Most Value-Added Firms Have Access to Needed Capital

Expanding capacity was the most frequently cited reason for undertaking capital investments, while compliance with regulations was cited less frequently than other reasons. Only a few value-added manufacturers reported problems obtaining outside financing. Most report using internal funds and bank loans to finance capital improvements, while few report using equity capital from new, unrelated owners or venture capital firms.

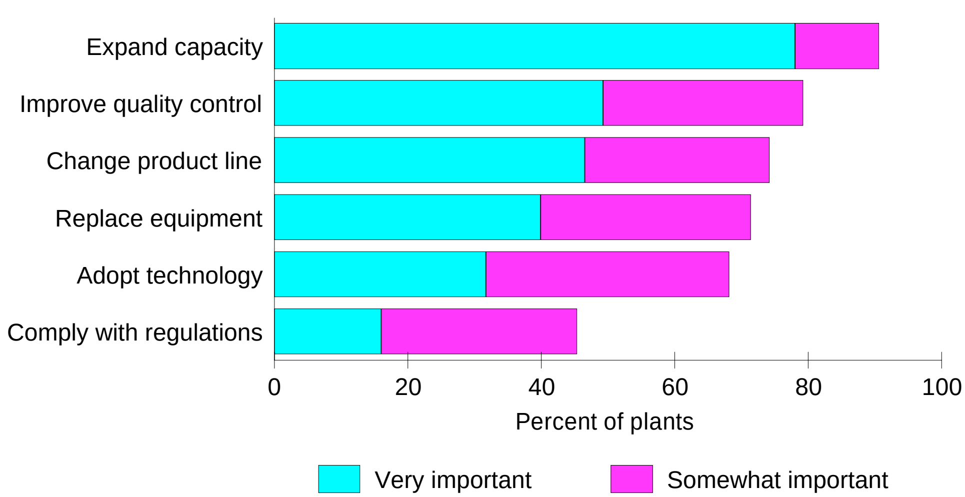
Both new and existing value-added firms need capital to survive and grow. Growing firms need capital to finance new equipment and construction to accommodate expanded operations. Many value-added plants need new or updated equipment to accommodate new technologies and raise worker productivity and competitiveness. Heightened public concerns with environmental quality and food safety have placed additional pressure on value-added firms to make investments in new technologies and equipment to comply with government regulations and standards.

The ERS Rural Manufacturing Survey (see description in “Data Sources” appendix) shows that 58 percent of value-added manufacturing plants reported having planned or undertaken a major expansion or modernization during the 3 years preceding the survey. This is slightly higher than the percentage (52 percent) of other manufacturing establishments reporting an expansion or modernization. Over 80 percent of printing, dairy products, and preserved fruits and vegetables manufacturers, and over 70 percent of sawmills and manufacturers of wood buildings and mobile homes reported an expansion/modernization.

Expanding Capacity Is Most Common Reason for Capital Investment

Capital investment is needed when old equipment or facilities are worn out or damaged and need to be replaced. Investment can also expand the scale of operations or upgrade the production process with new technologies or management techniques. The Rural Manufacturing Survey asked respondents who had expanded or modernized their plant and equipment within the previous 3 years about reasons for capital investment decisions. Expanding production capacity was the most cited reason for capital investments. Nearly all respondents identified “Expand production capacity” as an important reason. Nearly 80 percent said it was “very important,” and another 12 percent said it was “somewhat important” (fig. 1). These responses suggest considerable growth and optimism on the part of value-added firms.

Figure 1
Reasons for investing in capital improvements by value-added manufacturing plants
The most common reason for investing was expanding of capacity



Source: ERS analysis of 1996 Rural Manufacturing Survey.

Four other reasons for investment, “improve quality control,” “change or add to the product line,” “replace old or damaged equipment,” and “adopt new technology or management practice,” were also frequently cited as “very important” or “somewhat important.” Each of these reasons was cited by 70 to 80 percent of respondents as either “somewhat important” or “very important.” Quality control has been an increasingly important concern for manufacturers, as product quality has become an important determinant of a company’s competitiveness. Food safety concerns have also raised the importance of quality control in food processing industries. Many businesses are adopting new technologies and management practices to raise employee productivity, cut materials waste, and promote flexibility in the production process.

Among value-added industries, compliance costs associated with environmental and food safety regulations are an important issue. Sixteen percent cited “comply with new regulations” as a “very important” reason for capital investment, and 29 percent cited it as “somewhat important.” The frequency with which compliance is cited as a reason for capital investment suggests that regulatory costs are significant. Still, compliance with regulations is cited less frequently than reasons (listed above) that are directly related to maintaining or increasing the competitiveness of the manufacturing business.

