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TEACHING NOTE

MT KENYA GARDENS: RISK CONSIDERATIONS IN CHOOSING FINANCE SOURCES

1.0 Case Synopsis

Mt Kenya Gardens (MKG) was established in 1989 to grow and process fresh fruits for both the local and export markets. The founders; Gerald and Rosemary Muthomi operate the business as a family owned entity with a strong desire to transition it over to their children in the future. Starting it from a humble background, the Muthomi's have been able to grow the business to an annual turnover exceeding Sh. 100 million, employing over 40 workers and outsourced the growing of fruits to over 250 farmers in the Meru region of eastern Kenya.

In the 1990s, the directors were able to operate with minimal investment in property, plant and equipment as the business was small. They sold their processed fruits to the market directly and relied on public transport to deliver their supplies to the market. The direct selling and personal involvement in running the business has stimulated the annual demand from 100 tonnes in the 1990s to 2500 tonnes in 2011. To cope with the increase in demand, the directors knew that the solution was to upgrade their investment in machinery and delivery vehicles. The investment was estimated at Sh. 20 million but could not be raised from the internal sources of the business as the company had committed the available funds to financing their working capital requirements.

For a small business operating in the agriculture industry in Kenya, raising Sh. 20 million from the commercial banks in early 2000 in form of a bank loan was not easy. Economic liberalization had taken a toll on agricultural based companies with stiff competition from other countries. Lenders ranked the most risky businesses as those in the agriculture industry followed by those operating indigenous and small businesses. Now, MKG fell in all the categories and were therefore ranked "very risky". The directors also knew that a loan facility, equivalent of 60% of their total assets would put them into considerable risk in case the company failed to actualize the demand given that competition was also growing. The other alternative considered less risky and available to the Muthomi's was to invite a strategic equity partner Mr. Rein Hey to inject equity into the business. This meant that the new equity partners would have voting rights and could influence the decisions of the company; and possibly in the future acquire control of the

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Amos G. Njuguna, A Lecturer of Accounting & Finance prepared this case with the assistance of Professor Leif M. Sjöblom of IMD business school, Switzerland, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. United States International University (USIU) acknowledges the support of Global Business School Network (GBSN and financial support from Bill & Melinda Gates Foundation) in the preparation of this case study.

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business! The directors had to make a quick decision on whether to finance the intended investment by use of the bank loan and risk the company's assets given the uncertainties in demand or have a strategic equity partner who will introduce non-family members in the board.

2.0 Learning Objectives:

The general objective of the case is to introduce the students to risks facing agri-businesses as they make decisions to finance their expansion. The specific objectives meant to impact experiential learning are;

- 2.1 Why lenders consider agri-businesses as risky compared to other firms
- 2.2 Why lenders consider SMEs as risky compared to the big firms
- 2.3 The extent to which a firm's investment decisions are independent of the financing decisions
- 2.4 The risks associated with incorporation of external equity partners in a family owned business
- 2.5 The risks associated with borrowed finance
- 2.6 How to manage finance and other risks that face agri-businesses in the conduct of agri-business

3.0 Discussion Questions

3.1 Why do lenders consider agri-businesses as very risky?

Learners should appreciate that bankers are interested in the ability of the borrower to service the loans granted to them. To the banker, risk is the inability of the borrower to pay back the loan under the terms of the contract. In a nutshell, does the borrower have the capacity to pay back the loan? As such bankers are conservative in lending and will therefore consider both the external (macro and sector factors) as well as individual factors in before lending out a loan.

Specifically, bankers will view agri-businesses as risky because their cash flows are unpredictable or not guaranteed due to the following reasons;

- Price fluctuations of the agricultural produce
- Productivity of agri-businesses is dependent on climatic factors; if the factors change adversely, the firm loses and may not be able to repay the loan
- Market conditions – the supply of agricultural produce increases at the same time in different regions and for all the market suppliers thus middlemen take advantage to distort agricultural prices
- Storage of agricultural produce is difficult to manage and so a lot of output go to waste before reaching the market
- Poor infrastructure; thus affecting not only the collection of produce from the farmers but also the delivery of the output to the market – the produce ends up failing to reach the market at the right time – yet the produce is expected to be fresh at the time it reaches the market
- Inadequate mechanisms to handle the produce after harvesting (post harvesting handling risks)

- In the external market specifications of the expected produce in terms of moisture, colour and weight are made; these specifications are difficult to fulfill for agricultural commodities
- Their collateral is in the form of agricultural land; usually located away from the municipalities and urban areas hence lower valuation

The learners should appreciate that generally; these are the risks that firms in agri-businesses go through.

