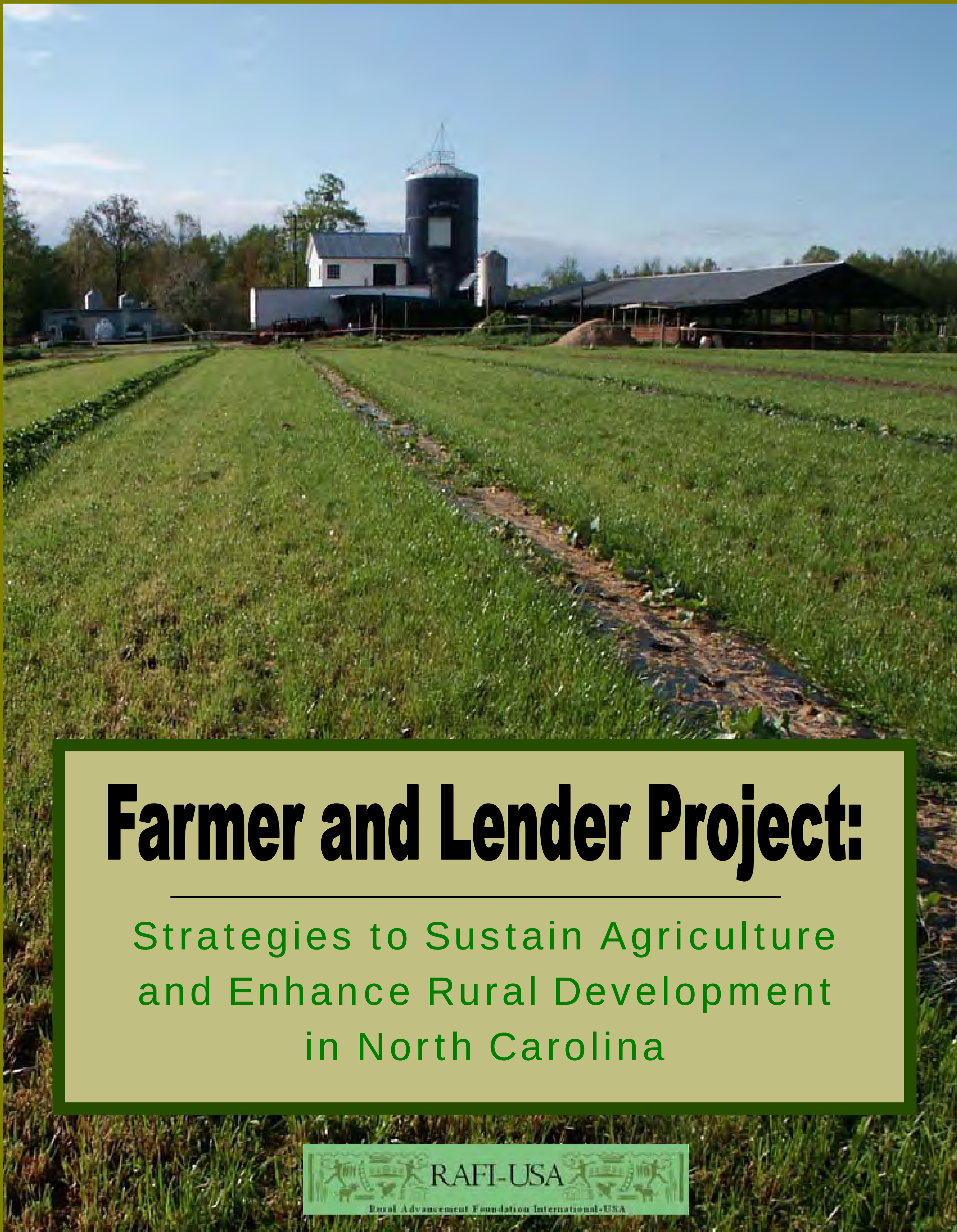

Farmer and Lender Project:

Strategies to Sustain Agriculture and Enhance Rural Development in North Carolina

RAFI-USA

Rural Advancement Foundation International-USA

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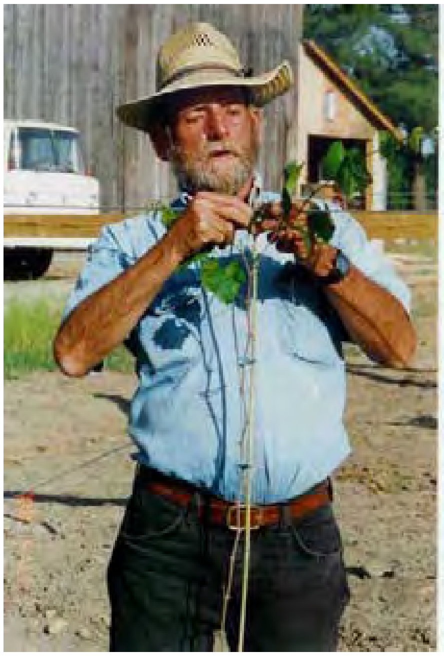
EXECUTIVE SUMMARY

This report aims to stimulate planning and action towards a capital and debt finance system that allows North Carolina lenders to support innovative state farmers through loans for new production, processing, and marketing initiatives. The current system of debt finance fails to meet the needs of some North Carolina farmers who are in transition from commodity crop production to more specialized, higher-value agricultural enterprises.



