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**FINANCING ADDED-VALUE
GETTING THE GREEN LIGHT FROM YOUR BANKER**

Jeffrey W. Kistner
New Business Development Officer, CoBank

Hello! As introduced, I will be talking today about financing added-value agricultural ventures, with an emphasis on ethanol.

Today, I'd like to share our lending experience with you and discuss the steps a lender takes when considering whether to finance added-value ventures such as biomass or ethanol.

The first three slides that I will present lay the groundwork for added-value financing. The first slide presents the equation. To calculate the equation, you must line up strengths, weaknesses and uncertainties in a column format. Strengths minus weaknesses have to be greater than uncertainties. If that equation holds true, you can proceed and go further.

The next slide highlights the factors that must be present to attract financing. There are five credit factors that lenders look at. The five credit factors are:

- Capacity, which is the repayment capability.
- Capital, which is the financial condition or the balance sheet of the business.
- Character, which refers to the management.
- Collateral, which is the quality and the value of the secondary repayment source. The collateral in most added-value propositions may only be used for the designated purpose and therefore, it is considered a special use asset.
- Conditions, which is the purpose, the amount and the requirement to operate the business. Lenders look at conditions from two perspectives – the external and the internal. External conditions cover such areas as the economy, whether there is enough production in the area to support the venture, demand for the output and government regulations. Internal conditions include the loan covenants and the business's ability to meet a minimum set of financial standards.

The next slide lists the start-up stages for the added-value project. You must follow each of these stages in order. If you attempt to jump ahead you'll have problems and end up backtracking.

The initial meeting is the official formation of the venture. Several questions must be answered at this meeting.

- Is there a group of producers that are willing to invest in, or to be part of this business?
- If there is, have you formed your organization? Is it not-for-profit, co-op, C or S Corp, LLC or maybe the new Wyoming Coop?
- Have you secured seed money? Seed money refers to more than just applying for a state or federal grant or finding an economic development person to do some work for you. It means that the members must make an initial cash investment that the venture can put towards research and development.

Once the seed money is secure, you must conduct a feasibility study. The feasibility study outlines the global picture. In this case global doesn't necessarily refer to international. It may be local, regional or national, depending on the market you wish to target and the proximity of your competition. The feasibility study addresses such issues as how your organization will fit into the global picture, and what you must do in order to be competitive.

After the feasibility study is complete, it must be extrapolated to the local level. The result is the business plan. It provides details about the operation, the market, management, and the organization's financials. It also addresses how to create business wealth for the investors. The business plan will be addressed in more detail later in the presentation.

Once you've completed the feasibility study and business plan, you need to find an attorney that will prepare a prospectus. A prospectus is necessary whenever a company issues stock. Its primary objective is to disclose all the risks associated with that investment. After the prospectus has been prepared, you can begin your membership drive. And then you can hold your annual meeting.

You should not seek financing for the project until all these stages are complete. Groups often feel that they need to talk to a lender about financing requests before completing the feasibility study. However, a good and true feasibility study will outline the capitalization or equity you need to raise to be competitive.

Once the financing is in place, you may need to hire a manager if you have not done so already. Hiring a manager is one step you can do before the others, as long as you have enough seed money to pay him/her. Finally, you construct your plant and begin the operation.

Now that you know the start-up stages for an added-value project, let's step back and discuss feasibilities. Previous presentations you've heard today have talked about feasibilities, so I'm not going to delve into these slides. Instead, I will summarize them in this fashion. There are five components to a feasibility study. These five components are covered in the next two slides.

The first component is technology. The second is management. Third is markets. Fourth is economic conditions. And the fifth is your financial projections. As you can see, those five components are basically what the USDA's guidelines require in order to do an analysis for the Business and Industry guarantee. Those five components are all summarized in a little more detail on these slides.

The feasibility study addresses supply and demand characteristics, it talks about market share, pricing trends and sensitivities. It covers transportation costs and responsive competitors. It outlines your cost competitiveness and determines if you will be a high-cost producer or a low-cost producer. It answers such questions as: Can you get into the market? Can you enter into contracts? Are your financial projections realistic? It also outlines scenarios for the worst case, best case, and "what if?" situations. Finally, it details your capitalization structure.

At CoBank, we have a benchmark system in place with financial information gathered from existing ethanol plants. Based on the information we've obtained, we believe ethanol plants are running somewhere around 55-60 percent capitalization. With break-even points somewhere around 90-95 cents a gallon. You should compare your own figures to these averages.

