe for failure
- A good farmer-borrower is a risk-taker, identifies unmet needs, and expands/adapts to fill that gap in an appropriate and planned way
- Entrepreneurial spirit is critical to successful small farms which must continually adapt to a changing marketplace and landscape

# Farm Management Skills

## **Lender needs to assess Borrower's character:**

- Commitment to the lifestyle
- Ability to access industry resources as needed
- Critical farm management skills
- Ability to respond to change: crop/product, regulatory policy, environment, markets

## **If a more complex farm, need to assess:**

- Capacity to handle larger operation

# Conditions: Know the Market

# Know the Market

## Common Markets for Simple Farms - Direct Retail: *CSAs and Farmers Markets*

### Pro

- Easy access for many types and scales of farm activity
- Can sell in small quantities and as product is available
- No future commitments or obligations
- Fits well with other markets such as restaurants, farm stands
- Cash basis; no complex payment terms

### Con

- No control over the market, limited pricing leverage
- Doesn't facilitate entry to larger or institutional markets
- Limited marketing/branding outside of market
- High time/cost to get product to "customer"; low yield

# Know the Market

## Common Markets for Complex Farms –

### *Institutional Buyers / Wholesale / More Diverse Customers*

#### **Pro**

- More reliable cash flow
- Larger dollar, single deliveries; route density
- Committed product demand
- Less time spent at markets waiting for buyers

#### **Con**

- Stricter requirements (quality, quantity, packaging, delivery)
- Wait for payment; invoicing, collection efforts
- Changing staff in institution requires new connections



# Know the Market

**Farm scale may dictate the market; market accessibility may also direct farm scale.**

- Strong marketing skills necessary to assess and gain entry to new markets
- Must identify optimal markets, determine proper pricing, obtain contracts, ensure that delivery goals are met
- Lack of aggregation and distribution infrastructure places burden on farmer to develop marketing approach and logistics planning get to market.
- Cooperative approach may be achieved but requires development of marketing approach and logistics strategy among participants

# Know the Market

## Assessing applicant's ability to get to market:

- How shelf stable is the product?
- Distance to sell product? Ability to get to market/customers?
- How strong is the demand for the product? Geographic reach?
- Who are the target customers and what to they want?
- How do target customers typically pay?
- Are there selling groups which provide marketing outlet?
- What markets are being sold into? Each has expectations for products and standards for payments.

# Secondary Factors

## *Why Are These Secondary Factors?*

- Not direct indicators of potential success; are fallback positions
- In a young and emerging sector, are least likely to be present in a financing application
- Reliance on fallback reduces emphasis on critical support needs
- Over-weighting will eliminate consideration of viable opportunities

# Cash/Equity

# Cash/Equity

What's the problem?

- Small farms are micro and small enterprises
- The principals often do not have strong liquidity to support enterprise
- Lending decisions often require base liquidity or minimum equity investment
- This can eliminate viable loan candidates

# Cash/Equity

- Small farms typically boot-strap
- Use credit cards for purchases; pay after seasonal sales
- Liquidity is net cash after products sold and bills paid
- Funds are reinvested in the farm; farmers live on limited budget and do not build liquidity
- Farmer and farm are one financial entity; no fallback
- Farmer is core employee – illness or interruption affects production and cash flow

*Lending goal is to strengthen farm cash flow and ensure farm viability and living wage for farmer/family*

# Cash/Equity

## Mitigants

- May have sweat equity versus cash contribution
- May have co-signer or guarantor
- Fully committed to farming and farming lifestyle
- Can accept and make full use of TA help
- Can adapt to changing environment
- Can leverage growth in sector through entrepreneurial spirit

# Collateral



# Collateral

Collateral should be obtained if available BUT is unlikely to be a strong loan fallback if repayment fails

- **Value in farming is of the value of the final product, in its best state of health**
- Maximum asset value is as “going concern” enterprise
- Removal of assets may directly impair farm production
- Interrupted growth cycle may impair product value (i.e., wilted produce, unhealthy livestock)

# Collateral

Asset Liquidation Values are hard to define:

- Farm equipment of limited value – small market; individual assets of low value; old or in disrepair
- May not be moveable – a barn, tubing for maple sap collection, irrigation system, HVAC
- Limited secondary market; hard to assign realistic value
- May need to sell through non-traditional methods such as Craig's List.

