Working Paper

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Community financing in the German organic food sector: a key for sustainable food systems?*

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Abstract

The rise of socially responsible and impact investing funds provides evidence for an increased interest private investors have in combining their financial and ethical concerns. At the same time, citizens increasingly engage in food networks and take on a vital role in the governance of agri-food systems. These developments might benefit farms and firms which are committed to sustainable food and seek funding. Through different community financing models, they can involve citizens who aim at supporting the development of a more sustainable food system.

While still a niche market, an increasing number of firms in the German organic food sector uses community financing to substitute or complement traditional bank credit financing. There is a wide range of different models which can be classified as follows: 1. Pure financing instruments, e.g. crowdfunding, profit participation rights, direct loans. 2. Financing models which base on a particular legal form, e.g. cooperative, corporation. 3. Financing in cooperation with an intermediary organization which pools citizens' capital, e.g. citizen shareholder corporation, land purchase cooperative. 4. Others (mostly related to primary production), e.g. community supported agriculture (CSA), leasing and sponsorship.

Community financing can increase financial independence from credit intuitions and provides an opportunity to receive funding which otherwise might be difficult to obtain. Given the high capital intensity in agriculture and rising purchase prices of agricultural land, access to traditional bank credit financing is a particular challenge for new or less productive farms. Access to finance can also be a key obstacle for smaller companies involved in collaborative short food chains and green start-ups that offer innovative products or services and/or lack business education. Apart from financial considerations, particular community financing models can also serve as marketing tool in order to build or intensify relationships to customers. As the example of the German energy transition shows, financial citizen participation can be crucial for financing the transformation of the energy sector. However, little is known about community financing models in the agri-food sector. Accordingly, this paper presents empirical evidence on community financing in the German organic food sector and discusses the role it can play in food system transformation.

Keywords: Community financing; impact investing; food system transformation; crowdfunding; profit participation rights; cooperatives; citizen shareholder corporations

JEL Codes: Q14; P13; Q01; G23

Introduction

The rise of socially responsible and impact investing funds provides evidence for an increased interest private investors have in combining their financial and ethical concerns (Wallis and Klein, 2015; Höchstädter and Scheck, 2015). At the same time, citizens increasingly engage in food networks and take on a vital role in the governance of agri-food systems (Renting et al., 2012). These developments might benefit farms and firms which are committed to sustainable food and seek funding. Through different community financing models, farms and firms committed to sustainable food can involve citizens who aim to support the development of a more sustainable food system.

While still a niche market, an increasing number of firms in the German organic food sector uses community financing to substitute or complement traditional bank credit financing. There is a wide range of different models which can be classified as follows:

(1) Pure financing instruments, e.g. crowdfunding, profit participation rights, direct loans.
(2) Financing models which base on a particular legal form, e.g. cooperative, corporation.
(3) Financing in cooperation with an intermediary organization which pools citizens' capital, e.g. citizen shareholder corporation, land purchase cooperative.
(4) Others (mostly related to primary production), e.g. community supported agriculture (CSA), leasing and sponsorship.

Community financing can increase financial independence from credit institutions (Oberholtzer, 2004 as cited in Opitz et al., 2019) and provides an opportunity to receive funding which otherwise might be difficult to obtain. Given the high capital intensity in agriculture and rising purchase prices of agricultural land, access to traditional bank credit financing is a particular challenge for new or less productive farms (Featherstone et al., 2005; Waterman, 2012; Bahner et al., 2012; Hüttel et al., 2015). Access to finance can also be a key obstacle for smaller companies involved in collaborative short food supply chains (Kneafsey, 2015) and green start-ups that offer innovative products or services and/or lack business education (Bergset, 2018). Apart from financial considerations, particular community financing models can also serve as marketing tool in order to build or intensify relationships to customers (Brown et al., 2017; Schäfer, 2019).

As the example of the German energy transition shows, financial citizen participation can be crucial for financing the transformation of the energy sector (Bauwens, 2016). However, little is known about community financing models in the agri-food sector. Accordingly, this paper presents empirical evidence on community financing in the German organic food sector and discusses the role it can play in food system transformation.

Alternative Food Networks, Impact Investing and Social Embeddedness

An extensive body of literature deals with *alternative food networks* (AFNs) which mainly refer to alternative modes of food production or provisioning and usually imply a reduced distance between producers and consumers (Tregear, 2011; Forssell and Lankoski, 2015). Initiatives for the mobilization of financial capital to support local and/or organic food production are one example of newly emerging types of AFNs where citizens take an active part in the initiation and management (Renting et al., 2012). Yet, specific research on community financing and the role of citizens as investors or shareholders is limited (Wenz et al., 2018). While community supported agriculture has been investigated for more than 30 years in the US and is now increasingly researched in the German context (Wellner and Theuvsen, 2017; Blättel-Mink et al., 2017), other community financing models either remain unexplored or are only examined in the context of sectors other than agri-food.

