# CHAPTER 7. ECONOMIC AND FINANCIAL PERFORMANCE OF EACs

## 7.1. Introduction

Are the EACs viable business-oriented organizations, or are they dependent on the political and financial support of INDAP and other government agencies? Latin America is full of examples of unsustainable 'bubbles' created by the political will and resources of a government, foreign donor or an NGO. These 'bubbles' grow and glow while the artificial environment in which they live endures, but burst as soon as the political winds change and the flow of subsidies dries out.

To endure in a competitive market economy, a firm will need to be able to innovate, to link to new and dynamic markets, to anticipate new developments, to increase its productivity, to learn and to harness knowledge to improve its strategies.

But even before these difficult objectives are met, in the short run a firm will only be sustainable if its income can meet its expenses and if its assets have a higher value than its debts. In the context of a government-funded effort, another important indicator of sustainability will be the degree to which the firm is independent of public subsidies to fund its expenses or its investments. In this chapter I look at these three indicators to answer the question posed above.

## 7.2 Method

The methods used in this chapter are described in detail in Chapter 3, Section 3.4.

| Aim | Method/Information source | Sample size |
|---|---|---|
| To analyze (1) EACs' operational performance, (2) EACs' financial performance, and (3) the relative importance of income generated from public programs. All these analyses were done for the 1999 fiscal year. | Un-audited balance sheets and income statements of EACs for 1999. Analysis by Certified Public Accountants of the information contained in these documents. | Balance sheets and income statements were requested from 1050 rural organizations. 410 of them provided complete information. |

Also of importance here are the definitions given in Table 7.1.

Table 7.1 Definitions of economic and financial indicators

| Variable | Definition |
|---|---|
| Current assets | Assets expected to be consumed or converted into cash during the next operating cycle. Include cash, amounts receivable, inventories, etc. |
| Non-current assets | Assets expected to be consumed or converted into cash after the next operating cycle. Include fixed assets, non-current receivables and long term investments. |
| Total assets | Current plus non-current assets. |
| Current liabilities | Funds payable during the next 12 months. |
| Non-current liabilities | Funds payable after 12 months. |
| Total liabilities | Current plus non-current liabilities. |
| Net assets | Total assets minus total liabilities. |
| Sales revenue | Income from sales of goods and services that constitute the EAC's stock-in-trade. |
| Revenue from other sources | Income from sales and sources that do not constitute the EAC's stock-in-trade, such as interest. |
| Total revenue | Sales revenue plus revenue from other sources. |
| Operating expenses | Expenses incurred in activities that constitute the EAC's stock-in-trade. |
| Non-operating expenses | Expenses incurred in activities outside the EAC's stock-in-trade, including depreciation, provision for taxes, etc. |
| Financial costs | Interest expense. |
| Total expenses | Operating plus non-operating expenses plus financial costs. |
| Operating income | Sales revenue minus operating expenses. |
| Income from public sources | Income from public programs and agencies (grants plus sales of services to INDAP programs). |
| Indicator of operational performance | Total revenue / total expenses. |
| Indicator of financial performance | Total liabilities / total assets. |
| Indicator of financial dependence | Income from government programs / total revenue |

## 7.3 Operational performance

The operational performance of an EAC refers to its capacity to generate sufficient income to cover its expenses. The indicator is the ratio of total revenue to total expenses. Table 7.2 shows that in 1999, 44% of the 410 EACs for which we have information had much higher total expenses than their total revenue. Just over a third of these EACs had total expenses that were either 10% below or above their total revenue, and thus could be considered to be more or less in equilibrium, with a small profit or a small loss respectively. Only about one-fifth of the EACs had revenues that were significantly higher than their costs and thus could be considered to be profitable[30].

[30] It may be interesting to compare these results with the fact that only 20% of US farmers made a profit in 1999 (personal communication, Dr. T. Reardon, Dept. of Agricultural Economics, Michigan State University, August 2001).

Table 7.2 Operational performance of 410 EACs in 1999

| Indicator of operational performance | Number of EACs | Percentage of EACs | Cumulative percentage of EACs |
|---|---|---|---|
| 0 (very bad) | 19 | 4.6 | 4.6 |
| 0.10 - 0.25 | 30 | 7.3 | 12 |
| 0.26 - 0.50 | 29 | 7.1 | 19 |
| 0.51 - 0.75 | 57 | 13.9 | 32.9 |
| 0.76 - 0.90 | 47 | 11.5 | 44.4 |
| 0.91 - 1.10 | 140 | 34.1 | 78.5 |
| 1.11 - 1.20 | 20 | 4.9 | 83.4 |
| 1.21 - 1.50 | 25 | 6.1 | 89.5 |
| 1.51 + (very good) | 40 | 9.8 | 99.3 |
| N.A. | 3 | 0.7 | 100 |
| **Total** | **410** | **100** | |

## 7.4 Financial performance

The indicator of an EAC's financial performance measures the organization's degree of indebtedness relative to its assets (total liabilities/total assets). Table 7.3 shows that in 1999 over one-third of EACs had extremely high levels of debt relative to assets, to the point where 24% were technically bankrupt. In Chile, many analysts agree that a liability/assets ratio of less than 0.6 shows that a firm is in a healthy financial condition; one-third of the EACs could be placed in this category at the end of 1999. An additional 29% of the EACs were in between these two states.

