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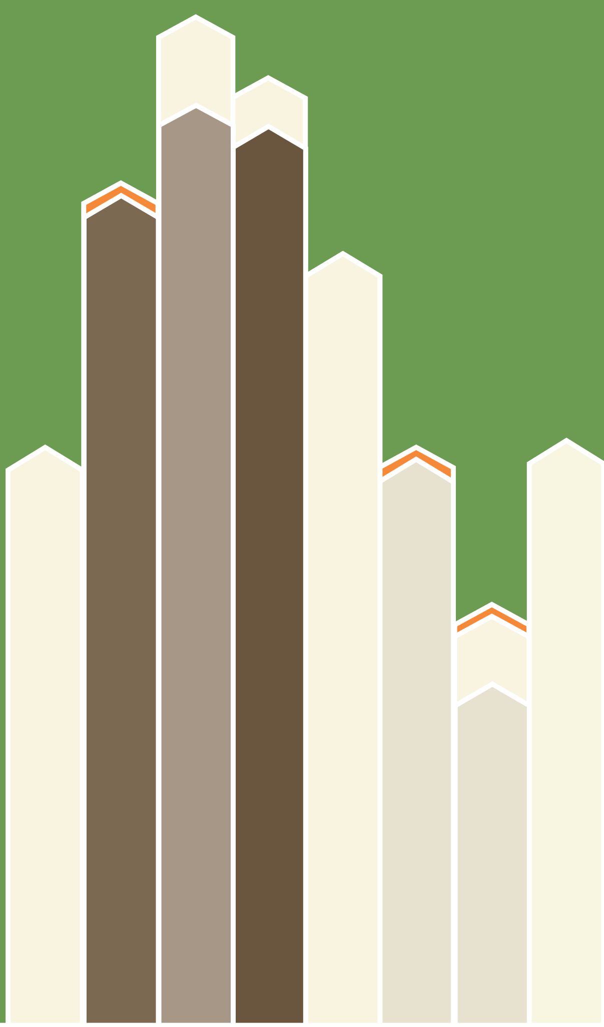
FINANCING FARMING IN THE U.S:

BOLSTERING COMMUNITY LENDING CAPACITY FOR SMALL TO MIDSIZED FARMS



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INTRODUCTION

Efforts to nurture more local or regionalized food systems have momentum in many communities across the country. For farm and food businesses supplying these value chains, access to capital is critical. However, informational and other gaps present challenges to lenders investing in production for regional food systems.

Small to midsized farming operations producing diverse agricultural products provide important community benefits. These farms, which include, but are not exclusively, small family farms or organic producers, help to keep farmland productive and viable while getting locally grown products into newly-developed regional markets and to local consumers. Many of these farms are showing signs of growth and profitability, and access to lending capital could drive new growth or markets for these businesses. But the scale of these farm operations and the relatively short history of their local and regional market development do not offer lenders the information and benchmarks they need.

The lack of knowledge or data on this sector can result in perceived risk, which can prevent important partners like community development financial institutions (CDFIs) from making capital accessible to farmers. With very few benchmarks available in the small to midsized farming sector, there are no standard answers to business lending questions surrounding small and emerging agriculture enterprises. Addressing the knowledge and data gaps necessary to answer these questions is critical for increasing access to capital within local and regional food systems.

Financing Farming in the U.S. (FFUS), a project of the Michigan State University Center for Regional Food Systems and funded through the W.K. Kellogg Foundation's Food & Community program, has explored these financing and data issues with farming and financial stakeholders across the country since 2009. The FFUS project has consistently found that stronger relationships between food producers and lenders, along with data, help lenders determine that these businesses are "risk-worthy."

FFUS has found that a step toward serving the financial needs of this farming sector is to build a continuum of community partners that offer opportunities to both learn about and address entrepreneur needs. Such collaborations, working successfully in regions across the U.S., are moving capital to farmers, developing benchmarks, and building capacity of local lenders and others to work with this essential and growing agricultural sector.

FFUS has also gathered ideas for further research that address the lack of familiarity with successful business models in the sector among most lenders. Lender inability or reluctance to engage—given the cost of capacity-building, the failure of existing data to capture and reflect on-the-ground bankability, and the cost and complexity involved in developing any common set of metrics for this farming sector—are recurring issues.

This document reviews learnings from several years of research and dialogue on financing production for regional food systems convened by FFUS. It identifies methods used in localities across the country, both for using and developing data, and for building the networks and relationships that will help support this important farming sector to grow. Additionally, it includes commentary from expert participants in this project on successes, challenges and opportunities for further building capacity of lenders to invest in production for regional food systems.

