UNITED STATES INTERNATIONAL UNIVERSITY

20111201
Amos G. Njuguna

MT KENYA GARDENS: RISK CONSIDERATIONS IN BUSINESS FINANCING

Introduction

As Gerald and Rosemary Muthomi held their quarterly meeting with Mr. Mutuku; their long serving marketing manager on 4th January 2001.Looking at market data for the previous quarter, they realized that the time had come to expand the business as demand for the previous quarter outweighed their capacity by 25%. From their vast experience in the horticultural industry, the couple had discerned that to increase capacity, they had to upgrade the technology used in the primary value addition process in addition to acquiring two distribution trucks; an investment that would cost them Sh. 20 million. The impasse however was the means to raising the funds as they had already overstretched their internal resources. Do we borrow the money from the bank or scout for a strategic equity partner? Rosemary asked Gerald as the meeting with Mr. Mutuku came to an end.

Company Background

After five years of working as agricultural officers with the Kenya government, the Muthomis decided that time had come to fully utilize their 3 acre piece of land, located 68 kilometers from Meru town to supplement their income. They invested their limited personal savings into the farm, eventhough they did not have a formal business plan. They focused on growing a variety of fruits including bananas, mangoes, pawpaws, and citrus fruits[1] on small scale basis. The business was later incorporated and named; Mt Kenya Gardens (MKG). The business initially began as a part-time venture since both husband and wife were still working for the Kenya government.

t inception, the couple used a small pump and one attendant to irrigate their farm and sell the fruits in the Meru region. The two founders borrowed unsecured personal loans amounting to Sh. 25,000 each from the Agricultural Finance Corporation; a loan that was granted because they were still in government employment. Despite infrastructural challenges, resulting from poorly maintained roads, the farm was so productive that the Muthomi's main markets shifted to Central and Nairobi provinces. . This expansion necessitated employment of an additional 5 workers.

[1] Bananas account for 60% of the sales mix, mangoes 15%, papaws 20% and citrus fruits 5%.

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.

Copyright © 2011 United States International University. You may copy, reproduce, publicly distribute, display and transmit any of these materials so long as it is for non-commercial purposes. All credit for such use must be given to United States International University. No derivative works should be made from the materials.

The business was able to generate revenues enough to meet business obligations and pay off the loans they had borrowed. It is at this point that the Muthomi's quit from gainful employment to concentrate full time in managing the business. Soon MKG became a household name in the supply of fresh fruits in the up market groceries and leading supermarkets in Nairobi. By 2011 the annual turnover of MKG exceeded KSh.130 million with a net worth in excess of KSh. 50 million.

Growth of Fruits by Outsourcing

With the increase in demand for fresh fruits MKG started sourcing fruits from other farmers to meet the increased demand. Farmers with quantities exceeding 200 Kg would deliver directly to MKG while those who had less quantity were encouraged to form groups and deliver to collection points set up by MKG. Outsourcing of fruit production initially led to inconsistence in quality delivered to MKG[2]. To address the quality issues, MKG embarked on rigorous farmer outreach programs where farmers were trained on good fruit production practices (understand the maturity of the fruits by observing the colour, shape, freshness and sound) and post-harvest management issues (market specifications that MKG deemed fit for processing). The training lowered the return rates to farmers from 40% in 1993 to 2% in 2011. Additionally, MKG screened their suppliers to ensure that they actually were involved in production and had potential and commitment to supply the fruits. At the outset the main fruits produced were pawpaws and citrus fruits but due price fluctuations associated with the two fruits, MKG reduce their production proportions significantly in the sales mix and increase the sale of bananas.

The Muthomi's

Both Gerald and Rosemary Muthomi graduated with agriculture related degrees from the Jomo Kenyatta University of Agriculture and Technology. While the 52 year Gerald was an agricultural engineer, Rosemary, was an agronomist. The two worked in the ministry of agriculture for five years before they left to establish MKG in 1989. The Muthomi's business goal was to build a strong and sustainable family business that would last for many generations.