Capital is as necessary a tool for farmers as a tractor or a harvester. Farming is a business and, as with all businesses, requires capital and debt financing to succeed.

In North Carolina, it is particularly our small- and medium-scale farmers who find themselves with new opportunities that can be realized only with access to adequate capital for innovative production and marketing techniques.

Rising global competition, fundamental changes in traditional commodity programs, and burgeoning new markets give North Carolina farmers a complex mix of challenge and opportunity. Some avenues to farming success are narrowing. For example, today's commodity prices make economic sense only to large farms.

At the same time, tremendous opportunities exist for small and mid-size farmers who grow and market farm goods in new ways. Specialty production, value-added products, direct marketing to consumers, local branding and other methods are generating profits for farmers in North Carolina and the rest of the United States. Such opportunities enable farmers to use innovation to avoid the trap of competing with overseas growers who have much lower costs of land, labor and inputs.

Implementing new crops, production practices, processing, and marketing strategies costs money. Debt financing for non-traditional agricultural enterprises is needed so farmers can buy equipment, hire labor, build infrastructure, and fund the transition needed for these emerging business opportunities.

Seizing these opportunities will require new ways of providing credit and debt financing for the growing group of North Carolina farmers who are prepared to work, innovate, and profit through new enterprises tailored to current agricultural conditions. An opportunity exists for lenders to make more good loans for enterprises that will enable small- and mid-scale farms to succeed.

Currently, lenders lack essential information about the economic viability of innovative farms; farmers lack the know-how to effectively present their business case to the lenders.

Much work remains to be done to enable lenders to make loans to more small- and medium-scale North Carolina farmers and for these innovative producers to gain access to capital needed to take full advantages of agricultural market opportunities.

Agricultural economist David Kohl wrote, "Capital providers can harness momentum by understanding and facilitating those that wish to change and have a good business plan for doing so."[1]

This report is meant as a step toward a well-functioning system of debt finance to sustain agriculture and promote rural economic development in North Carolina. Such a system will model Kohl's concept of capital's potential to harness economic momentum.

After analyzing issues of farm debt finance, the report gives conclusions of the Steering Committee. We note that improvements are needed to overcome the barriers in the current debt finance system and facilitate the continued existence of viable family farms in North Carolina. Also, farmers and lenders need an integrated system of technical assistance, along with new risk management tools to address the gap.

Based on these findings, RAFI recommends designing, operating, and evaluating a pilot project which coordinates and integrates three elements:

1) For farmers, technical assistance and training in business planning, financial literacy, and market assessment.

2) For lenders, training and up-to-date information on emerging market opportunities and evaluation of innovative enterprises.

3) To fund the project, a pool of funds to mitigate lenders' risks.

Farms form the backbone of North Carolina's rural economy and communities. A well functioning debt finance system is necessary to enable the state's farmers to make a successful transition to the new agricultural economy and provide lenders with a growing body of new relationships. The farm ventures supported by new capital will support North Carolina's rural communities by creating business for local merchants, retaining and creating new jobs, and contributing money to local and county tax bases.

[1] "Weighing the Variables: A Guide to Ag Credit Management." American Bankers Association, 2002.

OPPORTUNITIES FOR NORTH CAROLINA FARMERS

North Carolina agriculture is in transition. Changing federal farm programs and global economic conditions are leading to a rapid readjustment in the structure of agriculture in our state. Crops like peanuts and tobacco that once provided North Carolina farmers with a reliable income on small acreage are more economically challenging for modest-sized farming operations, now that federal programs are changing. Increasingly, farmers in Africa, Asia, and South America, are competing in the same markets as North Carolina farmers, but with much lower land and labor costs.

North Carolina has traditionally supported a relatively large number of small- and medium-scale farming operations. The viability of those operations to compete in a global commodity marketplace is in doubt. North Carolina farmers must adjust in order to survive this transition and continue to contribute to the rural economy.

In 1997, the average North Carolina flue-cured tobacco farmer grew just 27 acres of tobacco. In that same year, North Carolina took in almost $1.3 billion of tobacco income distributed among some 12,000 farms. In 2005, the first year after the tobacco buyout, North Carolina grew just $400 million worth of tobacco—a $900 million decline in income to farmers in just seven years. While the actual value of tobacco produced in North Carolina will continue to fluctuate in the coming years, the number of farmers growing tobacco will only decrease.