Once the feasibility study is done and you've got the global picture, you know whom you're competing against. For example, if you're building a plant in Missouri, you may be competing with Southern Minnesota or with Western Iowa or South Dakota. How will your operation fit into that region? In order to answer that question, you must bring it down to the local level with a business plan. The business plan covers "the three Ms"—markets, management and money.

The markets section will tell you who you'll be selling to, how much of the market share you want, and the quantity of product you can expect to sell. That "who" is a critical element. It covers your customers and competitors.

Management details the players. It consists of profiles on the board members as well as the general manager, who will run the daily operations.

And then finally, money. Which covers capital and cash flow.

Next, you'll address the marketing element. That marketing plan should outline how you'll create wealth for the investors and owners. It should provide details on your customer base and on the competition. And, it should include specific tactics for executing the marketing strategy. It should also include whether there is a distribution channel in place. You need to know if there are existing railroads that you can use to move the ethanol or if you will need to transport it by truck or barge.

The plan also answers such questions as: Are there alliances or marketing firms you can partner with? Are there marketing contracts you can enter into? And, it should include plans for market contingencies or backups. And, as you know, the backup plans should not only cover markets, but also the operations. One contingency that should always be covered is when to end your investment. For example, if you're losing money and have lost money for three years, you need to know if it's time to pull the plug.

Moving into the operating plan, you'll need to look at who's going to build the facilities, and select the engineers and the technology experts. Today, I believe ethanol is what is called a mature industry. We have proven engineers and proven builders that have successfully built and run ethanol plants.

An important component of operations is who's going to manage the operation. Management is a key component in the feasibility of an ethanol or biomass venture. So you need to know the individuals who have the expertise you need. This is a big issue when you look at the central corn belt and all the ethanol plants that are being discussed.

Before you begin your selection, you must answer some basic questions. Are you going to do a broad-based search for a manager? At what stage will you employ a manager? Hiring the manager in the early stages of start-up could be beneficial to help implement the plans and the membership drives if you have the right seed money to support or pay him/her. You must first determine the compensation package. And that package needs to be competitive, based on what your competition is offering. You also need to decide if you're willing to reward them based upon long-term results.

After you've selected your manager, then you start looking at the financial or the money elements. The financials in the business plan basically focus on three key items—return on investment, equity strategy, and debt strategy. As you can see, I have a subnote called guarantees. In most added-value ventures, looking at a USDA Business and Industry guarantee is an important element for the future success. From my perspective, you don't make the loan because of the guarantee. You do the guarantee to minimize some of the future risk in case something should happen with your business.

So, what is the risk of return? And, what's the right return on investment? It depends on what you are going to be satisfied with. As you can see on the slide, I've put the expected return for an investor at 15%. Is that right or wrong? That's just what I'm calling out for illustration purposes. In this scenario, I came up with 15% by assuming that the investor is going to take money out of his existing business, or farmer operation, and invest it in an added-value project such as ethanol. If he puts that money in the stock market, he can expect an average 10% return. Or, if he wanted to get into ethanol, he could also invest the money in ADM or Williams Energy stock. Therefore, if he's going to invest in your business, his return should be greater than 10%, because that is what the stock market average return has been.

Now if you're trying to bring in venture capital for your added-value project, they're going to be looking for a 20-25% return. Yes, venture capital is coming back to Ag as a result of the beating they've taken in the technology sector over the last few years.

Or, maybe the return on investment is just to cover the additional expense that you're going to incur to stay operating. Again, your expectation for the rate of return in that case would be different.

When you're determining the right rate return on investment for your operation, you need to make sure you don't include the return from the sale of your raw material. If you're going to deliver corn to the ethanol plant, that corn has a market price. An increase to the market price will have a negative effect on your business. It's fine to take your stock appreciation and your dividend and add that back to just the corn bushels delivered — there's your premium. But if you build your premium in upfront, the chance of your business showing a profit or paying a dividend is unlikely.

I've seen many instances in which an ethanol plant has increased the basis of corn in an area by 10 cents or more. Obviously this is beneficial to the farmers who did not invest in the value-added project, because they're receiving a higher corn price with no additional investment. However, while the producer members of the co-op are also getting a higher price for their corn, their return on investment from the ethanol plant is lower than expected. Therefore, you don't want to raise the market for the price of your commodity. What you want to do is increase the return on your investment.

Finally, if you're considering this venture because it provides the ability to stay on the farm, you'll need to look at this added-value venture differently. Basically, you're going to break even or even lose some money.