# Collateral

- Standard collateral advance rates may not support loan request
- Small farms typically have limited capital to provide down payment; needed advance rates may be 80% - 100%
- Collateral risk may be mitigated by guarantees, loan loss reserves or other credit support
- Lending requires creative loan structure

# ***Underwriting Growth and Change***

*Small farms are changing rapidly*

*The agricultural sector is changing rapidly*

- Use cash flow models to understand farm operation
- Overlay potential changes in farm – new products, new markets, longer growing season, new growing methods
- Help farmer network and develop critical skills; prepare them for conventional lending (Schedule F)
- Stay in active touch with industry members, monitor trends in region and in industry

# *Keys to Overall Success: Engage with the Sector*

- *Get to know the Ag sector in your communities:* a strong TA program and network of agricultural service providers help lenders evaluate risk and ultimately help the borrower to obtain credit.
- *Base lending decisions on appropriate lending benchmarks and measures,* weighted to the realities of this sector.
- *Test the fundamentals:* cash flow, market knowledge and conditions, farm management and production capacity.

## Question & Answer

## **Additional Resources**

# Upcoming Winter Webinars

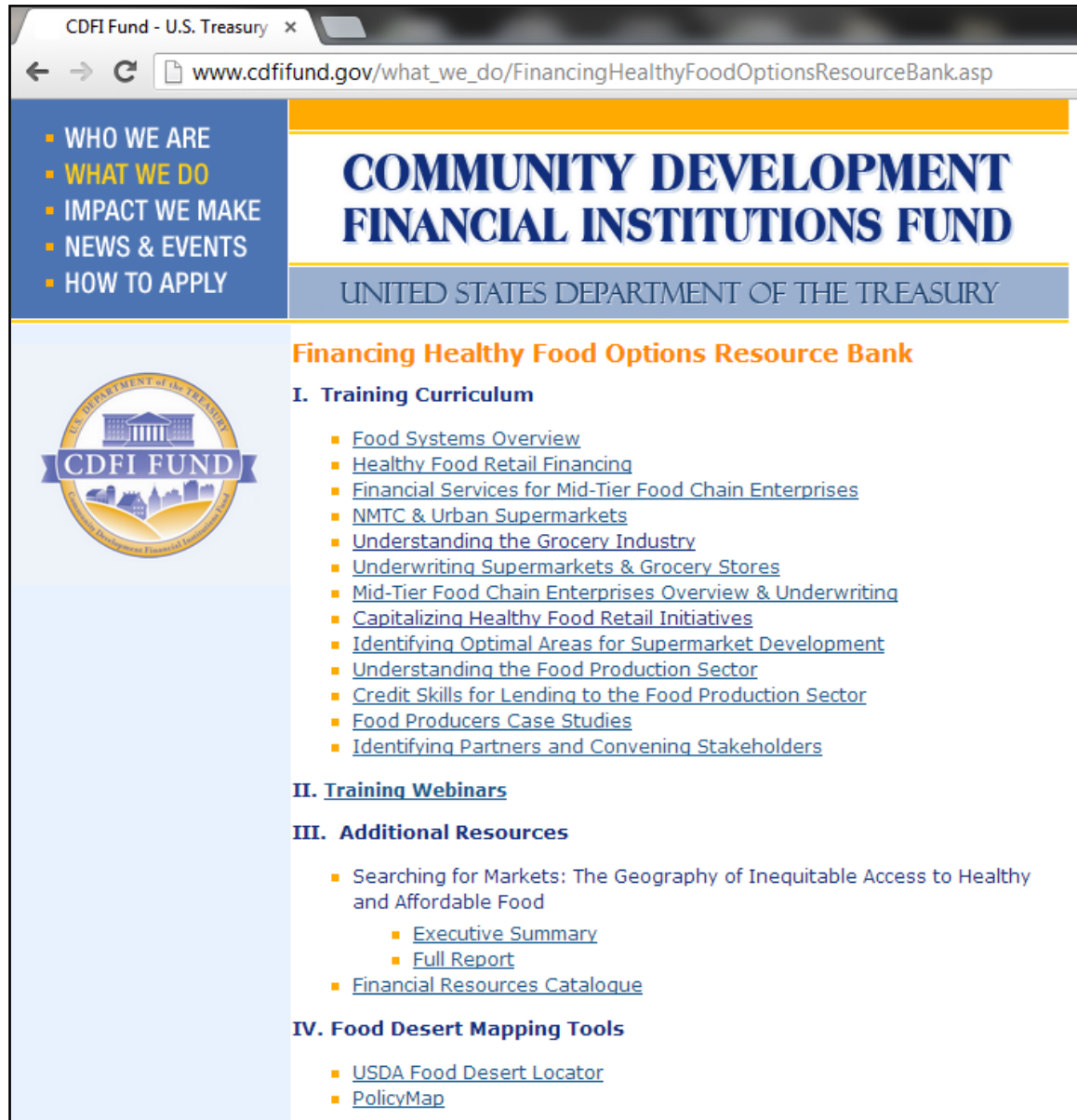
- **Financing Healthy Food Retail: Program Design and Social Impact Measurement**
  - December 6, 2012 @ 2pm ET
- **The Grocery Gap**
  - December 12, 2012 @ 2pm ET
- **Underwriting Supermarkets and Grocery Stores**
  - January 15, 2013 @ 2pm ET
- **CDFIs and Public Health**
  - January 24, 2013 @ 1pm ET
- **And more...**