Experts expect the number of tobacco farmers in North Carolina to stabilize at between 2,000 and 3,000 growers. That leaves as many as 10,000 farmers looking for new income sources if they hope to maintain the standard of living that they had in 1997.

Two strategies for farm survival in North Carolina include :

1) Grow big enough to earn a living on low-margin commodities; or
2) Differentiate farm products in order to secure higher returns in the marketplace.

Increasing costs of land and rents, scarcity of large acreage, and other factors mean that many farmers are unable to increase the size of their operations.

While some farmers will be able to continue to grow and compete in the global commodity market, getting bigger is not an option for the majority of North Carolina producers.

What kind of agriculture are we talking about?

In one way, this remains to be seen: The new diversity will be the product of creativity, ingenuity, determination, and consumer demand. Time will tell what particular crops, production techniques and marketing innovations go into the making of these diverse new enterprises. However, it is possible to point to some general types of innovative agricultural-business that present opportunities. For example:

- **value-added**
- **niche market**
- **product agriculture**
- **direct-marketed**
- **regional branding**
- **green label**
- **convenience packaged**
- **consumer-oriented**
- **extended season**
- **grass-fed**
- **pasture-based**
- **organic**
- **service-based enterprise**
- **agri-tourism**
- **on-farm education**
- ***et cetera***

In North Carolina, most farmers produce what is called an undifferentiated commodity, or more likely several undifferentiated commodities. That is, they grow to a standard which is the same for their neighbor and the farmer in the next county and the farmer half-way around the globe. In the world of undifferentiated commodities there is no real difference between a soybean grown in North Carolina and one grown in Argentina. Once these commodities leave the farm, they enter an industrial food and fiber chain. They are mixed with the same product from other farms, and lose all connection to the farm where they were grown. In commodity production, global supply and demand determine market prices. Commodity crops are very low-margin, meaning a grower must have many acres in production in order to piece together a livelihood. Competition is fierce and only very large and very efficient farmers will survive in commodity production over the long-term.

Due to historical land tenure patterns and the nature of crops like tobacco and peanuts under the federal farm programs, North Carolina has supported a large number of small and mid-sized farming operations. North Carolina lacks the land-base to accommodate the tremendous growth in scale necessary to keep all of these farmers sustainably employed in commodity agriculture.

If these farmers are to survive as contributing members of the rural economy, they must adopt an entrepreneurial model that provides greater returns than those received in small-scale commodity production.

The high-margin enterprises that have the greatest potential to provide a livelihood on the types of farms that we have in North Carolina are high-margin either because they are new and not yet widely adopted or because the enterprise is insulated in some way from global competition. In other words, in order for farmers to earn higher profits, their products must be differentiated from the products of their neighbors and their global competitors.

In a 2001 survey of U.S. consumers, 70% of respondents indicated that it was very or extremely important that their purchases supported a local family farm and was locally grown or produced.[2]

Opportunities abound for shortening the value chain – that is, allowing the farmer to reach the final consumer more directly. In reaction to agricultural products in the grocery store that have been produced more with shelf-life in mind than flavor, many consumers are heading to farmers' markets for their produce.

Fortunately, farmers, consumers, agricultural service providers, and community leaders have identified many strategies by which to differentiate products and earn higher returns from the marketplace. One Columbus County farmer has increased returns on his corn from $2 per bushel to $80 per bushel by grinding and sorting the corn into meal and grits. A farmer in the western part of the state is building on his lettuce production expertise by growing high-value micro-greens for specialty markets. Livestock producers have seen higher profits from raising "grass-fed" and "antibiotic free" animals. Several North Carolina dairies are bottling and selling their own branded milk products.

2 "Attracting Consumers With Locally Grown Products," Institute of Agriculture and Natural Resources, University of Nebraska at Lincoln, October 2001. http://web.archive.org/web/20030416062205/http://www.farmprofitability.org/local.htm#_Toc528127416

Growth of farmers' markets and consumer interest in farmers' markets reflect that trend, but the state's restaurants and grocery stores are also taking notice and attempting to find ways to buy more directly from farmers.

Options for farmers outside of traditional agricultural enterprises are many, limited only by consumer demand, farmer ingenuity, business skills, and availability of capital.

Major food distributors have recognized the demand from customers and the advantages

of product differentiation and are attempting to source identity-preserved farm products. Branding is a tremendous opportunity as the farmers who are developing labels for Bogue Sound Watermelons and Bladen County Beef can testify. Organic farming is the fastest growing sector of the agricultural economy. Organic and some of the new social justice and fair trade labels offer ways farmers can separate themselves from competitors.

Innovation is the factor shared by all these opportunities for small- and medium-scale farmers.

No one commodity will save the day. Nor will any one marketing strategy work for all new and innovative farm enterprises. It has been said before, but it is worth repeating here: There is no "silver bullet" for agricultural prosperity for North Carolina. What there is in abundance among our state's farmers and lenders is innovation, and innovation is the key to future agricultural success.