Table 7.3. Financial performance of 410 EACs in 1999

| Indicator of financial performance | Number of EACs | Percentage of EACs | Cumulative percentage of EACs |
|---|---|---|---|
| 1.25 + (very bad) | 30 | 7.32 | 7.32 |
| 1.24 - 1.10 | 31 | 7.56 | 14.88 |
| 1.09 - 0.90 | 83 | 20.24 | 35.12 |
| 0.89 - 0.75 | 70 | 17.07 | 52.20 |
| 0.74 - 0.60 | 49 | 11.95 | 64.15 |
| 0.59 - 0.30 | 65 | 15.85 | 80 |
| 0.29 - 0.0 (very good) | 71 | 17.32 | 97.32 |
| N.A. | 11 | 2.68 | 100 |
| **Total** | **410** | **100** | |

An additional indicator of the financial condition of Chilean small farmers' organizations in 1999 (including, but not limited to, EACs), is the total amount they owed to INDAP and the amount involved in defaulted loans (Table 7.4). This official information (audited by Chile's General Comptroller Office) was provided to me directly by INDAP. As of 31 December 1999, the 1,050 small farmers' organizations had a total debt with INDAP of $49.4 million. Of that amount, $39.4 million

were loans in good standing, while the rest ($10 million) were defaulted (20% of the total). Of the 1,050 organizations, 279 (27%) had defaulted on their loan payments.

The 598 organizations (57% of the total) with debts of less than $20,000, owed a total debt of $4.2 million (8.5% of the total). Of these, 21% had defaulted on their loans, giving a total of $0.5 million owed (5% of the total amount defaulted by all organizations, and 10% of the total debt of this group). The number of organizations defaulting is somewhat lower than average for this group of smaller debtors, and the amount of money involved is significantly lower than for other groups.

The 45 organizations (4% of the total number) with debts of $200,000 or more, had a combined debt of $21 million (42% of the total). Of this group, 21 (47%) had defaulted, and the amount involved added up to $6.1 million (61% of the amount defaulted by all organizations, and 30% of the total debt within this group of largest debtors). The top 10 organizations in terms of debt accumulated US $4.1 million in defaulted loans (41% of the total amount defaulted by all organizations)[31].

One should be very careful in extrapolating from this information to the conditions of most EACs. The largest loans are associated with very special projects and, as can be seen, are highly concentrated in a few very large EACs. These special 'megaprojects' - as they were unofficially called - have been subject to different decision-making procedures and to special support programs, than the vast majority of EACs.

In my interviews with many of the leaders and managers of these very large organizations, and with INDAP staff familiar with these cases, I generally received the same explanations for the failure of these large projects: (a) they were linked to very profitable but highly risky and dynamic markets (e.g., flowers for export); (b) they entailed complex organizations; (c) most of those involved (members, managers, advisors, INDAP staff) lacked the experience, contacts and expertise to run these complex firms; and (d) the public systems lacked the agility to respond to the early signs of trouble, both because of bureaucratic rigidity and also due to the political cost of having to recognize failure and act consequently.

Table 7.4 Debts owed to INDAP by 1054 small farmers' organizations (31 December 1999)

| Size of loan ($) | Number of organizations | Outstanding loans | | Defaulted loans | | Total |
|---|---|---|---|---|---|---|
| | | $ | % | $ | % | $ |
| 200,000 - 2,028,895 | 45 | 14,549,102 | 70.4 | 6,141,715 | 29.6 | 20,690,816 |
| 100,000 - 199,999 | 64 | 7,581,535 | 87.2 | 1,113,335 | 12.8 | 8,694,870 |
| 50,000 - 99,999 | 130 | 7,442,372 | 84.1 | 1,405,516 | 15.9 | 8,847,889 |
| 20,000 - 49,999 | 217 | 6,103,389 | 87.7 | 862,290 | 12.4 | 6,965,679 |
| 21 - 19,999 | 598 | 3,765,577 | 89.2 | 458,907 | 10.1 | 4,224,484 |
| **Total** | **1.054** | **39,441,975** | **79.8** | **9,981,764** | **20.2** | **49,423,739** |

## 7.5 Financial dependence

The indicator of financial dependence measures the extent to which an EAC relies on public programs and agencies to generate its income, either through direct transfers, grants or services sold to them. More precisely, the indicator is defined as income from government programs / total revenue.

