Creating small farm financing solutions

Small Farms in a Changing Credit Landscape

A Report for The Carrot Project

prepared by John Moukad

2010

Introduction

The Carrot Project's mission is to foster a sustainable and diverse food system by increasing both the availability of capital, and its wise use, to ecologically and financially sustainable small and midsized farms and farm-related businesses. We spent more than two years doing research to understand and describe the financing gaps faced by small and midsized farms, and to determine ways to fill these gaps. To that end, with our non-profit and lending partners we have launched two loan funds for farmers in Vermont, Massachusetts, and Maine — and hope eventually to serve the rest of New England and New York. Our research, which supports our work, is driven by dual desires: to shape the discussion of farm financing and to inform our programs as they grow and develop.

In 2009, John Moukad, an expert in community development finance, was asked to undertake a project, on the opportunities and limitations of credit, which would result in a presentation to The Carrot Project Advisory Board. We want to share the information from that well-received presentation with others facing similar issues and questions. Hence, this report, which was prepared (using presentation slides, written documents, and meeting transcripts) by Heather Bell, a 2011 candidate for an MS from the Agriculture, Food and Environment program at the Friedman School of Nutrition, Tufts University.

We hope you enjoy John's work as we much as we did.

Dorothy Suput
Founder and Executive Director
The Carrot Project

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Small Farms in a Changing Credit Landscape

Credit can be a powerful lever for creating change, but it doesn't work in isolation. Many variables shape the capacity for credit to operate in a given sector. In this instance we're considering financing for the small-farm sector, which is rapidly changing and growing. One of the big constraints on smaller farmers' access to credit is their capacity as borrowers. Many farmers are just starting out or are pioneering new ways of doing business; if they do not get the credit they need, it may as often be about their fiscal weakness as about any problem with the credit system. The other big constraint is the terrain in which lenders now operate. The most recent credit crisis is part of this situation, but the bigger factor is a series of long-range institutional and methodological changes that have fundamentally altered how credit is allocated. These changes have made it much easier for many people to access credit, but they can make it hard for borrowers with specialized needs, such as small farmers, to get capital.

There is great opportunity in focusing on credit in this kind of situation. But if you want to ensure that the development of the small-farm financing field is not constrained by want of credit, you have to work on both sides of the equation: the capacity of small farmers to borrow, and the readiness and engagement of financial institutions to lend.

This report is a broad overview that examines the changing situation of small Northeastern farmers, and reviews some of the ways in which lending has changed, as well as how those changes impact the financial institutions that have provided (or could provide) credit to small farmers. It concludes by reviewing some of the circumstances in which small farmers may face the greatest difficulty in obtaining credit, and by offering a range of strategies that might be used to remedy those challenges. The goal of this report is to draw out the dynamics of the small-farm credit situation in order to help The Carrot Project think about how it might use credit to support the development of the small-farm sector.

SMALL FARMS IN THE NORTHEAST: Opportunities and Challenges

Environmental and health concerns about the mainstream food system have created demand for alternative products and sources. Increasingly, consumers are seeking organic, local, sustainable, small-scale, or unusual foods and food products. Many people have been inspired to get into farming by the chance to help realize the change they think is needed, and by the widening business opportunities.

This change in market sensibility, marked by increased interest in what we eat and how it's produced, has created new opportunities for small farms in the Northeast. Until recently, they were an endangered species because the scarcity of land and high production costs made it hard to produce commodity crops at prices that could compete with those grown in less densely populated areas. Most of the farmers that are part of this new wave are focused on retail and value-added farming. They do not sell into mainstream commodity markets; instead, they depend on outlets where the special character of their products can earn a premium.

Success in these niches has different requirements than does traditional commodity farming. In contrast to traditional commodity operations, these farmers needn't necessarily make big investments in equipment and land. In addition to traditional competencies, these new farmers need:

- marketing skills and market judgment, which are central
- more personnel, for increased marketing and distribution functions

Rising demand for alternative food products has rapidly expanded the distribution opportunities for small farms. There are ever-more Community Supported Agriculture (CSA) programs, farmers' markets, and restaurants and other small-scale, wholesale food purchasers interested in alternative products. This dynamic sector is seeing a great deal of innovation and experimentation in production methods and business strategies. Some innovations, such as organic certification through USDA's National Organic Program (NOP), as well as CSAs, are fairly well tested and established, but most are at much earlier stages.