Our Steering Committee found that there is a gap in availability of financing for farmers attempting high-margin, non-traditional agricultural enterprises. There are many reasons for this gap, most having to do with the evolving nature of North Carolina agriculture, farmer business acumen, and the mismatch of innovative farming enterprises with the traditional financial system.

Any enterprise without a documented history in North Carolina is going to experience difficulty in obtaining financing. Even if a farmer has established a sound management record in conventional crops, new and unusual enterprises present unique challenges for the existing debt financing system. Agricultural lenders do not have the data they need to assess the risks and benefits of new production techniques, processing methods, and marketing strategies.

Nor do all farmers have the necessary business know-how to shift from requesting crop loans to asking for small-business loans. They are typically accustomed to preparing the minimal level of documentation to obtain annual operating loans for corn and other commodities. However, they often lack the capacity to produce the extra documentation required to secure financing for innovative farm operations.

The barriers within the existing debt finance system mean that innovative farmers are having trouble taking advantage of emerging market opportunities. This project has identified barriers to debt financing for non-traditional agriculture, and this chapter explores these barriers.

FACTORS BLOCKING CAPITAL FOR INNOVATIVE FARM ENTERPRISES

The Agricultural Microenterprise Gap:

While some lending institutions can make small loans, the economic fact remains that service and management of small loans tend to cost as much as larger loans.[3] Enterprises needing financing in the range of $50,000 and lower will find few lenders competing for their business.

The Divide Between Farm Service Agency & the Small Business Administration:

The benefits of federal loan guarantees to American enterprise are well known. Both the Farm Service Agency (FSA) and the Small Business Administration (SBA) have proud histories of helping finance farmers and businesses where commercial debt finance is not possible. However, we have identified a place where certain type of farm-enterprises "fall through the cracks" between FSA and SBA guarantees. Any project or venture that falls between the designations "farm" and "business" will have trouble in this loan guarantee gap. New farm-enterprises are a mixture of both agriculture and small-business, and thus may be unfamiliar to FSA and SBA. Given the collateral position of many farmers, and the growing consumer demand for these innovative farm-products, the demand for government guarantees will likely increase, and this guarantee gap will become increasingly wide.

[3] Farm Service Agency and Farm Credit institutions do have policies encouraging underwriting of smaller loans. Some commercial lenders also make smaller loans. These opportunities are limited.

The Very New Farmers Gap:

While it is challenging for experienced farmers to shift from traditional crops to innovative projects, new farmers will have obvious, additional barriers, even though they have viable ideas and farm business models. As new farmers venture into agriculture for the first time, capital for land access, labor, and equipment is critical to their success. Even programs designed for new farmers have challenging requirements.

Training, education, knowledge, and experience can be imparted by the agricultural curriculum within our university and community college system. Track records can be gained through apprenticeships, farm-incubator programs, and other creative relationships with experienced producers and landowners. Even so, very new farmers will require an equity-building program to meet the eligibility criteria for debt finance designed for new farmers.

Small and medium-scale farms are an important economic asset for our state. On average, our farmers are getting older and retiring. Access to capital is one of the chief barriers for a new generation of farmers. This being so, special attention needs to be placed on facilitating the entry of new, innovative and capable farmers. If farm transition is of value to society, the very new farmers may need special focus.

BARRIERS

Farmers who seek to diversify or grow into unusual enterprises encounter an array of barriers, including real and perceived risks, information problems, and insufficient tools for managing risk. Financial institutions are adept at understanding and managing risk: The lending market will fill any gap where the risks can be quantified and mitigated. As of now, however, the necessary data and tools are lacking.

RISK

Non-traditional agricultural enterprises present a higher risk of some types of failure because they function outside of the existing agricultural support network. Commodity and conventional crop enterprises benefit from a rich network of support such as research, extension, insurance products, production histories, enterprise budgets, established marketing channels, advocacy organizations, and in some cases price supports. This existing network is very well suited to traditional production and marketing systems. But, once a farmer steps outside of those traditional systems the support network is left behind, financing and technical assistance are more difficult.

In addition to the real risks of following an unusual path, there is the problem of *perceived risk.* This is raised by the lack of information potential lenders have about a particular production or marketing practice. The risks of conventional commodity agriculture are well known to both farmers and agricultural lenders. Some crops have decades of production data and know-how in managing both the production and the financing of these crops. However, most new crops and innovative enterprises lack this rich data history. Therefore, risks are difficult for lenders to assess, and the line between real and perceived risk is unclear.

A Continuum of Perceived Risk in Agricultural Lending

"Low Risk"

Commodity Crops
Conventional Production
Established Marketing

Non-Traditional Crops
Un-Conventional Production
Innovative Marketing

"High Risk"

This graph illustrates the risks some agricultural lenders perceive in various types of farm loan applications. When evaluating loan requests, some lenders will think of commodity crops as being low risk, and unfamiliar ventures as being high risk – simply because they lack data indicating otherwise. It is important to note that these are perceived risks, precisely because there are insufficient historical data to indicate real risk.

