

Facilitating the Flow of Capital to Niche Agricultural Producers in Rural Markets

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Abstract

Availability of capital has historically been a challenge in rural markets. Niche agricultural producers face a daunting task when trying to raise capital because they commonly have business models that are not well understood by providers of capital and, thus, they are considered high risk. As a consequence, traditional lenders are often apprehensive about providing financing because of this perceived risk. The successful flow of capital is a common challenge both for small firms seeking to acquire capital and for providers of capital. The ability to obtain funding is predicated on a matching of applicant's characteristics, as documented according to the funder's requirements. Niche agricultural producers may be representative of a group of potential capital users who view the loan application process is a barrier, rather than an opportunity, to growth of their business. Technical assistance can help overcome these barriers by educating the applicant about the process and requirements associated with capital acquisition. Government programs attempt to fill the financing gap by providing technical assistance that lowers perceived risk and expanding the borrowers' business networks. Understanding the alternatives in the capital acquisition process can help niche agricultural producers in their search for capital and assist governments and communities in developing policies that can facilitate the flow of capital.

Introduction

Availability of capital has historically been a challenge in rural markets (Sherrick, 1998). The successful flow of capital is a common challenge both for small firms that want to acquire capital and funders who are in the business of providing capital. Small firms often struggle with the process through which capital is raised because of a lack of business and financial skills (Timmons and Spinelli, 2004). Better information about how to develop capital acquisition strategies, information about the availability of capital, and criteria that must be met before capital can be obtained would assist small firms' capital acquisition efforts (Cassar, 2004). While providers of capital want to extend financing, they face challenges from applicants who are unprepared. Small firms and providers of capital alike would benefit from a method of furnishing information about how to prepare funding requests, identifying institutions that

provide capital for particular purposes, and criteria that must be met before funds are extended to applicants. The object of this study of published empirical findings is to synthesize them into a step-by-step decision model that would assist smaller, rural firms, especially, and others in their quest to acquire capital.

Accessing capital can be especially challenging for niche agricultural firms as their business model is often so different from others evaluated by providers of capital (Paulson and Sherrick, 2009; Richards and Bulkley, 2007; Pirog et al, 2006). Van Auken (2008) found that funding requests by niche agricultural producers were most often rejected because of weak business plan, lack of collateral, and failure to meet the funding agency criteria. The lack of coordination between funding agencies, gaps in the availability of technical assistance, and poor dissemination of information were other significant obstacles to capital acquisition. Wheatley (2001) emphasized that owners of specialized agricultural firms often lack business skills and may not fully understand the process through which capital is acquired, thus contributing to their difficulty in acquiring funding. The resulting lack of operating capital can place niche agricultural producers at a disadvantage in competitive markets.

The remainder of the paper is organized as follows. The background section presents the issues related to the financing of niche agricultural firms. A discussion of financial constraints describes the needs associated with niche agricultural firms, and leads to development of the model offered to facilitate the flow of capital to these firms.

Background

Agricultural demographics

The U.S. has 2.1 million farms on approximately 1 billion acres of land. Almost 1 million people claim farming as their primary occupation, and about the same number claim another principal occupation, but the total of these farmer categories is less than 1% of the U.S. population. About 2% of the population lives on farms, with the balance employed elsewhere. About 25% of the farms and 15% of the total acres are located in the Midwestern part of the US. The concentration in agricultural production is shown by the fact that 50% of the sales of agricultural products come from only 46,000 acres of farmland. From 2002 to 2007, nearly 75% of U.S. agricultural products were produced by 5% of the farms. U.S. agricultural production is capital intensive and often produces undifferentiated (i.e., commodity) products (US EPA, 2010).