To register: [opportunityfinance.net/fhfoweinars](http://opportunityfinance.net/fhfoweinars)



# CDFI Fund – Virtual Resource Bank

[http://www.cdfifund.gov/what\\_we\\_do/FinancingHealthyFoodOptionsResourceBank.asp](http://www.cdfifund.gov/what_we_do/FinancingHealthyFoodOptionsResourceBank.asp)



The screenshot shows a web browser window with the URL [www.cdfifund.gov/what\\_we\\_do/FinancingHealthyFoodOptionsResourceBank.asp](http://www.cdfifund.gov/what_we_do/FinancingHealthyFoodOptionsResourceBank.asp). The page features a blue navigation menu on the left with the following items: WHO WE ARE, WHAT WE DO, IMPACT WE MAKE, NEWS & EVENTS, and HOW TO APPLY. The main content area has a yellow header with the text "COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS FUND" and "UNITED STATES DEPARTMENT OF THE TREASURY". Below this is the "Financing Healthy Food Options Resource Bank" section, which includes a list of training curriculum topics, training webinars, additional resources, and food desert mapping tools. The CDFI Fund logo is visible on the left side of the page.

**WHO WE ARE**

**WHAT WE DO**

**IMPACT WE MAKE**

**NEWS & EVENTS**

**HOW TO APPLY**

## COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS FUND

UNITED STATES DEPARTMENT OF THE TREASURY

### Financing Healthy Food Options Resource Bank

#### I. Training Curriculum

- [Food Systems Overview](#)
- [Healthy Food Retail Financing](#)
- [Financial Services for Mid-Tier Food Chain Enterprises](#)
- [NMTC & Urban Supermarkets](#)
- [Understanding the Grocery Industry](#)
- [Underwriting Supermarkets & Grocery Stores](#)
- [Mid-Tier Food Chain Enterprises Overview & Underwriting](#)
- [Capitalizing Healthy Food Retail Initiatives](#)
- [Identifying Optimal Areas for Supermarket Development](#)
- [Understanding the Food Production Sector](#)
- [Credit Skills for Lending to the Food Production Sector](#)
- [Food Producers Case Studies](#)
- [Identifying Partners and Convening Stakeholders](#)


#### II. Training Webinars

#### III. Additional Resources

- Searching for Markets: The Geography of Inequitable Access to Healthy and Affordable Food
  - [Executive Summary](#)
  - [Full Report](#)
- [Financial Resources Catalogue](#)

#### IV. Food Desert Mapping Tools

- [USDA Food Desert Locator](#)
- [PolicyMap](#)



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## How to Apply

OFN welcomes all CDFIs that are committed to performance to apply for Membership. Our standards for Membership are different and generally higher than the CDFI Fund's requirements for CDFI certification. Not all OFN Members are CDFI Fund-certified and not all CDFI Fund-certified CDFIs qualify to be OFN Members.

To apply please complete OFN's new [online membership application](#). You will be able to provide all necessary attachments when completing the application. If you want to work on the membership application prior to submitting it online please download a [practice copy](#). We recognize that not all CDFIs are ready for or interested in OFN Membership. We invite these CDFIs, as well as non-CDFI organizations and individuals who support OFN's mission, to become [OFN Allies](#).

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- [Download our Membership Guidelines.](#)
- [Read our Membership FAQs.](#)
- [Contact our Membership Department at membership@opportunityfinance.net.](#)



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- Regular policy updates and analysis.
- Free participation in Quarterly Ally Calls led by OFN's policy team.
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Annual Ally dues are \$75 for individuals and \$250 for organizations.

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