An innovative farm-business model may pose lower actual risks than a conventional farm enterprise. With direct marketing, for example, the entrepreneur may have less risk than a contract-commodity grower because he operates as a price-maker rather than a price-taker. This is not to say that there are not real risks in innovative crops, production methods, or marketing models. These real risks are discussed next.

Non-traditional agricultural enterprises also lack tools for risk management – tools that benefit both farmers and lenders. Risk management programs such as federal crop insurance provide guaranteed income for a crop that allows the lender to treat the crop as collateral. These risk management tools rely upon the same data used by bankers, and so the same problems remain for emerging markets and non-traditional enterprises.

The Non-insured Crop Disaster Assistance Program (NAP) fills the gap where commercial crop insurance policies do not exist. This program is run through the USDA rather than through private insurance companies that offer crop insurance, and provides coverage equivalent to Federal Crop Insurance catastrophic coverage.

There are several problems for specialty crops under NAP:

- It does not cover livestock; it is of limited utility to highly diversified producers;
- and as catastrophic coverage, it provides very limited compensation.
- Moreover, the crop-values are set by USDA's average market price data, and do not recognize added-value production methods, business models, and innovative marketing.

The Adjusted Gross Revenue – Lite (AGR-Lite) program is a pilot federal crop insurance product that insures a 5-year average of the total gross revenue based on the farmer's Federal income tax schedule F.

This is a very promising program that could recognize the value of established niche and emerging markets.

- As a pilot, however, it has not been widely accepted,[4] and anecdotal evidence is that there are difficulties with the extensive documentation required.

While both of these valuable programs serve a segment of agriculture, significant adjustments are needed if they are to fully serve emerging markets and innovative farm enterprises.

The potential limitation of new insurance products is that by the time actuarial data are developed, the enterprise type is no longer innovative, and will have lost its competitive advantage in the market.

[4] In 2005 there were only 165 policies across the 17 states in which AGR-Lite was available. (Dismukes and Durst, 2006 Whole Farm Approach to a Safety Net. EIB-15. USDA ERS, p10).

The old tobacco program made good money for many farmers. It also developed a corps of farmers with strong tobacco production skills. However, the quota system did not require farmers to do the sophisticated marketing required with, for instance, the wholesale grocery channel. Nor did farmers have to do any "hard sells" to lenders to obtain financing for a tobacco crop.

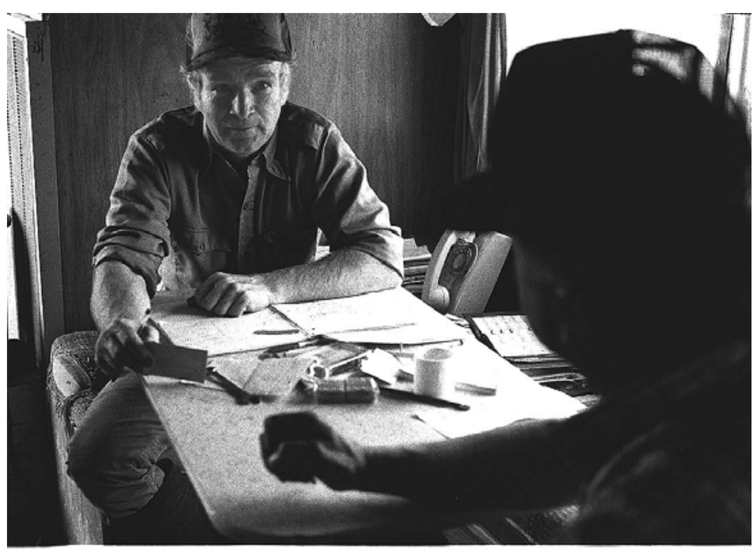
North Carolina tobacco farmers are eager to test their new ideas in the changing marketplace. To do so with success, they need to augment their existing business knowledge with targeted training for business planning, marketing, and capital access.

Like all businesses, successful tobacco farmers developed the specific skills they needed for their particular business. These farmers now need training in new entrepreneurial skills required by the new market demands.

Farmers may also lack the language to communicate their ideas to lenders, and the know-how for sound business planning and marketing. For too long, farms have not been recognized as the small businesses that they are. Small business assistance training is often scheduled at times, seasons, or locations that are impractical for farmers. Much of the assistance available to farmers is fragmented, uncoordinated, and incomplete.

Many of the challenges faced by innovative farmers are not new or unique to agricultural business. We know from the world of small business entrepreneurship development that undercapitalization, and shortcomings in business planning, marketing planning, bookkeeping, and financial reporting are common problems among entrepreneurs. But the recognition of farmers as small business people is only just beginning. The connection between farmers and the world of small business technical assistance has yet to be made and secured.