In contrast to the statistics on large farm operations, a sizable majority (90%) of U.S. farms are owned and operated by individuals or families, and a similar portion have gross revenues of less than \$250,000 (US EPA, 2010). About 60% of the farms and 29% of agricultural land held by U.S. farmers were considered to be “small” farms, and 65% of farmers supplemented their income with off-farm jobs. Family farms are important because they contribute to local communities through job creation and their support of local businesses. Farms with gross incomes of less than \$100,000 make almost 95% of farm-related purchases from their local community. Family farms also serve as responsible stewards of the land, help preserve community green space, and commonly use sustainable farming techniques (<http://www.sustainabletable.org/home.php>).

Between 2002 and 2007, the number of farms increased by 4%, with most of the increase in small and part-time operations (US EPA, 2010). One growing sector of the U.S. agricultural industry receiving attention currently is the U.S. organic industry, which increased its sales from \$20 billion in 2007 to \$24.6 billion in 2008. Sales of organic food products comprised about 2.8% of the total US food sales in 2006, and are growing about 20% per year (Organic Trade Association, 2007; 2009).

Entrepreneurial growth and capital availability

Richards and Bulkely (2007) and Steele (1997) argue that the entrepreneurial attributes associated with niche farm ownership are very similar to those for other businesses and that an entrepreneurial approach to operations can be a competitive advantage for modern farms. In fact, Smit (2004) contends that entrepreneurship has become the more important aspect of niche farming. Various programs through U.S. government, state and local economic development, and private agencies work to foster entrepreneurship in farming and to improve the flow of capital to the niche agricultural sector. States couple a variety of loan and/or grant programs with technical assistance to improve the financial capabilities of niche farming operations. Additionally, states offer many promotion and labeling, directories, market research, training and legal assistance program to help niche producers (Kilkenny and Schluter, 2001). Despite the number and expansion of programs aimed at providing financial as well as other resources to the agricultural sector, Goreham (2005) reports that many sectors remain poorly served. Similarly, Korsching and Jacobs (2005) maintained that agencies need to facilitate the flow of capital to small agricultural firms.

A number of programs are available to assist small farms, but information about those programs is not widely disseminated, thus limited their possible impacts (Richards and Bulkley, 2007). Inadequate information about the required criteria, contacts, and documentation, for example, might be especially limited in rural areas, where potential users are fewer and more widely dispersed. Without ready access to financial information and opportunities for developing business skills, their relative isolation may complicate their acquisition of capital. While the internet provides more opportunities for information flow, owners still must navigate the disconnected and difficult to understand information (Van Auken, 2001).

Niche agricultural producer business models are often not well understood by providers of capital. Issues such as non-traditional access to markets (e.g., direct sales to consumers, farmers markets, and cooperatives), the associated uncertainty of market forecasts, weather, unusual nature of some products (e.g., flowers or specialty grains) are typically not commonly evaluated by providers of capital. The business models from production to marketing present a new set of unusual and uncertain market dynamics. As a result, the producer requests for capital may be evaluated as being too risky to fund (Richards and Bulkley, 2007). Government programs are often designed to help fill gaps in capital availability through either direct financing programs, technical assistance that lowers funder risk exposure, or business network expansion that can facilitate capital acquisition (Beck, 2006).

Financing Constraints

Information

Much of finance theory is based on the premise that financing decisions should be determined by the combination of debt and equity that minimizes the cost of capital

(Modigliani and Miller, 1958). Several studies (Kuratko, Hornsby, and Naffziger, 1997; Gibson, 1992; Landstrom, 1992), however, argued that lack of information may be an obstacle to small firm capital acquisition because owners aren't aware of the sources of capital, the relationship between the business characteristics and appropriate capital, and the capital acquisition process (Ang, 1992; Landstrom, 1992).