The notion of *impact investing* can help to conceptualize community financing. While a clear and uniform definition is lacking, a systematic literature review by Höchstädter and Scheck (2015) provides the main definitional elements: Basically, impact investing describes an investment style which aims at achieving both a social or environmental impact and a financial return. Measuring the impact is often considered an integral part of impact investing. In terms of financial yield, an impact investment at least requires the return of the invested capital which distinguishes it from philanthropy.

Impact investing also coincides with the community financing theory developed by the University of Vermont Extension where return can also be understood as positive environmental and social impacts such as availability of fresh and nutritious food, improvements of soil fertility or water quality, rural economic development etc. (Waterman, 2012).

So far, the discussion on impact investing in Germany barely focuses on small investors but mainly perceives high-net-worth individuals and institutional investors as impact investors (Glänzel and Scheuerle, 2016). However, cooperatives, crowdfunding and other financing models in cooperation with local banks are considered potential impact investing mechanisms to include also the general public and small investors. They are expected to be particularly interesting for small investors when it comes to local investment opportunities because it allows for identification and observation of the intended impact (National Advisory Board Germany, 2014).

This assumption stresses the relevance of proximity and provides a link to AFN literature. Reduced distance is considered one key characteristic of AFNs (see above). According to Forssell and Lankoski (2015), it relates to localness and transparency, results in strong relationships and is often linked with the notion of *social embeddedness*. The embeddedness argument emphasizes the role of social relations for economic behavior in the sense that they provide a necessary condition for trust (Granovetter, 1985), and has often been applied in the context of AFNs (e.g. Hinrichs, 2000; Brinkley, 2017; Migliore et al., 2014). Accordingly, both geographical and relational proximity (Eriksen, 2013) are hypothesized to be of major importance for community financing in the agri-food sector.

Methods

Given the limited research on community financing in the agri-food sector, we chose an exploratory case study approach which allows to examine a contemporary phenomenon thoroughly (Yin, 2018).

In order to cover the variety of community financing models, we applied an embedded multiple-case design (Yin, 2018). As a first step, we selected financing models to be considered as cases and investigated in-depth. An increasing relevance in the German organic food sector[1], yet little scientific evidence on the particular model (see above) served as selection criteria. Furthermore, we aimed to consider at least one model out of the following categories: (1) pure financing instrument, (2) financing model based on a particular legal form and (3) financing in cooperation with an intermediary organization. Accordingly, we selected crowdfunding, profit participation rights, cooperatives and citizen shareholder corporations.

Within each of the four case studies, multiple farms or firms along the value chain for organic food served as embedded units of analysis. Per case, we

[1] An online research on the use of community financing in the German organic food sector revealed around 600 farms or firms which had applied community financing models. The results provided evidence for the relevance of the different community financing models and established the basis for selection of cases and embedded units of analysis.

considered at least one firm engaged in each primary production (agriculture, horticulture or viniculture), food processing and retail or trade. Furthermore, the selection of firms was supposed to cover both the typical application of the financing model within the sector and the diversity of usage. Our analysis focused on small and medium-sized enterprises (SMEs).

Case studies typically rely on different sources of evidence (Yin, 2018). We decided to draw on documentation, interviews and an online survey. As a first step, we reviewed the websites of our selected units of analysis, and materials such as news articles and crowdfunding campaigns. Between September 2018 and July 2019, we conducted 21 semi-structured interviews with representatives of the selected firms or intermediary organizations. In order to gain insights into the investors' perspective, we asked our interview partners to connect us with their supporters. We conducted 20 semi-structured interviews with investors and additionally set up a short online survey using ©QuestionPro. We received 107 valid responses.

We used ©MAXQDA to analyze the transcribed interviews and ©SPSS to analyze the results of the online survey.

Results

Crowdfunding

Crowdfunding enables capital seekers to collect money from a large number of people through an online platform. Depending on the return for the financial contribution, one distinguishes donation-based, reward-based, equity-based and lending-based crowdfunding (Gierczak et al., 2016). We considered one SME each from the agricultural, processing and retail trade sectors which have used reward-based crowdfunding. Furthermore, we included one farm and two processing and retailing SMEs which have used either equity- or lending-based crowdfunding.

