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Success Factors for Organizing and Operating New Agribusinesses or for Entering into Joint Ventures

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Rural America is seeing a resurgence of interest in new businesses, especially those businesses that may move agricultural producers up the food chain (Novack 2001). For producers, this resurgence is prompted by increasingly narrow margins in agricultural production, higher family living costs, and recognition that food chain businesses closer to the consumer generally provide a higher return on equity.

In rural America, as in most societies, change is often resisted and avoided until circumstances become severe. Financial circumstances for many families and businesses in rural America have reached that level. High land and operating costs, coupled with continued low commodity prices, result in narrow operating margins in many farm operations. Stable or declining community populations, some of it related to farm consolidation, puts financial pressure on main street businesses as well as on schools, churches, and government services.

A continued population decline has occurred in nearly every rural county that is not adjacent to a metropolitan area or does not have recreation or retirement attractions. Migration to cities by young people adds to the problem. In only a few of the rural counties that are not adjacent to metropolitan areas or the home of recreation or retirement attractions have expanding industries that offset the effects of farm consolidation or city migration.

Perhaps most significant is the increased recognition by producers that the initial product of most farms is a commodity—Number 2 yellow corn, soybeans, milk, eggs, pigs, or cattle. Commodities can be characterized as being in chronic oversupply and produced by many parties, each competing with the others for lowest cost of production.

These factors often motivate both producers and community businesspeople to seek to develop new businesses. Producers seek businesses that would increase the value of farm commodities and achieve for producers a return on equity higher than that in the farm operation.

Both producers and nonproducers see the benefit of providing more employment and business activity in that rural community. Additional jobs bring more families in as main street customers, people for church attendance, and children for schools. Other benefits include an increase in home construction and in the tax base for public services.

Community vitality is enhanced where efforts are successful. More jobs, more money, more people, more leadership lead, in turn, to improved communication facilities, libraries, and other community facilities and services.

The new agribusiness ventures and opportunities range from cooperative animal feeding operations to meat processing to packaging popcorn for retail. Some ventures are exclusively producer promoted and producer owned, and ownership may range from a few producers to a thousand or more. Some operations include nonproducers as co-owners.

Business structures vary, from cooperatives to corporations to limited liability partnerships. Some long-term farm supply cooperatives have formed processing subsidiaries. Joint ventures between producer groups and existing processors have developed in several areas.

This report will list three essentials for any successful business, will discuss some unique features of agribusinesses as related to these three essentials, will trace key steps in organizing agribusinesses, and will cite some agribusiness experiences.

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The Three Essentials

There is an oft-quoted phrase, “If you build a better mouse-trap, the world will beat a path to your door.” Unfortunately, in today’s competitive environment, this statement may be misleading. A high-quality product or service is important, of course, but rarely is it sufficient for success. To expect success in a new venture, there also needs to be (1) an identified market, (2) sufficient investment equity, and (3) effective management.

A void in one or more of these three essential elements is evident in nearly every new business that fails. In every business that succeeds, these elements have been present or, where a void has shown itself, leadership has corrected the void before the consequences became fatal.

An Identified Market. The product has to get sold. Product sale is the sole or majority income to a business. If the product cannot get sold, business failure is certain and usually rapid. Unless investors have provided unlimited equity capital, there is little time to develop a market for the product.

Costs begin with planning the business, leasing or building a facility, and hiring staff. Monthly costs include salaries, utilities, and rent or principal and interest costs on facilities and equipment. Input costs—raw ingredients and packaging or handling materials—are usually substantial.

Consequently, a first step in any new business venture is to identify the market and measure its potential for the new business. Depending on the market and the product or service, market risk may be reduced or limited by some form of expressed buyer intent or even a sales agreement. Equity investors and lenders need assurance that the product will sell.

For many new businesses, especially those in which significant volumes of a product are to be produced, obtaining a loan for either facilities or operations is often dependent on a pre-established marketing agreement for the product.

Sufficient Equity. Forty to 50 percent of the money needed to get a business started usually needs to be provided by the initial investors, the primary risk takers. The balance may be provided by loans. Adequate equity is essential for financing the plant and equipment, personnel, initial inventory, other start-up costs, plus a cushion for unforeseen costs. Adequate equity also helps in negotiating favorable loan terms.

Many who get involved in a new business underestimate the amount of investment equity needed. Some lack any business experience. Some have worked in businesses owned by

others and may have been oblivious to the need for equity capital. Those with previous business ownership experience may have built their business equity slowly over time.