Some EACs may divert part of these grants to cover some of their operational costs, but typically EACs use this income to cover the costs of the technical advisory services that the organizations provide to their members, to pay for market studies and the preparation of investment projects, and to

[31] At the time of writing this chapter, INDAP had begun actions to liquidate several of these larger EACs.

hire external consultants for management and technical advice. Hence, funding from government programs does not always constitute a subsidy to core operational expenses. In fact, most grants are certainly used for what can only be called very legitimate, appropriate, and necessary services provided by the EACs to their members. One cannot always, or even most of the time, attach a negative connotation to this type of income.

However, experience from many countries in Latin America over the past decades tells us that if EACs are very dependent on this type of income, they will be vulnerable if such support is suddenly withdrawn or policies suddenly changed.

Table 7.5 shows that almost a quarter of EACs generate all their income from government programs and agencies; these EAC are totally dependent on the prevailing political climate for their survival, and they have been completely incapable of linking to any market client in the private sector. If one adds those that generated 60% or more of their income from these non-market sources, the percentage of EACs overly dependent on government programs rises to about 32%.

At the other extreme, 37% of the 410 EACs in 1999 did not generate any income from public grants or from sales of services of any kind to government (although they may have received loans from public agencies); 100% of their revenue came from market sources. If one adds those that received funds from government to make up less than 10% of their revenue, the percentage increases to about 45%.[32] In between these extremes lie 23% of EACs who are quite, but not extremely, dependent on government.

Table 7.5 Financial dependence of 410 EACs in 1999

| Indicator of Financial Dependence | Number of EACs | Percentage of EACs | Cumulative percentage of EACs |
|---|---|---|---|
| 1.00 (very dependent) | 100 | 24.39 | 24.39 |
| 1.00 - 0.80 | 15 | 3.66 | 28.05 |
| 0.79 - 0.60 | 15 | 3.66 | 31.71 |
| 0.59 - 0.40 | 25 | 6.10 | 37.80 |
| 0.39 - 0.20 | 41 | 10 | 47.80 |
| 0.19 - 0.10 | 28 | 6.83 | 54.63 |
| 0.09 - 0.01 | 33 | 8.05 | 62.68 |
| 0.00 (fully independent) | 153 | 37.32 | 100 |
| **Total** | **410** | **100** | |

## 7.6 Combined analysis

To be sustainable in the short run, an EAC should meet all three conditions: its expenses should be lower than its revenue, its liabilities should be much lower than its assets, and its independence from government funding must be high. How many of the 410 EACs meet these conditions?

I have classified these 410 EACs into four categories (ranging from 'A': very good, to 'D': very bad) according to their performance against these three indicators (Table 7.6). These categories depend on subjective threshold values of what constitutes 'good' or 'bad' performance in each of the three dimensions:

[32] As a comparison, it may be interesting to note that the subsidy rate (share of total farm income) for US farmers in 1999 was 45%. Personal communication, Dr. T. Reardon, Dept. of Agricultural Economics, Michigan State University, August 2001.

- Operational performance: an EAC is doing 'better' if the index is greater than or equal to 1.00; that is, if the EAC was at least capable of meeting its total expenses from its own sales revenues (not including income from public sources) in 1999.
- Financial performance: an EAC is doing 'better' if the index is less than 0.60; that is, if its liabilities represent no more than 60% of its assets. This threshold value was suggested by several financial analysts whom I consulted, and it can also be found in some accounting and financial management texts (Amat, 1998).
- Financial dependence: an EAC is doing 'fine' or 'better' if the index is less than 0.15; that is, if at least 85% of the organization's total revenue comes from market sources. This is the most arbitrary of the three threshold values that I have chosen, but it appears likely that a firm can cope with the sudden loss of a client who represents less than 15% of its total revenue.

Table 7.6 shows that, according to the balance sheets and income statements provided by these 410 EACs, only 11% of them perform well in all three indicators. If one relaxes the threshold values a bit[33], an additional 20 organizations (5% of the total) could be considered to be 'almost As'. Hence, according to my evaluation method, only around 15% of the EACs are in reasonable shape.

Table 7.6 Evaluation of short term sustainability of 410 EACs

| Category/Subcategory | Explanation | Number of EACs | Percentage of EACs |
|---|---|---|---|
| A (very good) | High performance in all three indicators | 46 | 11.2 |
| B | Low performance in one of three indicators | 111 | 27.1 |
| B1 | Low in operational performance indicator | 27 | 6.6 |
| B2 | Low in financial performance indicator | 52 | 12.7 |
| B3 | Low in financial dependence indicator | 32 | 7.8 |
| C | Low in two of three indicators | 152 | 37.1 |
| C1 | Only fine in operational performance indicator | 73 | 17.8 |
| C2 | Only fine in financial performance indicator | 45 | 11.1 |
| C3 | Only fine in financial dependence indicator | 34 | 8.3 |
| D (very bad) | Low performance in all three indicators | 101 | 27.7 |

At the other extreme, 28% of the EACs fail to meet the standards in all three categories, and an additional 37% fail in two of the three. Thus at least 65% of the 410 EACs are in a bad to critical financial and economic condition. It is likely that they would fail if the policies and programs that are supporting them now were discontinued.