Most Investments Use Internally Generated Funds or Bank Loans

Most respondents to the Rural Manufacturing Survey used internal sources of financing for capital investments. About two-thirds of value-added establishments used retained earnings, and half of those that were part of a multiunit firm used funds from elsewhere in the firm. Most also used borrowed funds. Of the 58 percent of value-added establishments that used borrowed funds, 90 percent said they borrowed from a bank or savings and loan, 25 percent borrowed from individuals and families, and only a few respondents borrowed from other firms or issued bonds. About 11 percent acquired capital by issuing new equity investments. Of those, three out of four said the new capital came from existing owners, partners, or their families. One in four said capital came from new, unrelated owners, and only a few used a venture capital firm. About 1 in 10 value-added establishments reported that a government program had a role in financing their capital improvements.

Few Businesses Report Problems With Access to Capital

About 18 percent of value-added manufacturers had to curtail their plans for capital improvements due to problems encountered in carrying out their investment plans. Rural Manufacturing Survey respondents were asked to rate the importance of four potential problems that can hinder capital investment plans. Three problems, “acquiring support from headquarters,” “underestimated financial costs,” and “uncertain or changing product market situation,” were cited with roughly equal frequency (fig. 2). About 10 percent of respondents cited each as a major problem, and about 30 percent cited each as a minor problem. A fourth problem, “difficulty in arranging outside financing,” was also cited by 10 percent as a major problem, but was cited by fewer than 20 percent as a minor problem. This suggests that most existing value-added businesses are able to acquire the capital they need to expand or update their operations.

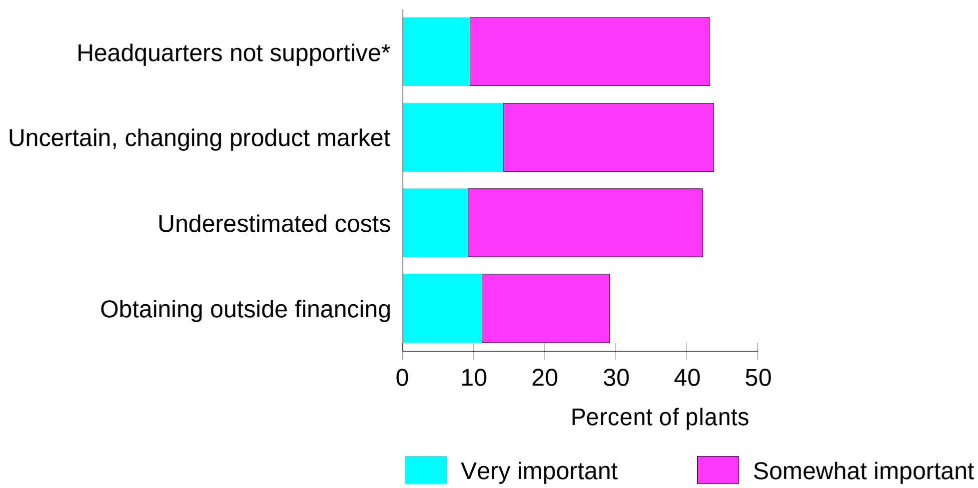
The responses by value-added businesses discussed above were very similar to those of other manufacturing businesses. The survey responses did not reveal any disadvantages or barriers to capital access specific to value-added firms. This is consistent with other recent studies that found few problems with access to capital for rural businesses. However, a weakness of this analysis is that it says little about the difficulties encountered by new firms or plants when attempting to raise capital. The Rural Manufacturing Survey includes only a very few new plants and says nothing about plants that went out of business or were unable to begin operations due to lack of capital. The survey also lacks information on very small firms (with less than 10 employees), which face the greatest problems in raising capital.

In particular, there are concerns about financing for innovative value-added activities that are unfamiliar to local bankers. New, risky businesses often rely upon venture capital firms, but small, rural businesses may not have access to this type of capital. Our survey shows that most new equity capital comes from existing owners and relatives. While these results indicate few problems with capital access, officials and economic development professionals planning a value-added development strategy should be aware of the possible capital needs of new start-ups and innovative business ventures. *[Fred Gale, 202-694-5349, fgale@econ.ag.gov]*

Figure 2

Problems encountered by value-added manufacturers when undertaking capital investment plans

Difficulty obtaining outside financing was reported less frequently than other problems



* Multiunit firms only.

Source: ERS analysis of Rural Manufacturing Survey.