Organic certification is a powerful branding tool, but is considered costly by many smaller producers. Small farms, even those that operate organically, often do not pursue certification because of the cost or because they work directly with customers who know them and their agricultural practices, and so, have less need of the reassurance of certification. But not having organic certification can limit distribution channels because many buyers require certification. Sometimes investing in becoming Certified Organic is critical to growth.

Increased sustainability in their farming methods is an important focus for many small farmers. A major challenge with this focus is that sustainability, from a marketing perspective, is necessarily only a claim because there is no standardized "sustainability" certification. Without detailed investigation, consumers have no ready way to distinguish well-grounded claims from purely promotional ones.

Diversification of production is a frequently used strategy for increased sustainability. It reduces dependence on a single crop or product and can produce efficiencies that are good environmentally and financially. Yet it also usually means that each crop or product is produced in modest quantities, which increases operational and marketing complexity.

Partnerships are challenging for farmers, just as they are for most small businesses. Any partnership that is not a marriage involves significant legal, accounting, and tax complications. This makes for difficulties for extended family businesses — a model particularly common in immigrant farming families. Break-ups, whether personal or professional, often destroy businesses.

Food safety represents a major potential risk for the sector. Right now, small producers have a good reputation and the public is more suspicious of the safety of commodity products. However, when problems are discovered with a product, everyone who produces it tends to get hurt. Even a small number of well-publicized incidents tied to small-farm products could shift the currently positive perception and the good will that accompanies it. The immediate impact could damage many parties that had nothing to do with the food-safety problem or violation, including producers of similar products — or even the whole sector. The long-term backlash could slow or reverse the momentum of local and small-farm production and distribution.

The rapid changes overtaking farming, the introduction of new production methods, and rising concerns about food safety all make new government regulation likely. Even reasonable regulation can be disruptive, sometimes destroying whole ways of doing business or pushing small operators out by requiring steps that are not financially feasible. Furthermore, regulation tends to be shaped by those who have the most at stake, and in food production that still means traditional commodity producers and their big customers. This situation could lead to inadvertent problems for smaller producers, as well as regulatory approaches that intentionally make it difficult for smaller operators to compete.

The Business of Farming

Most small farms start as less-than-full-time businesses. Many remain part-time or seasonal enterprises, and often, one partner has a "regular," off-farm job while the other farms.

People generally go into farming because of a desire to farm and to produce food — not because they want to run a business. This can mean that the business side of the operation is not always well managed. Particular challenges are record keeping/bookkeeping, business planning, and use of credit — the latter often less wise than it might be.

Though the available resources are expanding,
the support system for small, retail-oriented farms
is still fragmentary and in development.

Many farmers who depend on farmers' markets are running largely cash businesses, which have a bigger risk of loss from underreported sales and theft than non-cash operations. Accepting debit and credit cards at farmers' markets, though costly, can legitimate sale and income data, and may be necessary if the aim is to grow not just the number of purchasers, but also the average dollar amount of their purchases. Cash businesses also have a tendency to understate income for tax purposes, but that can reduce access to credit because tax returns are the basic documents on which lenders rely for income verification.

Sometimes the idealistic bent of farmers can work against a business framework. Some come to farming from a cultural perspective that is somewhat suspicious of business and profit (and commodity farming). Others are dedicated to farming itself, but don't have the skills on the business side and doubt that they could easily acquire them. The impulse to independence that attracts many people to farming probably leads some to be reluctant to seek help or to borrow at all.

Though the available resources are expanding, the support system for small, retail-oriented farms is still fragmentary and in development. The configuration and quality of support varies from place to place. As the field grows, support organizations and associations are multiplying, but few are well established; many are just starting out themselves. Traditional resources, such as cooperative extension services, are less dependable than they have been in the past because of budget cuts.

Small-Farm Financing

Many small farmers find that making their operations work fiscally requires a multi-pronged approach.

- Ninety percent of farms have more non-farm income than farm income. Income from outside work often dwarfs the net from farming, although non-farm income can include farm-related activities such as cheesemaking.

- The loans that farms get often depend, in part, on non-farm employment and the steady income it produces.
- Beyond non-farm income, many small farmers draw on other resources, including support from family or friends, and sometimes, their own savings.
- The initial source of capital for very small and new farms is often consumer credit: credit cards, vehicle loans, and home equity lines are frequently used. Credit card debt is expensive, and it can lead to trouble. However, when available, it is far easier to obtain than small loans and some who wouldn't seek a loan would use a credit card.
- Non-farm income and consumer credit make it easier for many farmers to get financing to start or grow their businesses; those with neither face greater obstacles.
- Some farm-related businesses don't easily meet the criteria for either farm or small-business financing. These businesses often provide critical services to other farms.