THE FINANCING FARMING IN THE U.S. PROJECT: FROM FOCUS GROUPS TO HEALTHY FOOD OPTIONS FINANCING

Financing Farming in the U.S. is a project of the Michigan State University Center for Regional Food Systems, funded through the W.K. Kellogg Foundation's Food & Community program (for more information on FFUS and its work, visit foodsystems.msu.edu/activities/ffus). FFUS began in 2009 as a loosely affiliated, yet deeply committed network, tapping the knowledge and intensity of those dedicated to creating capital access to construct an arena of "learning by testing out." FFUS has showcased effective lending approaches and practices, produced lender case studies from the small to midsized diversified farming sector, and authored a primer on lending skills needed for the small farm sector. The project also convened practitioners from across the country in 2012 and 2013 to explore additional research and applications. Activities of the FFUS have included:

- In 2009–2010, a number of smaller-scale farm lenders and advisers from across the country came together in a **series of structured focus groups** to explore strategies for improving the flow of capital to small, diversified farms. The process solidified a network of practitioners ready to keep working together on common challenges. It also produced a group report: ***Financing Farming in the U.S.: Opportunities to Improve the Financial and Business Environment for Small and Midsized Farmers through Strategic Financing.*** Released in June 2010, the report brought attention to the challenges faced by lenders interested in supporting smaller, diversified agricultural borrowers. It also showed that an increasing number of such farmers have bankable operations but are unprepared or hesitant to approach mainstream lenders.

- The report provided the context for **meetings with U.S. Department of Treasury Community Development Financial Institutions (CDFI) Fund and U.S. Department of Agriculture** officials in 2010 as the Healthy Food Financing Initiative (HFFI) was in early development stages. Later, the HFFI included the topic of financing farm production in a capacity-building task order awarded to the Opportunity Finance Network (OFN), national CDFI trade association. Core members of the FFUS network served as contractors to OFN to create and deliver a HFFI capacity-building training component, including case studies that focused on building lender capacity to finance small-scale farms. The FFUS team **coordinated and delivered training to CDFIs** in Durham, North Carolina (March 2012), and in Boston, Massachusetts (May 2012).

- The FFUS process of assembling training materials for OFN led to a second report: ***Financing Farming in the U.S.: Strengthening Metrics and Expanding Capital Access***. It illustrates successful lending practices among CDFIs and their strategic partners.

- This second report served as a catalyst for a national **Financing Farming for Food Security roundtable** in June 2012 in Washington, DC. This meeting focused on how stakeholders could collaborate to address gaps in business information that make lending in the smaller farm sector seem risky despite the growth of these enterprises and the markets they serve. The meeting confirmed the importance of reliable risk assessment metrics and benchmarks needed to stimulate capital investment for farm production. It also substantiated the many challenges involved in lending in the highly variable and unpredictable world of smaller-scale, diversified production agriculture.

RECURRING THEMES & OPPORTUNTIES

The FFUS project's research and outreach activities since 2009 have continued to focus on several key themes. Those detailed below arose during the 2012 Financing Farming for Food Security roundtable discussions.

Need for Appropriate Metrics

In any sector, lenders need reliable metrics and benchmarks on which to assess risk of investment decisions. But the range of critical "unknowns" in lending to diversified, small to midsized farms – from variability in local pricing to the availability of distribution and other market infrastructure – have proven to be challenges to the development of scale-appropriate metrics that support investment in this type of farm production.

The necessity of working with data currently available to build a financing foundation for this growing sector points to some opportunities for research to benefit the sector:

- Collecting and disseminating in-depth examples of appropriate loan structuring
- Harvesting and disseminating on-the-ground data, even if limited, to generate financial assessment resources for farmers as well as lenders and funders.

For those already taking preliminary steps to develop indicators or measures from their data, there may be opportunities to jointly develop indicators that both farmers and lenders could use to better assess and communicate farm business strength. Such efforts may include research projects accessing larger groups of farmers that could build a more representative picture than very small samples would. Indicators or measures for such a research effort may include:

- *Market prices.* One idea is to capture local pricing information through regional food hubs, which represent an emerging source of information about the market value of source-identified products from local farms to nearby markets. There is an opportunity to establish, over time, how prices in such differentiated and local markets compare to the commodity pricing that agencies and lenders typically use to assess a farm's profitability chances.
- *Dollars of gross sales per hour of labor.* Matt LeRoux, agriculture marketing specialist at Cornell University, offered this variable as one of the most pertinent and measurable in his work using Cornell's Marketing Channel Assessment Tool (MCAT). Dollars of gross sales per hour of labor is one of five variables the MCAT tracks and shares back with farmers after capturing information over a one-week period during the peak season. This variable can help illustrate an operation's overall profitability, a vital piece of information to lenders.