Gibson (1992) believed that owners' search for capital is often inefficient, unorganized, and unsuccessful as a result of their lack of information about the alternative sources of funding. This may be especially valid for niche agricultural producers because their expertise is likely associated with agricultural production rather than business financing. Additionally, niche agricultural producers have limited information about funding alternatives due to their location and inexperience (Drabenstott and Meeker, 1997). Busenitz et al (2003) suggest that the availability of information about alternative sources of capital as well as the process through which capital is acquired impacts the success of capital acquisition strategies. Providers of capital can play an important role in dissemination of information about funding alternatives, criteria to qualify, and the process to follow in order to be successful in acquiring capital, but still they are limited in their ability to effectively evaluate request for funding (Fries and Akin, 2004).

Van Auken and Jing (2009) found that niche agricultural producers' acquisition of capital was associated with their familiarity with providers of capital. Greater familiarity with a provider of capital leads to capital acquisition from the provider; conversely, less familiarity leads to less capital acquisition. Being familiar with sources of capital probably helps owners better understand the process through which capital is acquired as well as a better

understanding of alternative sources. A higher comfort level would most likely lead to a perceived ease of capital acquisition.

Technical Assistance

Rural areas possess environmental attributes that are not conducive to the success of small firms (Chrisman et al 2002). A study of rural niche agricultural producers found that few agencies offer them assistance (Van Auken, 2008). The most common forms of assistance were help with opportunity recognition and business plans, but even these forms were provided by less than 25% of the surveyed agencies. Additionally, agencies reported that funding applications often were not funded due to weak business plans. This finding was supported by previous research studies (Mason and Stark, 2004; Hustedde and Pulver, 1992).

External assistance can help business owners become more knowledgeable about all aspects of business operations, but can be especially useful when firms are attempting to acquire capital (Audet and St-Jean, 2007; Chrisman and McMullan, 2004; Chrisman, 1999; Lang, Calantone and Gudmundson, 1997). Berger and Udell (1998) suggested that the relationship between the small firm and its provider of capital impacts the flow of information, terms of funding, and success in acquiring capital.

The primary provider of financial assistance to niche agricultural producers came from community banks. Financial assistance included financial advice in addition to the acquired capital. To emphasize that relationship, firms that did not receive advice from a community bank did not acquire capital from it. Community banks are one of the major sources of advice for niche agricultural producers, thus they were well positioned to then provide funding (Zhang and Van Auken, 2010).

Facilitating the Flow of Capital

Improving the Flow of Information

The traditional theory associated with capital acquisition assumes that information is free and widely available. This assumption is likely not valid in the context of the small firm environment—and especially in the rural environment—because of challenges associated with the dissemination of information (Zinych and Odening, 2009). In fact, the lack of information about capital acquisition acts as an obstacle to small firm capital acquisition (Kuratko, Hornsby, and Naffziger, 1997; Paulson and Sherrick, 2009). Inaccurate information and the inability to gain access to capital markets could result in small firms either having a sub-optimal capital structure or being under-capitalized (Van Auken, 2001). This observation is supported by Chaganit, DeCarlis, and Deeds (1995), who emphasized that capital that is easier to obtain is used more often while capital that is difficult to acquire is used less often.

Van Auken and Carraher (2009) found greater flow of information through more technical assistance programs would be quite valuable in niche agricultural producers' search for capital. Their results demonstrate that technical assistance is needed, but not provided. Technical assistance commonly includes advising in the areas of business planning, financial advice, and marketing. Their study found that private sector assistance was preferred to greater government involvement.

A Facilitating Flow Chart

Capital acquisition can be a confusing and difficult process, especially because owners of small firms are often better at technical issues associated with the business (e.g., agricultural

production) rather than having strong financial skills. Lack of financial skills would include not comprehending the capital acquisition process, knowing where to find assistance, understanding metrics used to evaluate funding requests, and having the needed knowledge of finance. A step-by-step flow chart of the capital acquisition process, showing the roles of technical assistance and information constraints, is depicted in Figure 1.