3.2 Why do lenders consider small businesses as very risky?

Small businesses have inbuilt risks that make them less attractive to lenders. These risks emerge because of their small nature and tend to reduce as the business grows in size. The specific reasons why the small businesses are considered risky by lenders are;

- They are usually not well structured and so their management and control is exercised by one or two individuals
- Many SMEs do not have proper legal registration, which means that these businesses do not have perpetual succession. The death or legal incapacitation of the founders results to closure of the businesses – *separate legal entity theorem to be taught at this point.*
- Failure rate in the past – over 70% of SMEs have failed within three years of startup – *learners to note that lenders use available sector statistics in decision making*
- Inadequate or poor planning; which implies that although the business owners have the idea, they are not clear on the implications of that idea from the business perspective.
- Many SMEs do not have sufficient collateral to secure their loans. They start small and increase their value over time.
- Constant change of business – bankers think that SMEs are not focused and may therefore change locations and businesses at will and the law allows them to change businesses
- In some cases the technology used by SMEs is not cost effective and hence not attractive to the lenders
- Inadequate business policies relating to production, marketing, financial controls and human resource management.

Learners should appreciate that an alternative to cash flow based lending is asset financing; which for small businesses becomes difficult due to their limitation in asset values. For MKG, only land was available and the bankers considered advancing to them 40% of the value of the land!

3.3 To what extent did the factors mentioned in question 3.1 and 3.2 apply to MKG?

- Prices of citrus fruits fluctuated significantly within the time
- To a large extent, MKG relied on climatic factors for their main raw materials – even though they irrigated, majority of their suppliers – farmers relied on the climatic situation
- Market conditions – the supply of agricultural produce increases at the same time in different regions and for all the market suppliers
- Storage of the fruits was difficult to manage
- Poor infrastructure from Meru to Nairobi and Central province
- Technology in use was not the best
- The factors impacted on MKG because the value of the collateral available was far much less than they could offer
- Their land was located in Meru; an area that the bankers designated as rural and not urban or municipality and so collateral that MKG had was much less than the loan they anticipated to raise
- The company did not seem to be well structured at the time, with only Gerald and Rosemary Muthomi running the business
- Legal registration at start up – Mr. and Mrs. Muthomi had to borrow a loan from AFC on the grounds that they were employees and not as a business
- Inadequate or poor planning – there was no business plan at inception of the business; neither was there one when they were seeking finance for expansion
- Technology – MKG was using labour intensive technology that could have been improved.

3.4 To what extent are the firm's investment decisions independent of the financing decisions?

Learners should be made aware that the investment decision should precede the financing decision. *In other words, do not invest because money is available but invest because the investment is viable.* Once a decision has been taken that the investment is viable, seek for capital to finance the investment. This is the main postulate of the *fisher's separation theorem* that argues that a firm's investment decision is independent of the financing decision and so the financing decision chosen should be evaluated in the light of the risk-return relationship. The dilemma however is that riskier financing decisions may have higher returns (realized through lower actual and opportunity costs).

3.4.1 Where would a firm get funds to finance its expansion?

The two sources that make up the capital structure of a firm are equity and debt. Learners should be made aware that the directors must identify the optimal mix of debt and equity considering the value of the firm, the current debt levels, costs involved (actual and opportunity costs) and the risks inherent in each financing decision.

Although the *MM capital structure theory* argues that the mix of debt and equity in the capital structure does not matter in the determination of the value of the firm; the learners should understand that different combinations of debt and equity in the capital of a firm carry with them different levels of bankruptcy risk.

3.5 Should MKG finance their expansion by inviting Mr. Rein the strategic equity partner or borrow the loan from the Consolidated Bank of Kenya?

This question provokes learners to critically evaluate the use of external equity to finance their businesses. Learners should appreciate that the decision to bring on board a strategic equity partner carries with it both visible and invisible costs on the other hand, the decision to borrow is expensive, can result to bankruptcy and should therefore be carefully evaluated. However, despite the limitations, it has several benefits and can therefore be considered.

Learners should argue on the basis of the arguments for and against the two decisions. These are explained in sections 3.5.1 and 3.5.2.

3.5.1 Merits of using external equity to finance the business

- The strategic investor may bring in new ideas to the company
- The cost of equity is “cost free” – no direct costs are involved. To have a direct cost, the company must be profitable as the direct cost is the dividend paid to the shareholders. The 22% interest per annum on bank loan will be avoided if the company takes this option.
- Permanent capital – the amount will not be refunded except only if the company is wound up
- The company has no commitment to pay the dividends. Dividends can be suspended if the firm is not profitable or if there are investments to be made in the firm although this will depend on the decision of the major shareholder, which Mr. Rein Hay will assume.
- Further financing may be obtained in the future from the bank

3.5.2 Demerits of using external equity to finance the business

- The board will have “outsiders” – non family members. Family beliefs, values and ethics may be interfered with
- The strategy creates a permanent relationship – shareholders are owners of the company and have a claim on the assets of the entity
- Incorporation of the strategic equity partner often interferes with the succession plans in family businesses
 - Strategic equity partners are not readily available; even when they are interested, they conduct lengthy evaluations of the entity sometimes using dimensions that the original business owners did not earlier foresee
 - When the firm pays dividends, there is no taxation advantage as the dividend cost is not allowed as an expense when calculating the income tax payable by the company
 - The terms laid by Mr. Rein Hay were difficult for MKG; At the current revenue levels of Sh. 130 million, the terms would mean paying him Sh. 15.2 million on annual basis forever (perpetuity).