In the case of second or third generation businesses, the basic equity may still be held by a previous generation or is being purchased over time by the operating generation.

In a situation in which a new business is being developed, with a new product, a new operating system, and new employees, equity needs are high. In addition, it usually takes considerable time to reach capacity and operating efficiency, while rent or interest and loan payments for facilities and equipment, management and basic production staff, utilities, and insurance are essentially fixed costs from the start.

Ingredients and packaging materials need to be stockpiled. In addition, there are usually unforeseen problems and costs—normal “shake-down” problems in a new business. These unforeseen expenses may consume many dollars.

It should be expected that equity will decline in the first months, perhaps for the first year or two, of a new business. Sales income is not immediate; it takes some time for production efficiency to be achieved, and unforeseen problems may show up for several months. Operating costs simply use up available equity. Loan terms usually include monthly reports on equity and provide for a loan recall if the percent of equity falls below a certain point.

Especially surprising to some business operators is the equity needed for cash flow if the product sells more rapidly than anticipated and production has to increase to handle the market demand. When production volume increases, more inputs—ingredients, labor, utilities, and perhaps shipping costs—are needed and have to be purchased. Cash from those increased sales will come weeks or even months later.

This is a good problem to have, but it is also a problem to be anticipated and to be ready for with either equity or advance credit arrangements.

Effective Management. Many businesses fail or do not reach their potential because of limited vision and top management skills. Those that succeed invariably have a manager or a management team that focuses on goals; understands equity and cash flow; is able to hire and motivate good staff; and has experiences, linkages, or knowledge important in the specific industry.

Good managers not only do things right, they do the right things. They devote their time and energy on the high priority issues, issues that allow the business to make and sell a high-quality product (Uris 1986). A board of directors or a leadership group starting a new business

has to attract and hold the person who has and effectively uses those good management skills (or, in the case of a large business, the several people—finance, personnel, operations, etc.).

Features of Agribusinesses and the Three Essentials

Features of up-the-chain agribusinesses warrant special attention as they relate to the three essentials discussed earlier.

Volume. In situations in which producers and/or community leaders seek to increase the value of local farm commodities via a new business, high product volume is assumed in order to utilize a high volume of locally produced commodity—usually grain or animals. A million-bird egg production facility would use about a million bushels of corn and would produce, when in full production, about 20 million dozen eggs per year (United Egg Producers, private communication 2002).

A 45-million-gallon ethanol plant, considered by some to be needed for operating efficiency, would use about 16 million bushels of corn (Miller 2001).

Though these amounts of product are minor in relation to total U.S. or global use, these are large volumes. If there is no marketing arrangement before a plant is built and begins operations, the financial risk is enormous. It is the investor, also usually the deliverer of plant ingredients, who carries the primary financial risk. In those cases, the producers/investors risk both their financial investment in the new business and perhaps the value of the input commodity delivered.

The Product Is Still a Commodity. Any product that is sold in quantity by the gallon, barrel, dozen, or hundredweight is still a commodity. Grain, a commodity, goes into an ethanol plant. The ethyl alcohol and plant byproducts that come out are also commodities. Value may be increased, but it is a good idea to recall that commodities are invariably produced by many parties, each competing for the lowest cost of production. Oversupply is a chronic problem.

Input Scheduling and Flow. In cases in which the input to a new agribusiness is animals—broilers, finished hogs,

cattle, or sheep—the production schedule for those animals is critical. First, delivery of finished animals needs to be synchronized with plant start-up, and the production of the several or many suppliers has to be arranged to provide an even flow of animals of the right weight.

Management has to balance the risk of unforeseen start-up problems that might delay acceptance of ready animals vs. operating a plant at below capacity levels for a few weeks or months.

The risk is less when grain is the input, but there is still cost in holding grain for later delivery or missing an alternate market opportunity.

Extension of the Farm Business. Producers/investors may think of this new business as simply an extension of the farm business, so it would need comparable management skills. Thus, one of the producers/investors may be interested in managing the business.

The decisions associated with selecting and setting compensation for the manager of an up-the-chain agribusiness are often the most difficult and the most critical. In selection and compensation of management, other forces are often at work. Producers/investors may reference their own income tax returns in considering compensation rates for a manager. Why should we pay that person more than we make?