As commodity farmers transition to more entrepreneurial business models, they need improved support and training in analyzing and executing new business ideas, communicating these plans to their lender, and tracking and planning their finances.



LENDER EXPERIENCE

Lenders that specialize in agriculture are generally very knowledgeable about commodity production, traditional marketing practices, and conventional agricultural lending. But agricultural lenders may be less familiar with emerging market opportunities. When agricultural lenders turn to their reliable data-sources to evaluate new enterprises, they find the data lacking. They may therefore find it difficult to analyze project proposals describing new opportunities. Other lenders may have strong experience with small business lending in general, but lack familiarity with agricultural lending in particular.

The Chicago Board of Trade does not track prices for grass-fed beef. The Cooperative Extension does not have enterprise budgets for pastured-poultry. USDA is not collecting prices of vegetables sold directly from the farmer to the consumer.

Commodity agriculture has produced an extensive historical and market-wide knowledge-base of production yields, market prices, best practices, etc. In addition to government records and databases, agricultural lenders can tap both personal experience and institutional knowledge to inform their lending decisions in commodity production. Pricing data for some commodity crops goes back a century or more and commodity futures markets provide an indicator of market trends.

This base of knowledge is largely unavailable for non-traditional agricultural enterprises. We are in the very earliest stage of developing data tools for innovative farm enterprises. One example of such is the Rodale Institute's Organic Price Index (OPX)[5] which helps to address this information gap for well-established but not yet widely-adopted new enterprises.

However, the OPX and similar data do not address the root of what appears to be a "dilemma of differentiation."
We have seen the need for differentiation: In order for many small- and medium-scale farmers to earn profitable returns, their products or methods must be differentiated from those of their neighbors and their competitors around the globe. But this necessary differentiation is precisely what makes these new projects difficult to finance in an agricultural credit system accustomed to lending to undifferentiated production enterprises. Therein lies the dilemma of differentiation.

Moreover, the nature of the highest-potential types of enterprises and the most profitable emerging market opportunities is that by the time price and production data are available, these enterprises are no longer innovative.

Lack of information about a new enterprise is a major barrier to financing non-traditional agricultural enterprises in North Carolina. Lenders' acknowledgment of this dilemma of differentiation is significant in that it affirms that our current system is inadequate at tapping the full market of agricultural lending, and is not meeting the agricultural credit needs of the innovative farm entrepreneur.

[5] Begun in March of 2005, the Organic Price Index™ (OPX) is a comparison of terminal market prices and other wholesale and selected large-scale retail prices for organic and conventional foods and sustainably raised meats. Updated weekly, the OPX represents prices compiled from government and private sources in the Pacific Northwest, Midwest and the Northeast. The index uses data from wholesale markets for certified organic fresh produce and grains, as well as from the national market for certified organic dairy and sustainably raised meats.

Any successful rural economic development effort must take into account the role that farm businesses play as the base of the rural economy. Successful farm businesses provide jobs and support the tax base. Compared with other businesses, farms require minimal government-funded infrastructure such as water, sewer, and gas lines. As a result, farms pay out more in taxes than they require in services, thus subsidizing state and local government services to others.[6]

Business recruitment, long the chief strategy of economic developers in the South, has in recent years shown lower returns in terms of job creation and retention than in previous decades. International competition is a prime factor. Businesses that can quickly arrive and set up shop in one community can just as easily leave town whenever the global economic climate shifts. By contrast, existing farm businesses are tied to the land. They sink roots into the local community. They are family-owned and unlikely to leave. Local farms tend to buy their equipment, inputs and supplies locally, building a local economic infrastructure. Income from local farms re-circulates in the local community.

These farm-based businesses also enjoy an existing basic infrastructure for supporting their operations in terms of agricultural equipment and input supply sources. Family farming provides communities with an economic foundation that has long-term benefits, maintains land and environmental resources, and maximizes economic returns to the primary producers.

It makes good business sense to find ways to retain farmers as contributing members of the rural economy. To do so, the problem of capital must be addressed. Undercapitalization is a common cause of new businesses failure, including agricultural businesses. Adequate capitalization is a critical requirement for the success of any business venture. A common cause of failure for new enterprises is insufficient capitalization. Because debt finance is an integral component of capitalization for most businesses, a well-functioning debt finance system is necessary if North Carolina's innovative farm entrepreneurs are going to succeed. Unfortunately, the current system does not meet the needs of some farm-innovators.