The process originates when the firm makes the strategic decision to seek capital. The success of the process can hinge on the degree of deficiencies in any of these required areas. For example, niche farm operations likely are confronted with resource and business expertise constraints that limit the potential of their operations. These deficiencies can be overcome, however, with technical assistance from consultants or other service providers with expertise in capital acquisition. As shown in Figure 1, some firms seek assistance while others don't seek assistance. Firms that seek assistance receive help with identifying the appropriate target funder and preparation of documents. The needed documents are submitted to the appropriate funder for review and a decision. Funders could subsequently decide to fund, reject, or request more information. This type of technical assistance can be important to eventual success with acquiring the needed capital.

Firms pursuing capital without technical or financial assistance have a much higher chance of their funding request being denied or delayed. These firms (i.e., those following the right-hand path) may be nearly clueless about where to locate appropriate funders and what types of documents must be prepared in a formal request. While these incomplete requests will more likely be denied, Figure 1 provides the left-hand feedback path as an alternative outcome for requests that are midway between approval and denial. This path directs the firm

to actively seek assistance with its capital search, rather than directly seeking capital without sufficient guidance. Providing an easily accessible way to facilitate contacts with providers of technical and financial assistance could improve the flow of capital to niche agricultural producers. A visible network of these facilitators could reduce the frustration of delays and outright rejections of funding requests.

Conclusions

The ability to obtain funding is predicated on a matching of applicant's characteristics and documents with the funder's information requirements. Technical assistance can overcome funding barriers by helping the applicant understand the process and requirements associated with capital acquisition. Niche agricultural producers especially face a daunting task when trying to raise capital because they commonly have business models that are not well understood by providers of capital and, thus, are considered high risk. As a consequence, traditional lenders are often apprehensive about providing financing because of the perceived high risk. Government programs attempt to fill the financing gap by providing technical assistance that attempts to lower the perceived risk, through direct financing programs, and by providing opportunities to expand business networks associated with raising capital (Beck, 2006).

Many of the possible providers of capital have a local community connection or are government programs directed at economic development initiatives in general or agricultural firms specifically (Richards and Bulkley, 2007). These funders are often not well understood or visible and are thus not fully utilized. Greater technical assistance that can help niche agricultural producers prepare documents (especially business plan development) and navigate

the maze of possible funders will significantly facilitate capital flows. Government agencies and other providers of technical assistance may consider improving the flow of information to niche agricultural producers so their understanding of capital alternatives will be better and more comprehensive.