Here, more than in any of the other decisions, new business organizers need to be especially cautious and deliberate. It is critical that the tasks of management be delineated, skills be identified, a survey made of the type of people who succeed in managing such businesses, and information gathered on the compensation needed to attract and hold a top manager.

Steps to Organizing a New Agribusiness

Development of new businesses that move producers up the food chain and increase employment and business activity is not easy. Producers may have the highest motivation because they seek a higher value for their commodities; other community businesses may also benefit, however. That new business will need utilities and workers, perhaps feed ingredients and veterinary services, and probably paper, machinery, cleaning supplies, waste pick-up, and repair and maintenance services. Trucks that bring input or deliver product need fuel, likely from local suppliers. Truckers buy coffee, donuts, or lunch. If construction is involved, construction and equipment installation crews will need motel space and meals, perhaps for weeks or months.

These wider community benefits suggest that, in addition to producers, others in the community may be investors. They may also have business skills and experiences that would be very helpful in planning and developing the business and/or the structures.

Though a new agribusiness may be started by only one or a few investors, many new agribusinesses involve significant numbers of investors. This presents both opportunities and some problems. Most importantly, there are some tried and true steps that seem to be important for success, to increase the chance that a business will get developed and that it will be financially successful.

The first step is usually the formation of a steering committee—a group of people who will crystallize the business idea into a specific proposal, if financially feasible. Later, when the business is near formal establishment, a board of directors is named. That board may or may not be comprised exclusively of members of the initial steering committee.

The following steps are specifically suggested:

1. **Get the right people on the steering committee.** A steering committee should include needed experiences and skills. Members should be respected for good judgment, community/industry interests, and business or professional success. Each member should be financially able to make a significant investment and, if the project proves feasible, should be willing to make that investment. They should be willing to devote time and skill to the task. Committee members may be self-appointed or include those who have also expressed interest. A temporary committee might set up a system for member selection. The steering committee would then become responsible for the successive steps.
2. **Establish steering committee operating policies.** Some policies to consider are as follows: (1) The site criteria—must it be within the geographic community, or where market, transportation, utility cost, or other factors would have the most financial benefit? (2) Arranging for equipment and services—should the business seek bids or negotiate only with selected suppliers? (3) Conflict of interest avoidance—should steering committee members accept gifts or travel from prospective vendors? and (4) Employment in the business—should steering committee members be eligible? This may seem a conflict to some potential investors.
3. **Write a business plan.** This plan should include the stated mission of the business, the major business goals, and, in general, the strategies to be implemented to achieve the goals. This initial plan would naturally emphasize the organizational effort, and it would be refined, added to, and modified as the steering committee investigates market potential, studies construction and operating processes, and completes a financial feasibility report.
4. **Do a financial feasibility report.** From sources such as comparable businesses, from personal experience, from consultants, and from others, estimate sales volume and prices, marketing cost, input costs, construction, personnel, interest, utilities, and other costs. Do a complete, long-term cash flow by months, preferably for the duration of the anticipated major loan to the business. It is best to do at least two complete cash flows—an expected scenario and a worst-case scenario. Also complete a best-case scenario. Remember, “oops” happen, and both input and product prices fluctuate.
5. **Determine the form of business structure.** Should the business structure be a corporation, a limited liability corporation, a partnership, a limited partnership, a traditional cooperative, a closed cooperative, or take some other form? The right choice depends on the number of major investors, laws of the state, tax considerations, and other factors. Determine the size of the board of directors and how they shall be chosen (Hanson 2000).