As I was finishing writing this chapter, I was able to compare my results with those of a major review

[33] To 0.90 in operational performance, 0.75 in financial performance, and 0.25 in financial dependence.

done by a consultant firm under contract to INDAP (FUNDES Chile, 2001). In this study, 156 EACs'[34] balance sheets and income statements were subjected to an in-depth audit, each taking several months of work. FUNDES also assessed their operations and management. The study's most important conclusion is that 21% of these EACs *"demonstrated an acceptable financial condition, that is, these EACs can meet their financial obligations without problem, their liabilities are under control, and their normal operations yield sufficient resources to sustain their business."* The study also concluded that an additional 14% of these EACs could become viable business-oriented organizations if INDAP agreed to restructure their loans and cancel part of the accumulated interest. An additional 36% would need more in-depth support, including cancelling a substantial share of the loan owed to INDAP, as well as significantly restructuring their business plans, management and organizational structures. The remaining EACs were unlikely to survive even if they underwent an in-depth restructuring.

These results are more optimistic than mine. Since their study focuses on the most financially-exposed EACs, and since their analysis was much more in-depth than mine in this part of the study, I would tend to think that their results probably reflect better the true condition of at least these group of EACs.

What are the characteristics of the best performing EACs, compared to the B , C and D categories? Table 7.7 shows that, on average, they have larger than average assets, sales revenues, and operating incomes than most of the 410 EACs. They also have very low levels of income derived from public sources. Their total liabilities are not much lower than average, so it seems that it is not how much debt they have that determines success or failure, but rather their ability to gain access to markets where they can generate sufficient income to cover their expenses and reduce or eliminate their initial dependence on public support.

Table 7.7 Accounting factors of EACs according to performance categories (US dollars for fiscal year 1999, average per EAC per category)

| Category | Number of EACs | Total assets | Total liabilities | Sales revenue | Operating income | Income from public sources |
|---|---|---|---|---|---|---|
| A | 46 | 317,363 | 126,389 | 394,460 | 139,287 | 3,751 |
| B | 111 | 152,378 | 89,164 | 107,319 | 26,831 | 10,878 |
| C | 152 | 173,902 | 149,524 | 196,659 | 35,745 | 11,421 |
| D | 101 | 67,048 | 67,364 | 32,755 | 6,139 | 17,519 |
| **Total** | **410** | **157,848** | **110,348** | **158,089** | **37,655** | **11,916** |

This information contradicts the opinion of many EAC leaders and, especially, advisors whom I interviewed, who stated that the reason for the failed EACs was the lack or insufficiency of public subsidies. It also runs counter to the opinion of many INDAP staff and managers, many of whom feel that in order to be successful, EACs should be financed through grants rather than loans. From the point of view of a business-oriented organization, the key factor shown in Table 7.7 is that the more successful EACs are distinguished by their ability to generate income from market sales that are 55% higher on average than their costs, and 100 times higher than the subsidies they receive from government.

## 7.7 Discussion

At the start of this chapter I asked *"Are the EACs viable business-oriented organizations, or are they dependent on the political and financial support of INDAP?"*. I think the evidence shows quite

[34] The 156 EACs chosen for the study were those judged to be particularly exposed due to the size of their total liabilities.

conclusively that at the end of 1999 only about one-fifth of EACs were viable.

The EACs that perform poorly are highly dependent on public sources of support. Since subsidies are always scarce, their total income is very low and is not sufficient to cover their financial costs and often not even their operating expenses.

The message to farmers and government advisors is clear: do not start an EAC unless you can be sure that it will be able to tap into sufficiently large and profitable markets very rapidly, so that it can break or significantly reduce its dependency on public funds.

Whilst the data for the 1,050 small farmers' organizations (including but not limited to EACs) show that the projects which require very large start-up loans are more likely to fail, the analysis of the 410 EACs shows that the most successful ones are, on average, more in debt than the majority of poorer performers. This is a very important finding because recently there has been a tendency in Chile to extrapolate to all EACs from the failure of almost all of the special 'megaprojects' set up in the past six or seven years. One should not compare these megaprojects even with the larger, more 'normal' types of EACs. So, while it is wise to beware storming ill-prepared into large and complex business initiatives that require assets, access to networks and to highly specialized expertise not normally found in the sphere of public programs for small farmers, it would be a mistake to extrapolate that lesson to the point where only the smallest initiatives receive support.