[6] *FACT SHEET: Cost of Community Services Studies*, American Farmland Trust, Farmland Information Center, August 2004. http://www.farmlandinfo.org/documents/27757/FS_COCS_8-04.pdf

The debt finance system is slow to change of its own accord. Over time, successful innovative enterprises become accepted standard practice and are integrated into the existing finance system. However by the time a new idea makes this transition, the opportunity for a farmer to earn significant returns may have passed. For example: In the mid-1990's, baby salad mixes were bringing upwards of $10 per pound at the farm gate. So many producers jumped on the salad-mix bandwagon that, today, a producer is fortunate to get $3 per pound wholesale price for the product. For many North Carolina farmers, the difference between $10 and $3 is the difference between a viable small business and having to find off-farm employment. A well-functioning debt finance system that encourages entrepreneurial thinking and rewards innovation is critical to the economic integrity of North Carolina's rural communities.

Development of a debt-finance strategy that works for non-traditional agricultural enterprises must address the barriers identified by farmers and the lending community to capital access under the existing system. Those barriers include lack of business planning and marketing know-how among farmers, lack of familiarity within the lending community with emerging agricultural market opportunities, and the real and perceived risks of enterprises operating outside of the existing agricultural support infrastructure.

Any effort seeking to address these barriers must integrate three elements:

1- For farmers, technical assistance and training in business planning, financial literacy, and market assessment.

2 - For lenders, training and information on emerging market opportunities and evaluation of innovative enterprises.

3 - To fund the project, a pool of funds to mitigate lenders' risks.

1 - Business planning, financial literacy, and market assessment technical assistance for farmers.

Technical assistance of any kind is an extremely expensive proposition. For that reason, it is impractical to develop a completely new corps of business professionals whose job it is to help farmers hone and develop their business planning and communication skills. Therefore, farm entrepreneurs must be integrated as clients of existing entrepreneurship support services. Farm support organizations must take responsibility for helping farmers to connect to existing business development and planning services. Such services include the community college system, the Small Business Center Network (SBCN), the Small Business and Technology Development Centers (SBTDC), local, regional, and state Economic Development Commissions (EDC), the Service Corps of Retired Executives (SCORE), Cooperative Extension, and others from the fragmented world of entrepreneur technical assistance. One-on-one support is critical to effective technical assistance efforts. Also, technical assistance needs to be both credible and realistic – realistic to avoid producers wasting their efforts and money, and credible to gain the confidence of the lenders. A coordinated approach to this support is the key to the success of the technical assistance efforts.

2 - Information on emerging market opportunities and training for evaluation of innovative enterprises for lenders.

Front-line lenders are the lynchpin of any successful effort. These individuals are likely to be the first point of contact between farm entrepreneurs and the debt finance system. As such, they must be capable of helping farm entrepreneurs connect with the opportunities that exist within the debt finance system. These individuals will also bear primary responsibility for getting farm entrepreneurs through the lending process. No single individual can possibly stay abreast of all of the emerging agricultural market opportunities.

The institutions that lenders rely upon for agricultural production and marketing data must increase their monitoring and reporting of innovative and emerging market opportunities. A team of experts in farm marketing, production, and finance should be convened to assist front-line lenders with evaluation of new opportunities. Over time, this will enable North Carolina to develop and reap the economic benefits of unconventional agricultural enterprises.

3 - A pool of funds to mitigate lenders' risks.

Mitigation of lender risk is essential to enabling financial institutions to expand into new markets. Without incentives in the form of risk mitigation tools, lenders are unable to vary greatly from the *status quo.* A variety of financial mechanisms can mitigate risk, thus creating the credit enhancements necessary for lenders to make special loans. A few are described below; all have specific advantages and disadvantages in addressing the needs of innovative farmers.

- ***Pooled risk funds:*** A risk pool is a fund of money set up to distribute risk among participants and thus insure that the losses faced by any one participant are minimized.

- ***Savings match:*** A savings match program is a way to address equity issues among a group of borrowers by supplementing their savings. A good example of this is the California Individual Development Accounts (IDA) program, designed especially for very new farmers.

- ***Loan guarantees:*** A loan guarantee is a legally binding commitment by a government or an institution to pay part or all of a loan's principal and interest to a lender in case the borrower defaults.

- ***Crop insurance, revenue insurance, private price guarantee entity, and third-party market verification*** are other tools that could help lenders better understand and mitigate their risks.

While some of these already exist in North Carolina (e.g., loan guarantees), there is a need for expansion and targeting of programs, focusing on non-traditional farm enterprises.

Each of the three elements is valuable by itself, but none can address the credit gap on its own. A real solution that ensures that capital reaches farmers who are prepared to use the capital to enhance the viability of their farm operation must comprehensively address all the reasons for the current shortcomings in the system.

Additionally, a successful debt-finance strategy for innovative farm entrepreneurs must:

1. Nurture proof-of-concept or pilot-projects for those innovative enterprises with short track records. It should also address the gap in the market for those enterprises for which there is an unknown market, or which uses innovative production methods.
2. Recognize that not all business ideas and loan applications are viable. The program should not subsidize farm businesses with little chance of success.
3. Require client dedication and motivation as demonstrated by the client retaining personal financial risk.
4. Mitigate the risks of lenders as a way to encourage lenders to branch out into new agricultural lending markets.
5. Be farmer-friendly, accessible, feasible, and compatible with seasonal constraints and cash flows common in agriculture.
6. Be evaluated for success: Terms for evaluation should be set before the program is implemented.