As we move forward in the money segment, there are other items to consider when financing or planning a value-added project. Lenders look at financing the entire business and not just different components of the business. The entire business has three primary components to consider—the total cost of plant, property and equipment; startup expenses from the planning stage through full capacity; and beginning working capital.

Groups often wonder how much capital they need to raise. Unless your feasibility says differently, I believe you need to raise between 40% and 60% through your membership. However, for some projects it may be necessary to raise 125% of the total needs. The extra 25% is necessary to help carry them as they began to establish their brand.

The final monetary component is the cash flow, or capacity. Capacity depends upon several factors.

- What are the economic conditions?
- What does the competitive marketplace look like?
- What's the need or demand for the goods and services sold?
- Are there, or are there expected to be, technology changes?
- What's the government going to do?
- What's the cycle of the industry?
- And, are there any environmental effects?

As we look at ethanol today, every one of those components is critical in determining whether or not to enter into a biomass or ethanol project. In today's economy, ethanol is only worth \$.95-\$1.00 a gallon. The break-even point for most ethanol plants that are established and long-running is 95 cents per gallon. Which illustrates why producing competitively is so important. As more and more plants come on-line and as existing plants expand, production increases. So it is the least cost provider who will be able to survive these time periods.

Basically the need for goods and services is the same thing as supply and demand. The big question in ethanol is—Will California continue to use MTBEs? Or will they have to use ethanol? If they have to use ethanol, will a foreign country produce it, or will they buy it here in the United States from U.S. production?

Some of the technology changes that should be reviewed if you're considering starting an ethanol plant today are:

- How fuel sales will impact the industry and the future on ethanol.
- What the government is going to do when the incentives run out.
- And, whether or not there will be any environmental threats that could change ethanol.

To wrap up my presentation today, I want to talk about keys to success. During the past ten years, CoBank has looked at many added-value ventures. And we've come up with what we feel are the three most important keys to success: leadership, communication and capacity.

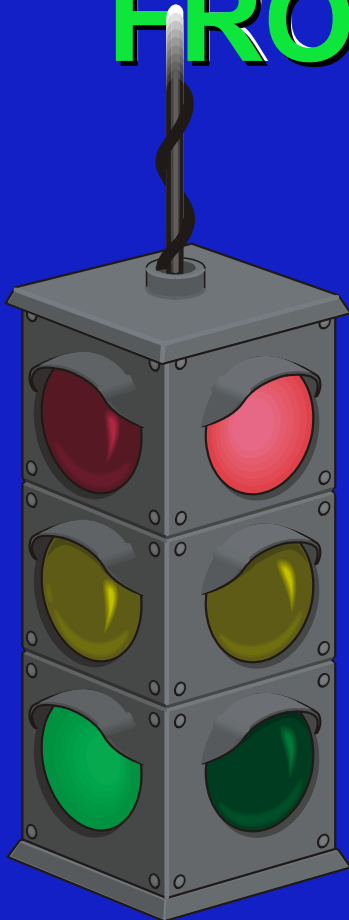
Leadership should be local. It should consist of local producers who are willing to put their reputation and their money at risk. Leadership should not come from engineering firms, marketing companies or economic developers. In addition, an excellent management team that's capable of developing and implementing sound business and marketing plans is critical. As is a well-thought-out risk management plan.

Successful added-value ventures are also well capitalized and able to cushion for unplanned adversities. They have 40% to 60% equity that's been raised by their investors.

The final essential key to success is communication. Frequent, open and honest communication with the investors. Communication that focuses on the value of their stock or their investment, not just the production statistics. And communications that are developed from the perspective of an added-value processor, not a commodity or livestock producer.

That ends my presentation. The final slide contains my name, e-mail address and telephone number. If you have any future questions, feel free to call me. Thank you.