New Methods of Data Collection

In any efforts focused on metrics or information gathering, a common challenge faced by small to midsize farm viability researchers is getting farmers to collect and share detailed and confidential business information. FFUS team members investigated the potential for information technology and technical assistance to address these issues.

Information technology. We explored the potential for using new software programs that help farms upload and manage their information electronically, from production planning and monitoring to sales and inventory. Examples of new farmer-friendly software programs include AgSquared, a small diverse farm record-keeping system; Local Orbit, an online marketplace system with back-office features; and SourceMap, a tool for tracking and communicating product origin to customers.

Designing a research project around sets of farms in networks, such as the Farm Beginnings collaborative through the Land Stewardship project in Minnesota, and using this information technology would require support to the technical assistance organization(s) and to the farms to collect and enter data initially. While this approach would require a substantial early investment in capacity building, the needs for technical support would likely taper off after farms received measurable benefit.

Information technology solutions will require capital investment over time. Individual farm development organizations like the Land Stewardship project will work with John Hendrickson of the University of Wisconsin's Center for Integrated Agricultural Systems to use a tool that puts a farm's development on a timeline with a resource inventory. It shows, in five-year increments, the changes in variables such as farm employment and capital needs. The Land Stewardship Project is working to integrate this tool into the work of the seven-state Farm Beginnings collaborative.

Linking technical assistance to farm viability. The Carrot Project, a core FFUS member, is engaged in a multi-year research project funded by the U.S. Department of Agriculture's Northeast Sustainable Agriculture Research & Education (SARE) program to measure small farm profitability and success. The Carrot Project's research rests on the FFUS assertion that increasing lender knowledge about the sector may result in the creation of a set of risk assessment metrics for the small to midsized diversified farm sector. These metrics will aid in describing smaller farm attributes, both qualitatively and quantitatively. The metrics will also enable lenders to address the risk issues associated with small and midsized farm lending, even in the early stages of the farm's development.

Collaboration & Capacity Building

FFUS has found that the most efficient step toward serving the financial needs of small to midsized diversified farmers is to build a collaborative continuum of community partners focused on both learning about and addressing entrepreneur needs. Such collaborations, working successfully in regions across the U.S., are moving capital to farmers, developing benchmarks, and building the capacity of local lenders and others to work with this essential and growing agricultural sector. This concept of a continuum of lending describes both the motivation behind and the art of lending within a sector for which there is no rulebook.

Examples of these continuum approaches include the Natural Capital Investment Fund (NCIF), a CDFI in North Carolina, and Coastal Enterprises, Inc. (CEI), a CDFI in Maine. Cited in *Financing Farming in the U.S.: Nine Case Studies of Community Development Financial Institution Lending in the Farm Production Sector*, NCIF is a leader in creating a continuum of lending to help ensure that financing reaches farmers. CEI is another CDFI pioneering a network or continuum of care approach, which CEI refers to as "advisory capital." What these lenders have in common are their efforts to link stakeholders locally, build organizational capacity, and offer a coordinated small farm lending force.

The Northwest Michigan Farm and Food 20/20 Fund is borrowing a continuum of lending model already tested by NCIF. This model, a practice recommended by CDFIs, is proactively working with the farm sector by providing capital through a variety of existing lenders, whose pools of funds are made accessible to small to midsized farms. Additionally, these lending networks build their own capacity through the use of decision-making tools such as the 5C's of Credit checklist, widely used by lenders to determine the creditworthiness of potential borrowers.

According to Gray Harris, director of sustainable agriculture at Coastal Enterprises, Inc., financing farming needs to be tailored, where the lender and farmer arrive at a place of understanding. "Underwriting should be a result of deep relationships across a network that establish financing terms," said Harris.

Too time consuming? Harris points out that this form of technical assistance is a risk mitigation strategy, enabling innovative financing, and increasing overall tolerance levels for the lender. CEI has built a network of food system understanding.