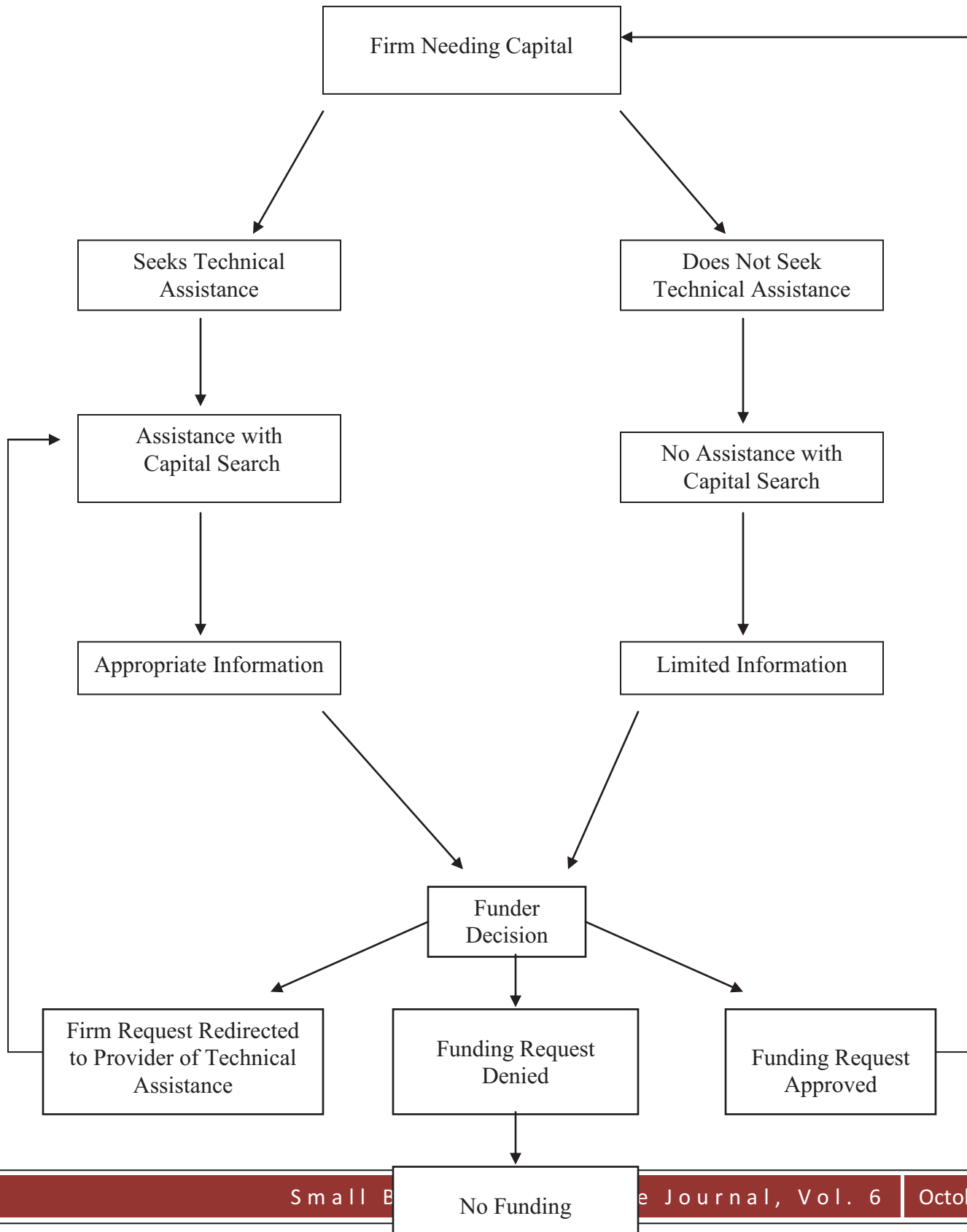
Anecdotal evidence and previous research have stressed the importance of technical assistance and the role of information in improving the flow of capital to niche agricultural producers. This paper has integrated previous findings into a facilitating flow chart that explains the dependence of capital acquisition upon technical assistance and information. This model makes several contributions: (1) it outlines the steps that firms needing capital should follow; (2) it stresses the importance of obtaining technical assistance in the capital acquisition process, as well as the importance of providing appropriate information to potential funding decision-makers, and (3) it identifies an alternative decision of “redirect” for those capital seeking firms that did not obtain assistance in their capital search. Capital-intensive producers with growth potential but without extensive financial experience, such as niche agricultural markets, may be helped by government and community policies that facilitate the flow of technical assistance, information, and, ultimately, the capital that they seek.

No easy or quick solution will likely be identified or implemented to achieve better flow of resources to niche agriculture producers. However, the liabilities associated with a niche farming operation, especially if the farm is small, and lack of business skills of the owner, can be addressed through better flows of information and technical assistance. For example, a single website that provides easy-to-understand and navigate information sources could be developed that contained links and descriptions of various assistance programs. This could be

coupled with print information available at the traditional assistance access points, such as government extension offices and community banks. Technical workshops might ultimately facilitate the flow of resources, but the niche farm owners would still need to participate. The challenge will likely continue for niche producers, providers of capital, and government support agencies. A key aspect of confronting the challenge is to achieve greater cooperation and information sharing among all stakeholders.

Figure 1

Process of Capital Acquisition:
Role of Technical Assistance and Information



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