FINANCING VALUE ADDED -- GETTING THE GREEN LIGHT FROM YOUR BANKER



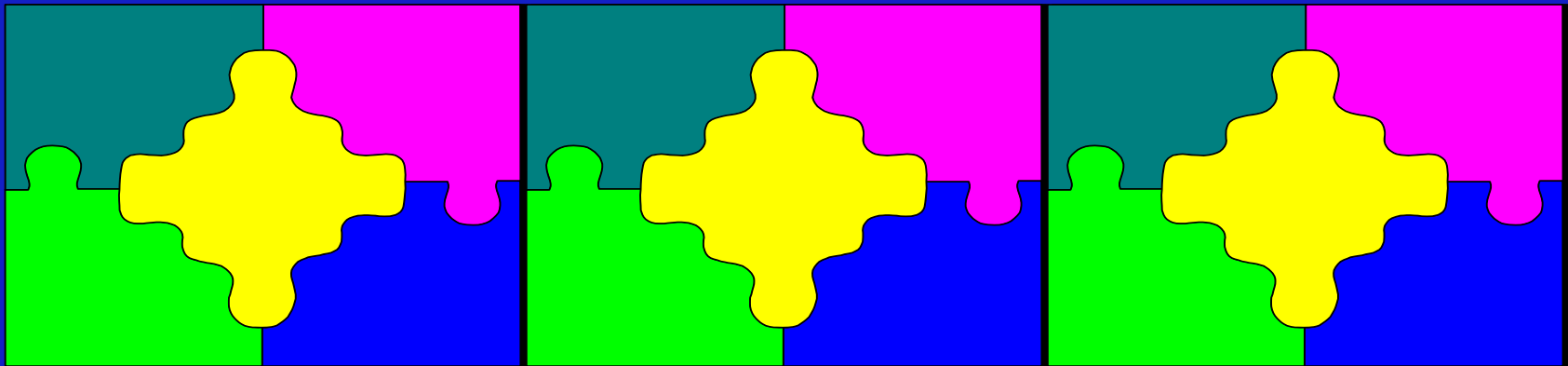
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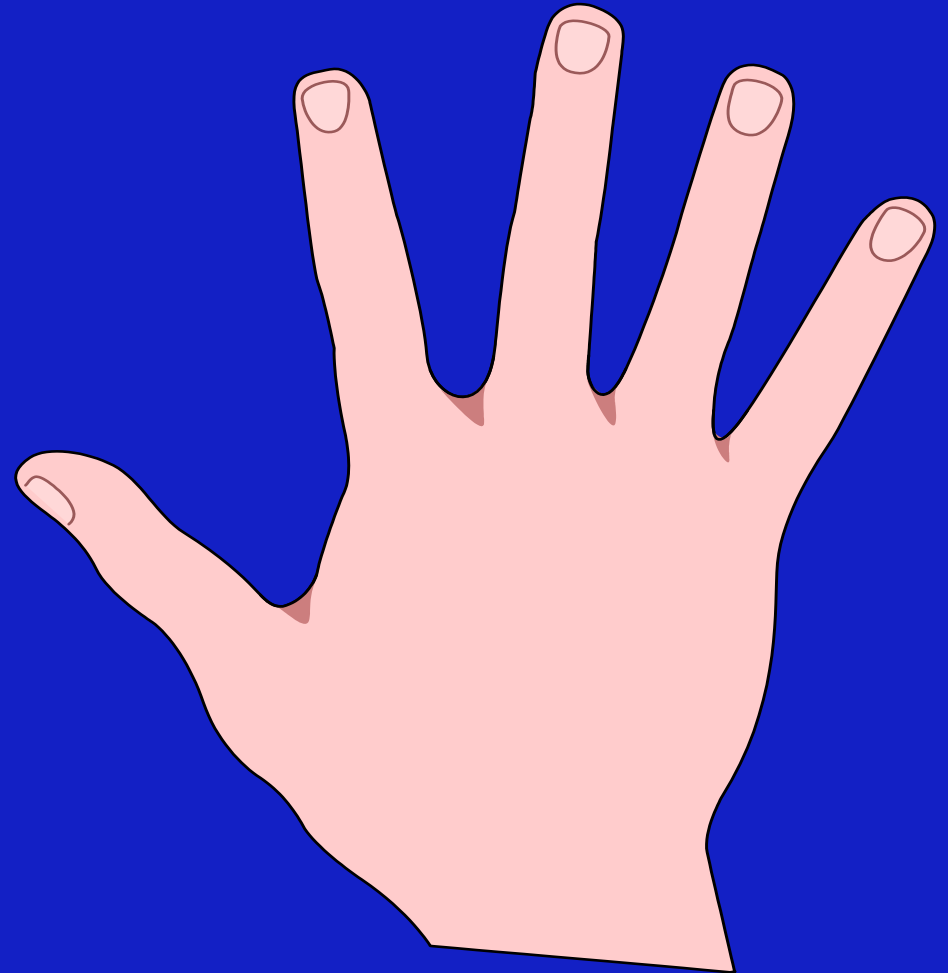
THE ADDED VALUE EQUATION

**Strengths - Weaknesses >
Uncertainties**



WHAT DOES IT TAKE TO ATTRACT FINANCING?