THE LENDER TERRAIN

The banking landscape has changed significantly in the past two decades. Banks now:

- are fewer in number
- are less place-based
- are generally less oriented to retail lending
- maintain leaner staffing
- are more oriented toward volume production and efficiency, and less willing or able to spend a lot of time with individual customers or loans
- are less willing to venture into areas in which they don't specialize
- are expert only in areas that are specialties of the institution
- maintain, even in rural areas, fewer loan officers with farm-lending expertise

Many of the loans banks make are sold and bundled into securities. This is common with home mortgages, as well as with commercial property loans, vehicle loans, and even credit card receivables. The bank's role is originating and servicing these loans rather than holding them in portfolio. This structure emphasizes conformity to industry standards rather than individualized judgments, and has reshaped banks' approach to lending and risk management. There is less room than ever before for small or quirky loans, or any lending that requires individualized attention and judgment.

Banks could be sources of business loans for small farmers, but it would be unusual for a bank to make a major push into lending to small farms, particularly since they might expect borrowers to migrate over to the federal Farm Credit program as they get stronger and their credit needs grow.

Consumer Credit

Credit cards, car loans, and even home equity lines are readily available. Though home equity lines of credit are not technically "consumer credit," they have functioned for many like lower-cost (because they are collateralized) credit cards. The housing crisis has led to tighter standards in this area, but the general structure continues to be a major source of credit for many people and small businesses.

These credit vehicles are driven by automated credit scoring systems that: sum up a potential borrower's risk profile (often in a single number); factor in the value of the collateral, if there is any, as in the case of car and home equity loans; and produce a standardized response re: credit amount that can be extended and terms of credit. Though this *is* lending, it surely doesn't have the feel of old-school lending. There is often no loan officer sitting across the desk from you. It is an information management system that produces the decision, rather than a personal judgment. This process consumes little loan officer time, involves little judgment, and encourages an emphasis on volume.

The upside is that if you qualify, you have almost immediate access to the credit you want. If secured by a car or a house, it may even be fairly low-cost credit. If it is unsecured, as through a credit card, the interest and fees may be high, but the credit limits tend to be high and you are free to use it however you choose.

The downside is that it's standardized and based on credit history, including credit scores. If you don't have a credit history or have had credit problems, it will be difficult to get credit in this way, and though credit scores may not entirely drive the final decision, they will be factored in. A good score won't get you a business loan, though it will help, but a bad score will often prevent you from getting a business loan.

Of course, the upside also has a downside: such easy and unmanaged access to credit makes it easy to borrow more than you can repay. Furthermore, being able to use the borrowed money in any way you (the borrower) want maximizes freedom, but it also means that you don't get any kind of guidance from the lender about how to use it well or responsibly. That can be as dangerous as borrowing too much. Guidance used to be an important part of the process. Sometimes it was intrusive and constraining, but it often helped people to borrow the right amount and use it in the most effective way. Lenders' guidance was also, at least sometimes, a real resource to borrowers and a way to gain financial knowledge that helped them to succeed.

Some distribution arrangements provide critical financing for small farmers. CSAs, for instance, are not merely distribution channels; they also usually provide financing by having members make payments well before the delivery of the produce. Increasingly, buyers and distributors who need small-farm or local products are also prepared to invest in their suppliers. They may offer various kinds of support: loans or grants, favorable payment terms or prices, and/or in-kind support. Getting financing from a distribution source or customers can simplify things for some farms, though such arrangements will also tend to increase a farm's dependence on that channel.

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Farm Credit

The Farm Credit System and its regional credit associations are not banks, but they play a critical role in farm financing and do a substantial portion of all the lending to farms. The Farm Credit system harbors a big share of the farm-lending expertise that is out there.

Since the national, post-WWII growth in farm size, Farm Credit's primary business has been lending to these larger farms. For decades, that is what farming and farm finance were understood to mean. That began to change a couple of decades ago, especially in the Northeast, where farms have long been pushed out by large, low-cost producers, rising land values, and development pressure. Today, commodity farms make up only about half of Farm Credit's lending in the region (though New York may have a bit more than most of New England). Most new borrowers and lots of older businesses are transitioning to some kind of retail model.

Though many speak easily of "Farm Credit," the institutions that make it up are diverse. The three credit associations that cover New England and New York are governed by common regulations, yet have significant latitude in how they respond to local conditions, and each has its own history, culture, and character.