Harris noted, "Farm businesses have capital needs not currently on the market; capital should to be sensitive to cash flow needs and thin margins. Advisory capital offers farms training wheels; an approach demonstrated by collaborative lenders and technical assistance providers bringing different pieces to the financing package. The ultimate goal is focusing on farm success."

LEARNING AS THEY LEND: COMMENTARY FROM FFUS PARTNERS

The FFUS project work over the past several years has found that a broad array of lenders are finding the need for, and are working toward, an infusion of more information in lending decisions.

Risk of Missing the Deal

Rick Larson, NCIF's North Carolina program director, shared that one of the major risks CDFIs face is an "internal risk": a lack of understanding about farm financing that may lead to missed opportunities to make good, impactful loans. Larson explained that a lack of knowledge can result in perceived risk, which can inhibit CDFIs from being proactive in making themselves accessible to farmers. NCIF's continual effort to understand the farming sector within which it lends has enabled NCIF to progress beyond taking a "calculated risk" to making an "educated decision."

However, Larson believes a key piece of information still missing is existing data that describes small-scale operations. "From pasture-raised lambs to diversified specialty crops, what is missing are smaller-scale farm budgets that [University of North Carolina] Extension has developed for years for larger commodity operations," said Larson. "There is a lot of data if you are growing conventionally and selling within large-scale retail operations, but organic green beans are a different story. Smaller scale operations may command a premium in certain markets, but that data is hard to come by." Larson and NCIF's loan review committee tend to focus on existing farmers who have a history and can post sales and cost data.

Harvesting and Disseminating On-the-Ground Data

We have determined that lending to small to midsized diversified farms requires both fundamental business lending skills as well as a clear understanding of the sector's unique aspects. As this is an industry with very few absolute benchmarks, there is no rulebook available with standard answers to business lending questions surrounding small and emerging agriculture enterprises. Those providing both lending and technical assistance support are learning more about the farm business itself by testing metrics that aid in overall decision-making.

The Carrot Project's Northeast SARE grant to study changes in farm profitability is an example of ongoing data collection that ultimately aids lenders in assessing farm viability. The premise that sound technical assistance and access to capital have an impact on the viability of a small-scale farm has merit, according to anecdotal information collected by The Carrot Project: initial Carrot Project borrowers are doing well and are meeting their business and financial goals.

Dorothy Suput, The Carrot Project's executive director, noted that the organization pursued such a deep dive to better understand how farmers could strengthen their capacity to bring in debt capital. "Good farmers know how to farm but don't necessarily know how to use financing to strengthen or grow their farms," Suput said. "Our goal is to assess if the technical assistance offered to farmers actually helps those farms put together an 'investment ready' application."

The Carrot Project's research should produce multifaceted results: technical assistance impact, educational tools to help newer farmers incorporate debt into their overall business strategy, and the ability to share business characteristics of small-scale farms with lenders who incorporate these characteristics into risk assessment. The Carrot Project's long-term goal is to provide sustainable capital to small and midsized farms; its research assists in determining the economic impact that The Carrot Project brings to the sector.

The Carrot Project's program model is designed to incubate, learn from, and establish financing programs to foster a sustainable, diverse food system. Premised on the importance of successful small and midsized farms in the U.S., The Carrot Project's dual program initiatives — financing programs and collaborative research — strengthen the knowledge base for the small and midsized sustainable farming sector.

Learning from Peers

Significant work is required to track and understand the variables involved in assessing small to midsized, diverse farm operations. Numerous discussions in the FFUS network throughout 2013 led to these conclusions:

- There is a growing proliferation of and value in small and midsized farm production evident in regional food system-related economic development. Growth is particularly notable among current national food hub activity, along with the continued use of the Healthy Food Financing Initiative's Financial Assistance Program.
- Effective lending models that rely more heavily on future performance, rather than historic benchmarks, do exist. CDFI models that take this approach align with a more regionally focused food value chain or system. Such a model brings lenders into farm sector development by exposing them to integral components of a shortened food value chain (a system of relationships and businesses that operate to move food from production to its final destination); one way to facilitate this exposure is to include representatives from the borrower community on loan review committees. Focusing on future performance, examining potential benefits of an investment to the broader community, and weighing values such as environmental and social consciousness are also elements of a community economic development approach to lending utilized by some CDFIs.