	Sh. Millions
Annual turnover	130
After tax profit margin at 53%	68.9

Dividend payout (40% of profits)	27.56
Amount to Mr. Rein Hay 55% of dividends	15.158

Note: Mr. Rein Hay can still increase the amounts as he will be the major shareholder.

3.5.3 Merits of financing the expansion by use of bank loan

- There will be no insiders in the board so the succession plans of the family will not be interfered with
- Loan interest is a tax allowed expense and so the income tax paid will reduce as a result. The *tradeoff theory* argues that firms are assumed to trade off the tax benefits of debt with bankruptcy costs off debt when making their decisions. The risks inherent in bankruptcy (implied) is offset by the tax saving as interest cost is tax deductible.
- The relationship with the Consolidated Bank of Kenya will be temporary – after five years the bank will not have any claim from MKG if they service the loan effectively
- The amount would be available sooner than in the case of a strategic equity partner

3.5.4 Demerits of financing the expansion by use of bank loan

- Risk of bankruptcy if the cash flows are not realized as expected – to a family business, this means loss of sentimental value in the business and loss of good original ideas.
- Interest will have to be paid on the loan at 18% per annum. Although the interest is on reducing balance basis, the total interest will amount to Sh. 10.4 million about 52% of the amount that was initially borrowed
- The bank will require collateral for the loan
- The bank views the business as risky (its agri-business and SME) so the personal guarantee of the directors will also be required
- The bankers may vary the interest rate in the future – if inflation rates and base lending rates increase
- There are other incidental costs associated with borrowing that are usually charged upfront. In the case of MKG, the costs amounted to 8.4% of the loan value.

3.6 Factors Modifying the financing decision – Good practices in making financing decisions

- Asset-liability matching – management must attempt to match the duration of the finance source with the duration of the investment project. The instructor to mention; aggressive financing – period of financing is less than the investment period and conservative financing – period of financing exceeds the investment project period.
- Pecking order hypothesis – firms avoid external financing when they have internal financing available and avoid equity when they can engage in new debt financing at reasonably low interest rates. They also avoid debt in terms of excessive interest cost in favour of equity.

- Right financing – firms can significantly reduce financing risks and enhance investment returns and company value over time by determining the right investment objectives, policy framework and institutional structure given the market conditions.
- Firms should maintain their debt asset ratios in reasonable proportions given the level of efficiency of the financial markets and the industry standards.

3.7 How has MKG managed the risks that they face as agri-businesses?

It should be noted that MKG has over the years been very conservative and have used various approaches to manage their risk exposure. The risks captured in one way or another in the case, and how MKG has dealt with them are summarized in below.

Risk	Management Technique used by MKG
1. Price fluctuation of citrus fruits	<ul style="list-style-type: none"> • Diversification to products whose prices are relatively stable for instance the movement from more of citrus and pawpaw to bananas • Sale by order where prices are pre-agreed before delivery
2. Transport capacity	<ul style="list-style-type: none"> • Collection point must have at least 800 Kg of produce to use the collection van
3. Agricultural risks e.g. climate, crop pests and diseases	<ul style="list-style-type: none"> • Outsourcing production to other farmers • Irrigating their land
4. Poor quality of produce at entry to MKG	<ul style="list-style-type: none"> • Training the farmers • Screening the produce delivered by the farmer and returning the element that does not meet company specification
5. Risks in production processes	<ul style="list-style-type: none"> • Effective supervision • Qualified employees • Well motivated employees • Use of the right technology
6. Risk of loss on storage	<ul style="list-style-type: none"> • Constant monitoring of the production losses • Sale by order • Faster delivery to the market • Well trained people to handle the produce • Improved technology
7. Risks in transit	<ul style="list-style-type: none"> • Outsource of transport to Mt. Kenya Greens
8. Competition	<ul style="list-style-type: none"> • Customer assurance • Fresh deliveries • Addressing customer concerns as soon as they set in • Promising what they can deliver and exceeding the customer's expectations
9. Disaster – fire, injury of	<ul style="list-style-type: none"> • Branding of the product • Insurance

employees

10. Quality and quantity of the product delivered in the market

- Screening of the products brought in to the firm
- Checking on every fruit before it is delivered to the customer
- Weighing the product before it is delivered in the market
- Giving an allowance of 1% in quantity to the customer
- High quality production process

4 The Decision taken by MKG

After intensive consultations, Gerald and Rosemary Muthomi decided to finance their family by use of the Consolidated Bank of Kenya loan. The bankers conducted a comprehensive evaluation and realizing the risk management and operational strategies that the company had put in place approved the loan. This was the first loan that the bank provided a small firm in agri-business. The machinery and vehicles were acquired and the loan paid back in three years earlier before the scheduled time.