The credit associations are structured as cooperatives, and have a mission of supporting farming. In addition to lending, they provide other financial services to farms. They have also recently begun new efforts to support young, first-time, and minority farmers. However, there are limits on when they can lend to farm-related businesses, even when such a business is important to other farms. Some credit associations are trying to get permission to stretch this boundary.

More than most banks, these credit associations may be ready to reach out and make loans, even small ones, to new farmers if they have:

- demonstrated competence
- a sound business plan
- a history of responsibility (as measured by a credit score, among other things)

Still, in general, they are more oriented toward picking winners than taking chances, which is understandable given their cooperative structure and the long-term engagement to which making a loan can lead. Their historical character as the financiers of commodity farms may make them seem (and sometimes be) less welcoming to alternative producers, but many such producers are now among their borrowers.

If small farmers are going to become an important part of the food production system, Farm Credit, and its lending and financial services, will be a big part of it.

Community Development Financial Institutions

Community development financial institutions (CDFIs) are another potential lending resource for small farmers in the region. They are typically nonprofit, mission-driven organizations that make credit available to people and institutions that might otherwise be unable to obtain credit. They are focused on community and economic development, often with a particular emphasis on job creation. There are several very strong CDFIs in the Northeast region, though their service areas might not cover the whole region. Their capital comes from financial institutions, social investors, foundations, and government.

None of the regional CDFIs has made farm lending a major focus, but several have been doing, or considering doing, some farm or farm-related lending. Most are experienced in lending to small businesses. One sector they naturally focus on is farm-related businesses, which can't qualify for farm lending (particularly from Farm Credit), but nevertheless produce jobs and are critical to the success of farms that need their services.

CDFIs do a lot of lending to borrowers who have weaknesses. Like all lenders, they want to pick winners, but they are often ready to take chances in the process. They frequently provide capacity-building assistance (i.e., pre-, mid-, and/or post-loan support and guidance), and sometimes combine technical assistance with lending. CDFIs would be best in helping build the capacity of farmers who face special obstacles, such as language barriers or bad credit, or who are not yet likely to be regarded as "ready borrowers" by banks or the federal Farm Credit program.
CDFIs' costs are lower and they are more ready to make loans at a scale that would not make sense for other institutions. Still, they need programs to make financial sense for the institution, either on their own merits, or with the help of grant-funded subsidies.

Government programs play a critical role
in managing the extra risk that may be involved
in serving small and new farmers.

The capacity of CDFIs is limited. They have good knowledge of their service areas, but little knowledge of agriculture. And though many are self-sustaining institutions, their movement into new areas usually has to be supported with grant funding. Most would need low-cost loan capital and, possibly, some risk capital, to pursue new directions.

Government Programs

Government programs play a critical role in managing the extra risk that may be involved in serving small and new farmers by:

- providing loan guarantees
- offering grants and loans that can serve as risk capital
- offering low-cost loan capital

USDA's Farm Service Agency (FSA) is the central federal resource for farm lending, offering loan and guarantee programs through local offices. Though the programs seem well targeted to support small farms, they are not widely used, particularly in the Northeast. That may reflect limits in funding and availability, but may also be, in part, the result of the complexity of their process, which:

- requires an applicant to have been turned down by another lender
- is paperwork intensive
- is slow to issue decisions and funding

It should be possible either to help farmers use FSA's programs or to identify the design or funding issues that prevent them from being widely useful. If FSA's programs can be used more readily, they could be valuable, but if they can't, working to change them could be a very productive advocacy goal.

Other federal resources that should be useful in addressing small farmers' credit needs include:

- USDA's Rural Development Division, which provides capital and grants for rural lending activities
- the Small Business Administration (SBA), which provides both business loans and loan guarantees, as well as funding for business assistance services (excluding farms, but not farm-related activities)
- the federal Department of the Treasury's CDFI Fund, which provides risk capital, loan capital, and technical assistance funding to support CDFIs and their borrowers
- the CDFI Fund's New Markets Tax Credit program, which could be a useful long-term source of low-cost capital

Each of the states in the region also has programs supporting the development of farms. These programs might also be sources for capital or service dollars. It might also be possible to work in partnership with some of their farm viability programs to expand their efforts to produce "ready borrowers."

When building borrower capacity is part of what is needed to expand credit, lending should flow from, and be tied to, business assistance. Lending efforts should be aligned, as much as possible, with activities in which personal relations with potential borrowers are developed.