The Business Model

MKG applied a straightforward business model. They produced their own fruits or bought the fruits from farmers and paid for the produce in within 7 days[3]. The fruits underwent de-greening; a process that involves handling the fruits at the right temperatures and humidity to prepare them for the market, with tolerable loss allowance of 2% due to moisture loss. [4]. After de-greening, the fruits were packed and branded and distributed to the up market groceries and leading supermarkets in Central Kenya and Nairobi. Eighty five percent of MKG business was based on direct orders while the remaining was solicited business. Even with intense competition MKG was able to retain over 80% of their older customers and still attracting new ones. Mrs. Muthomi explained; "the key to customer retention is applying strategies based on four 5 core attributes; ensure fresh deliveries, timely deliveries, promising what you can deliver, addressing customer complaints in person as soon as they are noted and branding the products."

[2] Losses were realized as a result of poor handling, not observing maturity time and poor storage.
[3] All farmers must have a contract with MKG and only farmers who appear in the payroll of the group are paid.
[4] Actual production losses average 1.4% over the last 5 years

MKGs transport requirements were met through outsourcing from Mt Kenya Greens, an autonomous company also owned by the Muthomi's. MKG paid Mt Kenya Greens for the transport services rendered on a bi-weekly basis based on the prevailing market rates.

The company encountered many challenges including external constraints such as price fluctuations, excessive reliance on manual processes in handling and distribution of fruits, competition from middlemen, sensitivity and perish-ability of the fruits, poor road network that increases fuel and vehicle repair costs and the customer's precise need for fresh fruits ready for consumption.

MKG Management Team

At the helm of MKG were the two directors, Mr. and Mrs, Muthomi. They were equal shareholders at 50%/50% equity. They managed a professional team comprised of Chief Accountant, Human Resources Manager, Marketing Manager and the Logistics officer (see exhibit 1). The logistics officer also headed operations and coordinated collection of produce from the farmers as well as ensured that the production process was efficient and timely. The marketing manager's role was to maintain customer relationships, ensuring that orders were fulfilled and cash collected from the customers within 15 days. Mrs. Muthomi asserted that all employees were hired on the basis of competence and consistence of personal values to MKG's values. The company encouraged professional growth of its employees through appropriate training in their specific areas of expertise. This had contributed to motivated staff with minimal staff turnover at MKG.

Growth of the Business

Within the first five years, MKG sold their fruits to the market directly and relied on public transport to deliver products to the market. The direct selling and personal involvement in running the business stimulated the annual demand from the initial 100 tonnes in 1989 to 1500 tonnes in 2000. To cope with the increased demand, MKG knew that they needed to upgrade their operations by investing in a banana value addition unit and delivery vehicles. Although the investment was estimated at KSh. 20 million, the company value at that time had reached KSh. 35 million. Conservative estimates indicated that the anticipated investment would enhance economies of scale, enhance efficiency, reduce labour costs and consequently lead to an immense 36% annual growth. The anticipated investment could not be financed from the internal sources of the business as the company had committed all the available funds to financing their working capital requirements. Two options were available to MKG; seek a strategic equity partner to inject the funds or borrow the required amounts from the Consolidated Bank of Kenya where the company had held its main account since inception.

Strategic Equity Partner

The search for a strategic equity partner in Kenya was a daunting task. Many of the potential investors that MKG approached were not interested in MKG's offer. Others feared investing KSh. 20 million in an agricultural based company while competitors shied off from mergers with MKG. Mr. Muthomi eventually got a potential investor; Mr. Rein Hey from the Netherlands who got into the negotiations. According to Mr. Muthomi, the investor was to inject KSh. 20 million in the company. The amount would not attract any interest and therefore, the chances of being "auctioned" in case of a market lapse were slim. After a site visit by the potential investor; the Muthomi's were more confused. The investor proposed a 55% stake in MKG and a stable dividend policy that would require MKG to distribute at least 40% of its earnings. The directors felt that the investor valued the company much less and "valued" the money he was to inject in MKG more than the idea that the couple had nurtured from "a small pump" to a multi-million business. Additionally, this did not augur well with the Muthomi's succession plan because they always saw the business as a family concern that their three children would run in the future. The directors promised to get back to Mr. Rein after a month.