- **C**apacity--Repayment ability
- **C**apital--*Financial condition*
- **C**haracter--Management
- **C**ollateral--*Quality and value*
- **C**onditions--*Purpose, amount and requirements*
 - *External*
 - *Internal*



START UP STAGES FOR ADDED VALUE

- ✓ Initial meeting
- ✓ Organization formed
- ✓ Secure seed money
- ✓ Feasibility study
- ✓ Develop business plan
 - ✓ Operation plan
 - ✓ Marketing plan
 - ✓ Management plan
 - ✓ Financial plan
- ✓ Develop prospectus
- ✓ Membership drive
- ✓ Annual meeting
- ✓ Finance project
- ✓ Hire manager
- ✓ Project construction
- ✓ Begin operation

CONDUCT FEASIBILITY STUDY



- Use third-party assistance
- Market analysis/Marketing plan:
 - Supply and demand characteristics (inputs & output)
 - Market share
 - Pricing trends and sensitivity for finished goods and raw material
 - Transportation of products and raw materials
 - Response of competitors to additional supplies/suppliers
 - Technology employed
 - Relative cost competitiveness

FEASIBILITY STUDY (CONT.)

- **Ease of market entry**
 - **Contracts with buyers**
- **Realistic income projections**
 - **“What if” assessment**
 - **Worst / best case scenarios**
- **Capitalization**



COMPREHENSIVE BUSINESS PLAN

- ***Markets***

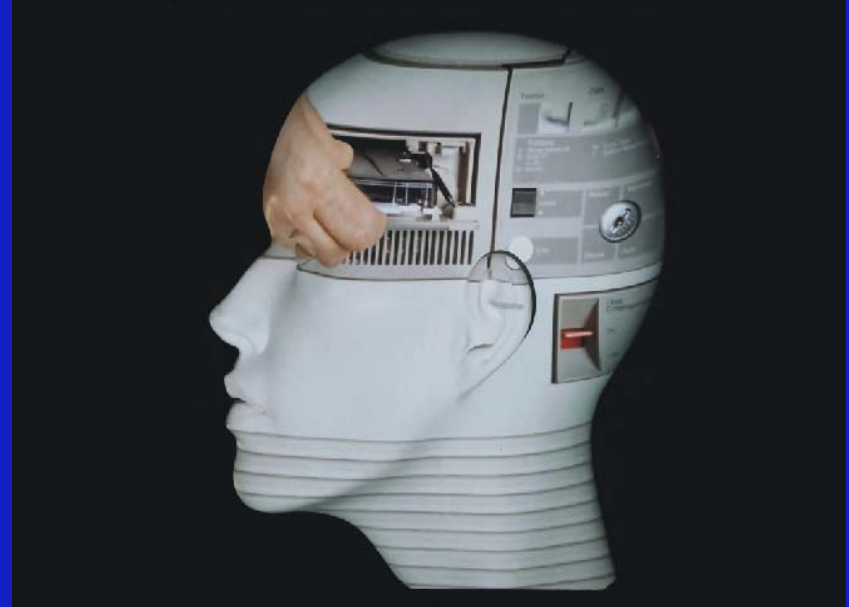
- Who
- What
- How much

- ***Management***

- Board or local leadership
- Operational

- ***Money***

- Capital
- Cash flow



MARKETING ELEMENTS OF BUSINESS PLAN

- *Marketing plan*
 - Strategic and tactical orientation
 - Who are your customers, competitors?
 - Distribution channels
 - Alliances and partnering
 - Nature of marketing contract(s) - legal review
 - Contingencies / back up plans



MANAGEMENT ELEMENTS OF BUSINESS PLAN

- *Operating plan*
 - Building facilities
 - Utilize engineers and technology experts
 - Plan for cost overruns (minimum of 10%)
 - Select management
 - Broad-based search
 - Employee early in process
 - Compensate to attract the best
 - Reward based on long-term results



MONEY ELEMENTS OF BUSINESS PLAN



- *Financial plan*
 - Return on Investment
 - Equity
 - Debt
 - Guarantees?

And now more about DEBT...

RISK AND RETURN-- WHAT ADDS VALUE FOR YOU?

- Return on investment?
 - Should equity investors expect 15% for a value-added venture?
 - Higher target w/ venture capital involved - 20%-25%
- Return for additional expense?
- Investor analysis should not include return from the sale of any raw material input - Project basis only!
- Ability to stay on the farm?