CONCLUSIONS

As agriculture has changed in the Tar Heel state, North Carolina's farmers have grown and learned along with the changes. Many modest-sized farmers currently find themselves caught between increasing global competition, changing commodity programs, and burgeoning new markets.

To compete in the global commodity market, farmers need to do precisely the opposite of what is demanded by the new market opportunities. Instead, by differentiating their products, using non-traditional production methods, and applying new marketing methods, some North Carolina farmers will succeed and remain in business.

Currently, though, some of the state's best small- and medium-scale farmers are having a hard time getting the financing they need. Barriers stand between them and the necessary tool of capital. The barriers are complicated, but certain solutions are evident.

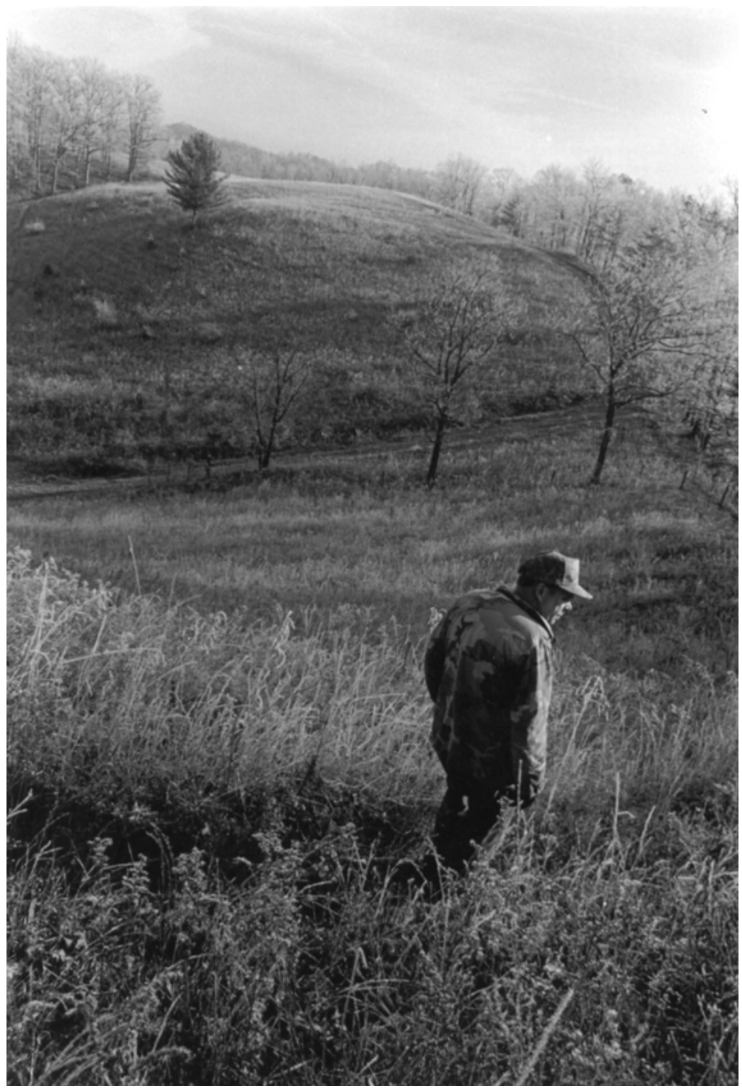
After exploring these issues, defining the problems, and reporting on the recommendations of the Steering Committee, we have reached a simple conclusion.

In order to maximize opportunities for our state's farmers and agricultural lenders, we need three things:

- Coordinated technical assistance for farmers
- New information for lenders, and
- New risk management mechanisms for new farm enterprises.

Based on these findings and our own research and experience, RAFI-USA recommends a small pilot program that will link these three elements. A special targeted loan fund can be established, emphasizing non-commodity agricultural enterprises. Initial funding can come from private philanthropies, patient investors, and public grants and appropriations. Such a fund should be held and administered by an existing financial institution.

It should be designed to meet the criteria discussed above, and with thoughtful consideration of geography, demographics, and local capabilities. The pilot-project should be launched on a small scale initially, in one county or in a carefully defined region. The target county or region should have lenders who are champions of the project; farm-entrepreneurs who are ambitious and innovative; and cooperative extension agents, entrepreneurship agents, community college staff and university professionals who work well together in providing technical assistance to farm-businesses. The project should have realistic goals and clear measurements of success.



A pilot project with this design and purpose will yield meaningful data and lay a foundation for possible expansion to farmers statewide. This in turn will help small and medium-scale farmers transition to viable businesses, and assist in the improvement of our state's rural economy. Helping farms remain economically viable will strengthen our state and improve our resiliency to economic transitions in the future.

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