PER UNIT RETAINS/ADD-ONS

A CAPITAL ACCUMULATION TOOL

IN FARMER OWNED BUSINESSES

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I. FARMER OWNED BUSINESSES - THE CONCEPT

Farmers in most developed countries have organized successful businesses and borrower owned financial entities. Frequently these are organized as service cooperatives but in many instances producers have sought more flexible corporate structures and have set-up limited liability companies, limited or general partnerships, family owned farming corporations, as well as all sorts of joint ventures and combinations of different corporate forms. The primary reasons for organizing these businesses are to improve farmer incomes and profitability by vertically integrating into farm supplies or farm management services, marketing, processing and other value added businesses.

On the other hand, it has frequently been seen that processing and marketing firms not owned by farmers also attempt vertical integration by becoming producers as well. This drive is motivated by the same forces that farmers find hard to resist, i.e., capturing additional profits through economies of scale obtained by vertical integration and value added enterprises.

In wealthier countries and amongst large farmers in developing countries businesses can be put together with appreciable equity investments by the interested partners and bank financing is usually arranged for the balance needed to get started. But even in these instances, farmers forming their own value added businesses resort to a variety of financial engineering techniques to finance the ventures.

In developing countries farmers interested in forming their own business, e.g., a service cooperative or another form of value added enterprise, face difficulties raising sufficient equity and financing to put together these types of businesses.

In the paragraphs that follow several simple mechanisms will be discussed that can be useful tools for farmers to avail themselves of in order to adequately capitalize farmer owned businesses.

II. CAPITAL ACCUMULATION - CHALLENGES AND OPPORTUNITIES

A. Under capitalization - the most common reason for business failure.

One of the principal reasons for business failure the world over is under capitalization. Frequently the partners involved lack adequate collateral to obtain sufficient bank financing, which tends to be on the conservative side. Lending decisions are frequently made and based on collateral decisions and not on a thorough analysis of the project. The business may start but then, after a brief period, there is a capital shortage and borrowing capability has been fully utilized. The most frequent result of this situation is contraction, loss of competitive edge and missed targets of business opportunity. Business failure is usually the result in these cases.

Farmer owned businesses in the developing countries are usually the type of firm that suffers most from under capitalization and agricultural cooperatives lead the list of under capitalized firms. But there are mechanisms that can be used by farmers to raise capital on a regular and consistent basis.

B. The Per Unit Capital Retain

One of the most frequent used mechanisms to raise capital in farmer owned businesses is the per unit capital retain. For each pound, kilogram, quintal or ton of product delivered to the business for processing and/or marketing a small "cess" or sum is retained to be credited to the share account of the individual concerned. As product is delivered over time the stock holder's account is gradually built up.

In some instances, farmers have signed exclusive marketing contracts with their business organizations and then, based on this contract, a medium term loan is negotiated with a financial entity which pays over the loan proceeds to the firm as paid-in capital. The firm agrees to act as collection agent for the bank and retain a fixed amount from each product delivery to pay off the farmers' loans.

C. The Per Unit Capital Add-On

Another mechanism which was used in the U.S. and in Bolivia, Honduras, Uganda and several other developing countries, is known as the per unit capital add-on. Usually farm supply businesses started by farmers by pooling their requirements for fertilizer, chemicals, feed, fruit and vegetable packing supplies, tools, etc. are able to obtain prices more advantageous than individual farmers can obtain from the small shops in their communities or in the nearest market town. This "savings" derived from the achieved economy of scale and value added through group purchasing is not 100% reflected in the price to the farmer stockholders and/or customers of the business.

In addition to the direct costs attributable to the procurement process and an appropriate amount of corporate overhead, which is added to the wholesale acquisition cost of the supplies, a small per unit capital add-on is also charged on each item for sale from the business. Farmer stockholders purchasing fertilizer, for example, might see an invoice written as follows:

Cost of 5 ton 18-26-0	$ x,xxx.xx
Transport/loading/unloading	xx.xx
Indirect costs @ 7%	xxx.xx
Sub total	$ x,xxx.xx
Capital add on 5%	xxx.xx
Invoice total to be paid	$ x,xxx.xxx

Each sale is registered in the name of the stockholder and the amount added-on to each invoice for capital is credited to his/her capital account. If a store customer is not a stockholder, yet purchases farm supplies through the farmer owned business, he would be asked to pay a higher price established by raising the indirect cost percentage and would still be required to pay-in to the capital account. Since this customer is not a stockholder, either because he doesn't qualify or because he does not wish to become one, the capital obtained through this sale is credited to a special corporate capital account or to a corporate reserve account. In this manner, unallocated capital is also built up, which is also necessary for any business.