*When should you expect to break even with a new venture?
Three years?*

ITEMS TO CONSIDER WHEN PLANNING A VALUE-ADDED PROJECT

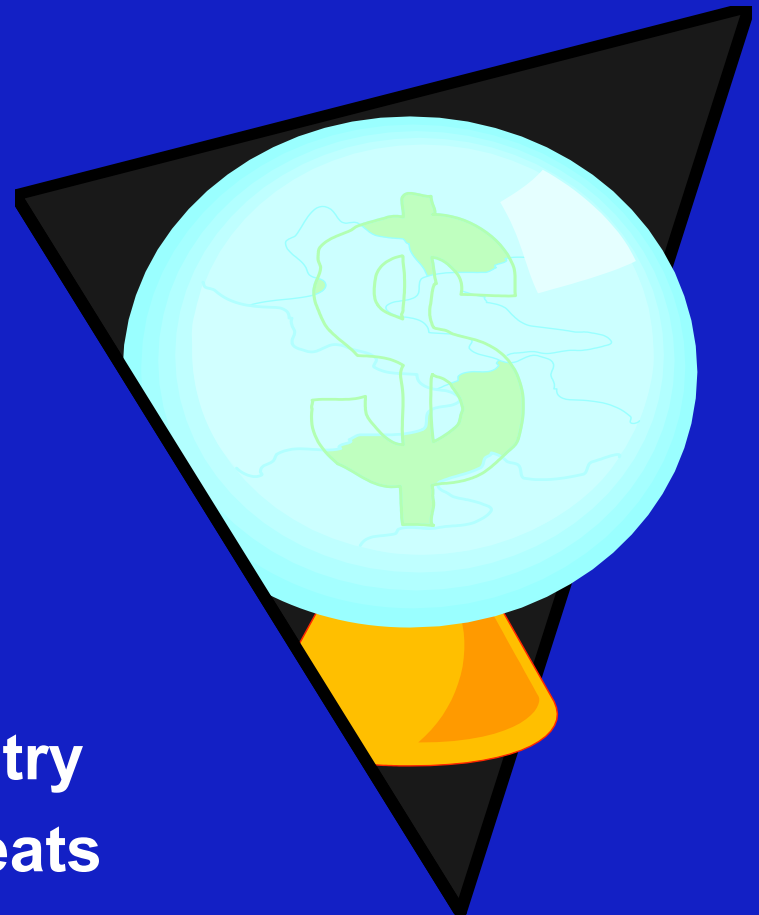
- Total cost of plant, property and equipment
- Start up expense planning to full capacity period
- Beginning working capital

Plan to have 40-60% equity



CAPACITY--REPAYMENT ABILITY DEPENDS ON...

- General condition of the economy
- Competition
- The need for goods and services sold
- Technical changes in the industry
- Regulatory climate
- Cyclical nature of the industry
- Environmental or other threats



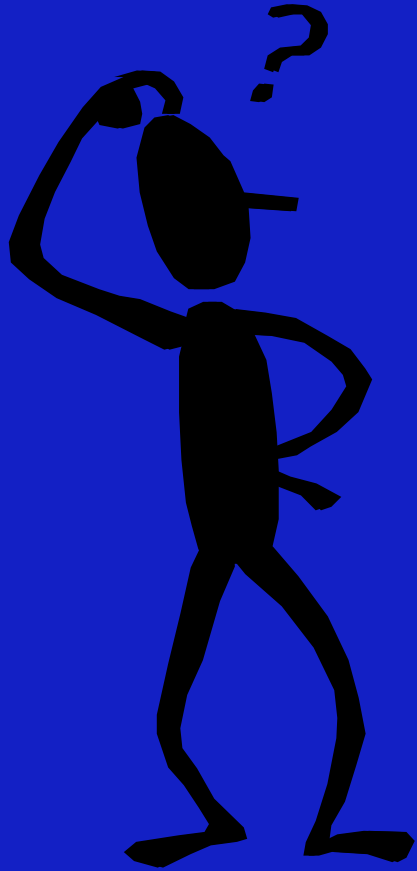
KEYS TO SUCCESS



- Leadership - Local investors; JV partners; project manager
- Excellent management
- Sound business and marketing plan
- Excellent risk management plan and execution - solid contracts
- Well capitalized to cushion unplanned adversity
- Communications with investors: frequent, open, honest
- Remember to focus on value of your stock, not just return to products committed
- Remembering your no longer a commodity or livestock producer, but that added value processor

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