KEY QUESTION:
Can Small Farmers Get the Credit Their Businesses Can Support?

Though some small farmers are able to find needed financing to maintain or expand their operations, others encounter challenges. Those latter farmers tend to:

- be just starting out
- lack a business plan
- seek very small loans
- have no non-farm income
- have no profit history, and no "second way out" via collateral or non-farm income or assets
- have no credit history or have impaired credit
- be dependent on informal partnerships
- have investments in assets that have value to their business, but have much less value as collateral
- be trying to move from part-time to full-time farming
- depend on somewhat vulnerable distribution channels
- be farm-related businesses that do not qualify for farm loans, but still look unconventional to small-business lenders
- be seeking rapid growth for existing operations
- be pursuing innovative new production or business strategies
- be immigrants and/or linguistic minorities that are more likely to fall into many of these categories and may also face bureaucratic and linguistic barriers

Tackling the Challenges

Strategies for addressing these challenges to small farmers might include:

- finding ways to increase utilization of existing programs that support capacity building and government risk sharing (with FSA, Rural Development, SBA, CDFI Fund, etc.)
- developing some sort of incubator system that focuses on getting farmers ready to borrow. This could be a stand-alone effort or wrapped around other programs that aim to build the viability of farms, and could involve:
  - training
  - practical support in business management and record keeping
  - provision of flexible credit and assistance in building a record of responsible credit use
  - negotiation of potential obstacles to borrowing (bad credit, legal structures, etc.)
  - some kind of Individual Development Account (IDA) for education, future investments, or reserves
  - other resources, brokered in as needed
- making, buying, or providing capital for specific types of loans that might otherwise not be made — for instance, those for facilities that support other farms but qualify for neither farm nor small-business lending
- pooling low-cost capital and lending it to promising local lending initiatives from banks, CDFIs, or credit associations
- developing a risk-sharing pool that would allow organizations to offer modest credit enhancements to lenders making qualifying loans
- bringing on an expert circuit rider who would travel the region:
  - assisting CDFI lenders who want to do more farm or farm-related lending, but cannot bring on people with the necessary expertise
  - helping lenders and support organizations utilize government programs
  - adding a "getting ready to borrow" focus to the business assistance and training offered by others
- creating the kind of credit development/credit repair program that organizations conduct with potential home buyers, with the aim of helping participants access credit for their businesses. Such a program could focus on:
  - disadvantaged groups (low-income, minority, immigrant) that are unlikely to be able to work through the issues on their own
  - people with otherwise promising skills (such as demonstrated operational or marketing skill)
  - disadvantaged people with otherwise promising skills
- helping small farmers get consumer credit for small loans, perhaps by using cash or IDA deposits to collateralize credit cards
- creating an IDA to help small farmers launch or grow their businesses and improve their prospects for accessing business credit
- doing microlending with a peer role in allocation of credit and collections. This could greatly increase the viability of microlending by putting much of the underwriting and administrative work in the hands of the farmers

Summary: The Optimal Small-Farm Financing Picture

Some of the questions The Carrot Project asks and works to answer are: How do we move to an optimal situation for small farms to receive the financing they need? How do we support small farms in their efforts to start and operate enterprises based on emerging business models? What leverage do we have with lenders? A combination of the strategies described above, and the vision of a highly functional and effective borrowing-and-lending landscape for small farms, provides The Carrot Project's point of entry to effect change. Features of such a landscape would include:

- capable borrowers with
  - the operational and marketing skills they need
  - proven business models
  - thoughtful business plans and credible financial projections (even when the applicants themselves don't have business experience or capital)
  - good access to specialized support when they need it
  - strong supply/distribution systems
- skillful lenders with
  - significant knowledge of the borrowers' businesses
  - commitment not only to making loans, but also to the long-term success of the borrowers (and to their relationships with borrowers)
  - good institutional support
  - reasonable access to capital
  - resources to deal with the level of risk they face
- external business conditions that are conducive to success

John Moukad has worked in community development for more than 20 years. His focus is on community development finance, affordable housing, and education. Past positions include vice president at YouthBuild USA and program officer at the Enterprise Foundation. John currently operates an independent consulting practice that specializes in business analysis and strategy development. His clients include social investors, intermediaries, and community-based nonprofit organizations. He recently became a member of The Carrot Project Advisory Board.

The Carrot Project's mission is to foster a sustainable and diverse food system by increasing the availability of capital, and its wise use, to ecologically and financially sustainable small and midsized farms and farm-related businesses.