6. **Choose experienced legal counsel.** It is important to have counsel who have worked successfully on similar businesses and comparable business structures. They will be the ones to write the investment prospectus or offering memorandum, and they will, thus, need to know both state and federal laws and regulations. Relatively few attorneys have had significant experience with producer ownership in value-added agricultural businesses, especially with cooperative-type business structures. Why pay an attorney to learn?
7. **Be cautious in selection and use of consultants.** Special skills may well be needed for project design or other functions; however, the steering committee needs to be front and center on all issues. They are the people potential investors will quiz. Consultants are expected to take pride in your project's success, but they have no long-term commitment or obligation. The steering committee does. It is often assumed that a consulting engineer is essential for dealing with permit granting agencies, for example, and that, once employed, that consultant will "take care of everything." Regardless of how good that consultant may be, such is often not the case. One or more members of the steering committee should be designated to be totally responsible for each issue, keeping the process on track and the total steering committee informed.
8. **Pay special attention to dollar size and features of equity shares.** Consider total equity needed, numbers of potential investors, and their available cash or borrowing capacity. If you want community investment from people who may not be in a related business, keep equity share size low; people can always buy more than one share. At the same time, one could establish a policy that those who deliver inputs, such as corn, must buy a certain number of shares.
9. **Pay attention to equity share details.** Be aware of down payment and final payment terms. Will the funds be placed in an escrow account? One business required 20 percent down payment to be put in an escrow account and the balance due on a 15-day call at the time a construction contract was to be let. If the purchaser did not follow through with the last 80 percent, they lost the initial 20. That helped sales and cash wasn't needed, but it virtually ensured that all purchasers would pay their 80 percent on call.
10. **Be cautious in purchase commitments on equipment and basic operating systems.** This is especially true for computer hardware and software purchases. New businesses, especially those being put together by an inexperienced steering committee, are vulnerable to a good sales pitch, a discount on a new machine design, or "cutting-edge" software just being developed. It is better to stick with what is known to function in existing businesses of your type. You will have enough problems with the new business without having to work the bugs out of a manufacturer's new machine design or a supplier's new software.
11. **Steering committee members must invest in the venture.** It is the members of the steering committee who should know most about the project and have the greatest confidence in the financial feasibility of the business. If members expect their neighbors and others to invest, they must have demonstrated their own willingness to invest.
12. **Get potential investors to information meetings.** Few eligible investors will invest if they do not get to one or more of the informational meetings. Before that first informational meeting, do a dry run on the presentation with people who will be critical, and then make refinements in the presentation as appropriate. Make sure the presentation is succinct, accurate, and informative. At the meetings, make time for steering committee members to answer all the questions. This is the steering committee's job, not a consultant's. Be totally open; if you don't know the answer, say so. Get names, phone numbers, and addresses of attendees. Make sure attendees have a take-home document that summarizes the project.
13. **Follow up with potential investors.** Divide the meeting attendees' names among steering committee members for follow-up. Answer their questions. Invite them to another meeting, if one is scheduled.
14. **Keep area people informed.** Before, during, and following informational meetings, get information out to area people. Use the media fully. Develop a list of all area media—daily and weekly papers, radio, and TV stations—with fax numbers or e-mail addresses, names of editor or key staff, and, for weeklies, the day of publication and when they need the material. Write the media release and send it directly. Don't expect news media to write the articles. Weeklies don't have the staff, and no one there knows the project as well as the steering committee.

How About Joint Ventures?

Start-up businesses initiated by producers to move up the food chain may be short in one or more of the three basic essentials for success—sufficient equity, marketing contacts, or experienced management. Producers may, therefore, choose to form a supplier alliance with an established processor, perhaps even become a part owner of that up-the-chain processing business.

Producers can provide a steady supply of specified input, such as grain of milling quality, natural pork, or organic soybeans. Should producers become part owners of the processing business, they can participate in earnings, and perhaps respond more quickly to changes in final product demand.

How do producers evaluate a potential partner? Should they be investors? If so, how do they evaluate such an existing processing business? How do they determine the business's value and the value of an ownership share? How do they negotiate?

Here is where outside expertise is likely needed—people and firms experienced in evaluating businesses for investors, doing the “due diligence” that discloses true and current worth. Producers need to check out several firms that specialize in this work, get feedback from their previous clients, and talk with venture capital investors to find out who they use and why.

What should producer groups or other prospective investors/purchasers find out about a business in order to be confident about a joint venture or purchasing an interest?

Here are some major items:

1. **Complete financial data.** Compile audited balance sheet for recent years, showing assets and liabilities in detail; current and projected cash flow; profit/loss

statements for recent months and years, plus projected statements.

2. **Sales data and information.** Collect sales volume and value by months and years; projected sales and rationale for such; cost of sales per unit of product; and interviews with customers to learn their degree of satisfaction and, when possible, their future product purchase plans. Then, compare that with sales projected by the company.
3. **Management structure, expertise, depth, and effectiveness.** Do they have a handle on the key issues such as up-to date financial, sales, and personnel information? Or, is information incomplete or late? Can each person explain the information they have and justify the projections? What is management's relationship to the current board of directors?
4. **Dependability and quality of input suppliers.** Though producers/prospective purchasers may intend to supply the raw commodity for processing, the business also needs packaging material, equipment, and other ingredients. Interviews can disclose whether their invoices have been paid on time and other information about how the company does business.
5. **Operating efficiency.** Do the operations appear to be running smoothly? Are the facilities clean and equipment well-maintained? Does there appear to be good communication at operating levels? Is the employee attitude positive? Do employees know the goals of the business and how they are contributing?