D. Retained Earnings Distributed on a Patronage Basis

A third commonly used technique for raising capital in a farmer owned business is to retain corporate earnings or profits in the business but allocate them to stockholders in accord with some previously agreed on formula. The mechanism adopted would depend on the real corporate objective. For example: If the farmer corporation is a marketing/processing firm organized by pineapple producers, it is interested in stimulating deliveries of pineapple and in increasing volumes for fresh marketing and processing. Furthermore, the assets of the corporation used to process and market pineapple are obtained with shareholder equity leveraged through bank borrowing. The farmer who delivers more pineapple is using the assets of the company to a greater degree than another farmer who only delivers small quantities of fruit. It is therefore logical and appropriate that the farmer who delivers more pineapple and uses the equipment more should contribute more capital to the company. Likewise, the profits of the company are derived because it markets and/or processes pineapple and the farmer who delivers more pineapple is contributing more to the profit than a farmer delivering a lesser amount. Therefore, it makes sense to allocate net profits for distribution to those stockholders who delivered pineapple and in accord with the amounts each delivers.

By operating in this manner, farmer equity will be built somewhat in proportion to pineapple deliveries or use of the assets of the company. Larger farmers will therefore build equity at a faster rate in accord with their use of the corporate assets, which is appropriate.

III. APPLICATIONS

A. Privatization

All three capital accumulation techniques are ideal in countries embarked on privatization of government owned businesses. Farmers frequently don't have adequate capital, the borrowing ability or the organizational structure to purchase outright the assets up for sale. A milk or canning industry may be valued at several million dollars but the majority of dairy or fruit farmers may only own two or three milking animals or a few acres. But these same farmers might be willing to dedicate a few cents off each liter of milk delivered or off each kilogram of fruit delivered to gradually accumulate equity.

If a way can be found to establish a trust fund which would be used to purchase the assets from government and hold these in trust for farmers delivering milk, or grain, or fruit, for example, the state owned business could eventually be divested to the producers of the commodity being processed at the firm. This would be far more equitable than simply selling-off the assets to the highest bidder, who might not have the producers' nor national interests in mind when acquiring the firm being divested.

B. Nucleus Farming Companies

In some countries nucleus farms have sprung-up and established contract farming relationships with growers, who are supplied with farm inputs, credit and technical assistance which is recovered by the nucleus farm through product deliveries. But in 99% of these operations farmers are mere contract growers and do not participate as equity partners in the business. This is bad business as an important source of equity financing is being overlooked. Furthermore, it has been documented that farmers with equity interests in a particular company will be more loyal to the firm, especially as they are brought into representation on the board of directors and begin to receive their share of profits.

C. Agricultural Service Cooperatives

Cooperatives are business undertakings by farmers who band together to form a corporate body to provide themselves with services resulting in improved farming operations, increased incomes through marketing collectively and/or lower factor production costs through group purchasing of input supplies. Cooperatives are <u>always</u> in need of additional capital for operations, asset acquisition, etc. By establishing one or more of the mechanisms outlined above cooperatives can begin to build a sound capital structure, increase borrowing capability and leveraging abilities. By increasing member equity, borrowing can be reduced thereby reducing interest costs and impacting directly on the net profit.

D. Producer Associations

Farmer associations are necessary to carry out service and representational functions required by farmers. Associations usually undertake one or more of the following services:

* representation of producer interests with government
* promoting increased consumption of the product for which the association has been organized
* establishing and maintaining quality standards in the sector
* producing and certifying seed or planting material

* financing applied research required by farmers to solve production problems, to discover and test new varieties, to find new uses for the product, to document the nutritional qualities of the product, etc.

* gathering, maintaining and dissemination of statistics regarding area under cultivation, names and addresses of registered farmers, costs of production, yields, variety performance, catalogues of seeds, etc.

* provide technical or extension services to members related to the specific crop

* training services for farmers relating to the specific crop

* serve as a contact point for foreign buyers, investors, suppliers of machinery and farming equipment

* serve as counterparts to foreign technical missions seeking to assist the private sector develop improved capabilities

* business promotion services such as feasibility studies, assistance in putting together business undertakings among members, assistance in obtaining financing for crop production and/or firms dealing with the commodity.

The producer associations usually are financed through a per unit retain or cess established on each unit of product entering the commercial sector. For example, a milk producers association would establish a cess on each liter or pound of milk or cheese being sold. Collection agreements would be enforced by appropriate legislation and funds would be collected at milk and/or cheese processing industries. Any dairy product entering the market would contribute toward the dairy association, which would establish programs in benefit to <u>all</u> dairy farmers.

A cocoa producers association, a fresh vegetable producers association, a North Western Province Farmers Association, a pineapple producers association, a dairy producer association, etc., are all examples of types of associations found in many countries. Perhaps in the United States of America these associations have evolved more than in any other country. But in the United States, associations play a <u>vital</u> role in the agricultural industry and have contributed significantly to position that industry as one of the leading agricultural industries in the world. Most associations in the U.S. are financed through a cess or per unit retains.

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