NCIF has been able to meet a triple bottom line mission — sustainable economic development, environmental stewardship, and social justice — through debt, equity financing, and technical assistance. An example of "packaging" is NCIF's combined grants and micro-loans to limited-resource and minority farmers to develop on-farm storage of commodity grains. "RAFI-USA [Rural Advancement Foundation International-USA] documented that North Carolina farmers face a gap in appropriate agricultural finance. We see ourselves as helping to fill the niche," said Rick Larson, North Carolina program director.

Yet, more information is needed, and CDFIs continue to learn as they lend. For instance, NCIF's lending practices have been influenced by the sector itself. NCIF has extended its lending more broadly in the food system value chain to include product aggregation businesses and retail outlets. "Lending to pasture-raised lamb farmers necessitates our knowledge about the market place for this product. It would be fantastic for CDFIs to have access to market data for this product. We do understand the low margins across the value chain, but our familiarity comes from our lending across that value chain. Easier access to data up-front would make our jobs much easier," Larson said.

Relationship lending, for these lenders, implies both a long-term, community-based perspective and a commitment to garner information about the financial viability of smaller-scale farming. Suput explained, "We want to know more than [if they can] pay back the loan. Is the loan an investment in a farm business that will yield a return in the future? We try to project what the farm will look like in eight years. This makes the information usable for farmers and lenders alike." Metrics such as those collected by Cornell's MCAT and data developed by the Carrot Project can provide important information points that suggest key metrics to help assess a farm's viability.

LOOKING AHEAD

Continuing to facilitate peer learning and testing of approaches has grown our understanding of farm financing challenges, strengthened the relationships between farmer and lender, and begun to fill knowledge and skill gaps among farmers and the lending community. "All the work we have done through FFUS and OFN [Opportunity Finance Network] is applicable to how we underwrite, finance, get the capital pool from, and gain knowledge about the market," says CEI's Harris.

As FFUS convened lenders and farm development organizations that are learning through on-the-ground experience, it became apparent that financing is in a different place than it was three to four years ago. Offered Harris, “It’s still a hard sector to finance. However, financing farming is as much or more on the table among financial institutions and farmer development organizations across the eastern side of the country than ever before. Beyond just pulling social capital together and making a loan, lenders are able to discuss due diligence in underwriting. Harris also noted that CDFIs now communicate about lending approach, attitude, and issues such as risk tolerance, dedicated capital pools, staff knowledge of production methods, regulations, and other questions that, at one time, seemed unanswerable. Those on the ground level are continuing to pursue information to inform the sector itself and to create knowledge for lenders, farmers, and other food producers.

The time is ripe and opportunities exist to dig deeper as lenders move pent-up capital into fledgling but growing regional food systems. Starting with the financing needs of small and midsized diversified farming and moving through the food value chains, CDFIs are using lending approaches that have community economic development at their core, in part relying on future performance rather than historic benchmarks.

This approach to meeting the financing needs of local and regional food systems has led to community and economic benefits including:

- Expansion of food hubs as economic development tools that enable greater supply among small to midsized farms to meet increasing demand for local food
- Support for historically underserved farmer populations, from African-American grain producers in North Carolina to Hispanic strawberry farm owners in California to indigenous New Mexican farmers.
- Emergence of innovative food production methods in dairy, livestock, and produce, prompting social investor and nontraditional lending partnerships.

All point to changes in markets, metrics, and farm producers that open opportunities to learn more about where to invest, how to invest, and who to include to move this forward. Said Harris, “CDFIs are becoming known among the farm community as the place to get a loan. With alternative infrastructure models like food hubs needing different types of capital, CDFIs are now being approached by more varied and interesting sources of capital. ‘Aspirational’ and ‘developmental’ are the lenses through which capital sources approach this sector. They want to know how sustainable the businesses are across the food value chain, including farmers.” As an example, Harris cited being asked to serve as an intermediary between a seed supplier and farmers. The CDFI was asked to garner information from the intended product purchasers (farmers) for input in product innovation.

Opportunities and tools to continue learning and networking are abundant. “These tools are being created by the people who come to the table wanting small, independent farms to succeed,” said NCIF’s Larson. “In some ways, local, independent farming is a perfect sector for CDFIs because CDFIs specialize in filling capital access gaps. That said, CDFIs have to be smart lenders because limited-resource and beginning farmers lack the backup systems of subsidies and insurance that commodity farmers use to reduce risk. Helping to grow regional food systems cannot rely on a cookie-cutter approach. CDFIs must earn the trust of farmers and that depends on the successful learning of the few CDFIs now engaged in the sector. We’ve learned a lot but it’s a process, answers aren’t easy, and it takes time.”

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