The Consolidated Bank of Kenya (CBK)

The Muthomi's had ease approaching the CBK as they had held the main business account in the bank since the company's inception. The company had a good financial history; it had never had an overdraft or a cash flow crisis. They requested for a loan to expand the business. Such a loan would attract interest at 22% per annum for five years and other upfront costs[5] amounting to 8.4% of the value of the loan. Mr. Kagiri, the manager of the Meru CBK branch was puzzled to hear the request that the Muthomi's made to the bank. He held two circulars from the head office; one requiring all branch managers to be extra cautious when lending to small and medium size enterprises and the other one requiring them to limit lending to businesses in the agricultural industry because the Kenyan economy was undergoing liberalization and local firms, especially those in the agriculture industry faced severe competition from their foreign counterparts. Additionally, the market value of MKG had not been professionally valued. The bank manager informed the couple that even if the bank was to lend them the money, they would have to get a loan equal to 40% of the value of their land as it was located in a rural setting. The Muthomi's argued that they were a low cost company (see cost structure in exhibit 2), had never defaulted on their payments to suppliers and were quite profitable with after tax profit margins exceeding 50% (see exhibit 2). Another hurdle they had to overcome was the costs associated with the loan. They would have to spend a cumulative cost of Sh. 16.8 million over five years (see exhibit 4) to get the Sh. 20 million loan in addition, the monthly payments for the loan would exceed Sh. 500,000 "ten times more than both of us had originally borrowed from the Agricultural Finance Corporation" Mrs. Muthomi stated. The bank manager was to consult with his boss at the head office and inform them of the outcome after two weeks.

Decision Time

The Muthomi's had to make a decision; take Mr. Rein Hey offer as a 55% equity partner to get an injection of Ksh 20 Million or borrow from CBK and pay costs of Sh. 16.8 million for the Sh. 20 million loan. The key decision constraint was that neither the strategic equity partner nor the bank was willing to renegotiate the terms of the deal thus making it a "take or leave it" decision for the couple.

[5] These costs related to stamp duty on registration of charge, valuation and bank administration costs.

Exhibits

Exhibit 1: Organization Structure

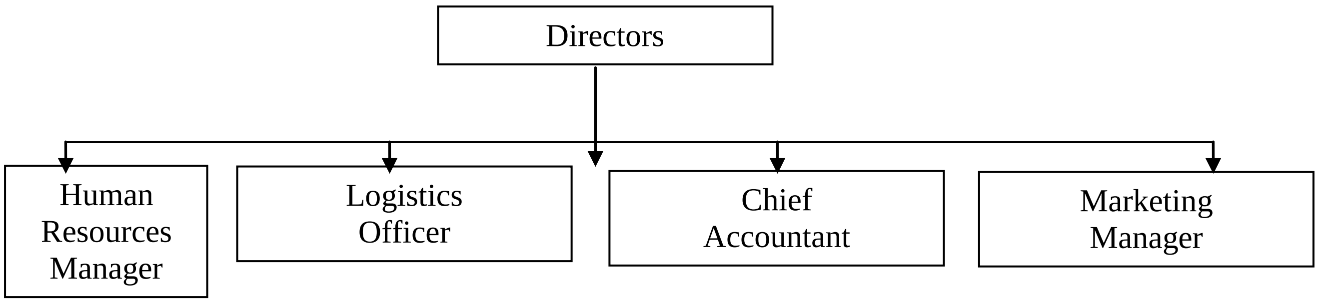

Exhibit 2: Average Unit Costs and Prices

	Sh.
Price charged to customers per Kg	55
Direct Costs:	
Purchase price from farmers	14
Transport cost from collection point to MKG	4
Other production costs	2
Transport cost to the market	5
Total direct costs	**25**
Indirect costs	1.5
Total costs	**26.5**
Profit	**28.5**
Profit margin	53%

Exhibit 3: Loan Repayment Schedule

Year	Balance at beginning of year	Interest (22%)	Repayment	Principal	Balance at end of year
2001	20,000,000	4,400,000.0	6,984,118.7	2,584,118.7	17,415,881.3
2002	17,415,881	3,831,493.9	6,984,118.7	3,152,624.8	14,263,256.5
2003	14,263,256	3,137,916.4	6,984,118.7	3,846,202.3	10,417,054.2
2004	10,417,054	2,291,751.9	6,984,118.7	4,692,366.8	5,724,687.4
2005	5,724,687	1,259,431.2	6,984,118.7	5,724,687.5	(0.0)
	TOTAL	**14,920,593.5**	**34,920,593.5**	**20,000,000.0**	

** The workings assume that repayment is annual. The actual monthly repayment was Sh. 553,378.

Exhibit 4: Total Costs Associated With the Loan

Cost	**Sh.**
Upfront costs (stamp duty on registration of charge, valuation and bank administration costs 8.4% x 22,000,000	1,848,000
Interest charges (see exhibit 3)	14,920,594
Total Costs	16,798,594

© United States International University