Some Tested Agribusinesses

Neither space nor prudence allows detailed discussion of all the reasons why individual businesses succeed or fail; where there may have been temporary voids in equity, management, or sales, and how they got corrected; or the voids that were fatal. Nor can one be certain of the specific factors that brought businesses success. Even so, cited here are a few up-the-chain agribusinesses that illustrate the potential which exists.

NC+, headquartered in Lincoln, Nebraska, started as a cooperative corn seed processing and sales business by Nebraska producers. Current owners are mostly second generation. The business produces and sells soybean, sorghum, alfalfa, and other seeds, as well as corn, and ranks in the top 10 U.S. companies in seed corn sales. NC+ has research and processing facilities in Nebraska, Kansas, and Iowa; is profitable as an operating business;

and provides a high value market for the seed produced by its member owners.

West Liberty Foods in West Liberty, Iowa, is a meat processing business that was started in the mid-1990s by Iowa turkey producers when the processor who was handling their turkeys decided to get out of the business. Producers put up capital, bought and updated the plant, and hired an experienced manager. Within months, turkey meat was in oversupply, prices dropped, and considerable equity got used up. Members put in more equity, and the group obtained back-up financing and somehow got through the financial pinch. The business has since obtained a major fast-food contract and expanded into handling other meats. It purchased a second facility and now has a third plant under construction.

Southwest Iowa Egg, a producer cooperative near Massena, Iowa, was designed as a market for area corn. It was organized by an 11-member steering committee, beginning in late 1995. A thousand \$2,700 equity shares were sold during and following 19 informational meetings

in early 1998. An egg marketing agreement with downside price protection was negotiated, land was purchased, and production began in early 1999. The business soon encountered an egg surplus, the lowest egg prices in 20 years, and a number of start-up problems involving equipment and computer software. As anticipated, equity declined the first two operating years, but several improvements in operating efficiency brought per share equity back to the original \$2,700 by April of 2000.

Sioux-Preme Pork is a processing business with experienced management based in Sioux Center and Sioux City, Iowa. A network of natural, Berkshire, and other pork producers who supply the plant purchased, via a producer network, 6 percent of the company. The total transaction also involved a major investment by a private fund, tecTERRA, an arm of the private Iowa Agricultural Finance Corporation. Cybus Capital Advisers, co-general partners in and managers of the fund, did the due diligence needed by both the fund and the producers. Expansion of the producer network can occur, both in pork volume and in number of members, depending on market growth for product.

Summary

The resurgence of interest by agricultural producers and others in rural America to start new businesses brings with it both opportunities and problems. There are opportunities to increase the value of raw farm commodities (e.g., grains, animals, animal products), to provide jobs and other business activity in the community, and to provide some return on equity to producers and other investors.

Businesses do not automatically succeed, however. Up-the-chain processing and packaging businesses usually require different or additional ownership/management foci than other farm operations. Most producers focus on the job to be done; little focus is placed on personnel policies or a management structure.

Most producers put a high priority on themselves, as individuals, owning or controlling land, their machinery, and their animals—their total operations. When they become part owner of (or investor in) a business, ownership and control are shared. Most decisions are made by a group—the steering committee or board of directors—or are delegated to management. That is difficult for some farm operators to handle.

The three essential elements for business success are sufficient equity, a market for the product, and effective management. Any discussion of agribusiness warrants a special focus on these three essentials.

To get a new business organized, some especially significant issues are key—for example, choosing the right steering committee members, writing a business plan, determining financial feasibility, selecting the right business structure, using appropriate consultants and legal counsel, selecting equipment and processes, and getting potential investors to informational meetings.


Especially in situations where equity, management, and marketing ability may not be sufficient for a fully successful, independent business, some form of joint venture by producers with an established processor may be the best route. An established processor, for example, should know how to run that business, should have marketing contacts and credibility, and, most importantly, if operating successfully, should have borrowing capacity.

Finally, to consider a joint venture, producers and others involved need to check that business out thoroughly. If a partial purchase is involved, there should be a credible means to establish its value. Here, experienced evaluation and negotiation advice is usually needed. There are five things for which to look: (1) complete financial data; (2) sales volume, value, and trends; (3) management structure and capacity; (4) dependability and quality of input suppliers; and (5) operating efficiency.

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