The relevance of crowdfunding for the financing of the firm differs widely among the analyzed SMEs. The equity-based crowdfunding campaign ran by a farm aimed at securing its continued existence by transforming private property of the farm and farm land into common ownership. In this case, crowdfunding was existential for the farmers as they could not rely on bank credits. As opposed to this, equity- and lending-based crowdfunding in the processing and retail trade sectors rather served as a mean to increase independence from (house) banks and to establish a balanced capital and financial structure. Similarly, reward-based crowdfunding complemented bank credits in all units of analysis considered. However, its importance in financial terms is less clear. The collected capital allowed SMEs to develop and also provided the basis for a bank credit. Nonetheless, reward-based crowdfunding also served as marketing tool to test a new product, to attract public attention and to build relations to future customers.

The main motive mentioned by investors was the support of a particular form of food production or processing. While a return in the form of natural produce was interesting for many supporters in reward-based crowdfunding, financial yield expectations were formulated by very few investors in the context of equity-based crowdfunding.[2]

In general, the relationship between capital seekers and investors in crowdfunding can be described as impersonal. Although the personal environment and existing networks play a major role for disseminating the online campaign, the majority of supporters do not have a personal relation to capital seekers. To some extent, crowdfunding supporters have become regular customers of the SME.

All interview partners emphasized that successful crowdfunding requires considerable effort, e.g. related to planning and preparation or communication during and after the campaign. An appropriate product or investment object, an appealing film and selection of rewards are further success factors mentioned by interviewees. Given the efforts associated with crowdfunding, several capital seekers stressed that they consider it not only as a funding mechanism but also as an investment in marketing.

Profit participation rights

Profit participation rights are a financing model which contractually grants participation in profits and losses of the emitting company. We included five organic SMEs, one farm and two firms each from the processing and retail trade sectors, which have used this model.

Independence from banks was the main motive mentioned by capital seekers. In some cases, banks even denied a credit. According to one interviewee, this was because of lacking trust in the organic food sector. However, for most SMEs the model serves as one financing component amongst others. Only for

[2] We could not interview investors involved in the equity- or lending-based crowdfunding campaign ran by processing and retailing SMEs. As they offered higher financial yields to their investors, motives might differ widely from supporters of reward-based crowdfunding campaigns or the equity-based crowdfunding campaign ran by a farm.

one unit of analysis, profit participation rights in combination with the cooperation with a land purchase cooperative are existential. In this context, two managers emphasized the relevance of profit participation rights for improving the firm's equity ratio and thereby facilitating access to bank credits. Further motives include a responsible handling of financial resources in terms of transparency and trust between investors and capital seekers. Marketing considerations appear to be less relevant as a motive for choosing profit participation rights although the financing model turns out to have considerable impact on the relations between firms and consumers. While new consumers may be gained through the financing model, existing relationships tend to be strengthened.

Investors are often (long-term) customers and employees. Especially in the case of retailers, the relationship is considered personal, positive and trustful, both by investors and capital seekers. Beyond their financial contribution, investors support the firms to some extent, mostly by being 'ambassadors' spreading word of mouth in favour of the firms.

The online survey and interviews with investors revealed that the main motive for engaging in profit participation right is to support the (regional) agriculture and food sector, while return is only a subordinate motive.

From capital seekers' point of view, there are hardly any noteworthy challenges related to using the financing model. Mentioned challenges mainly concern a high time effort for administration and communication. The main success factor relates to strong and trustful relations to consumers, to which clear communication before and during the investment project may contribute. This is echoed by the investors interviewed.

Cooperatives

Cooperatives provide a legal framework to financially involve citizens. The cooperative can either be equivalent to the legal structure of the firm or solely serve as financing instrument. We considered a farm which uses the cooperative model to raise capital to purchase farm land, and three SMEs from the processing and retail trade sectors which are organized as cooperatives.

Cooperative managers stress the importance of financial contribution by members, especially if they lack access to traditional bank credit financing or if cooperative shares provide equity capital necessary to raise an additional bank credit. In the case of the land purchase cooperative, the cooperative model was chosen as it provides an intermediate form between individual ownership and endowment. To some extent, marketing considerations are relevant for choosing the cooperative model because members often become customers and hence contribute to revenues.

The main motive of cooperative members relates to the support of a more sustainable form of food production and processing or business approach in general. Given that none of the cooperatives presents the prospect of a dividend, financial yield expectations are not relevant.

Personal relations between the initiators of the cooperative and the members play a major role. Existing relations and networks facilitate the mobilization of capital. However, with increasing cooperative members, personal relations between members and management tend to become weaker. In all cooperatives considered, a deeply committed inner circle serves as board members or as 'ambassadors' for the cooperative.

This circle of supporters is also the most important success factor for community financing through cooperatives. To build up such a circle of supporters requires huge efforts into communication and persuasion. In addition, particular challenges stated by three cooperative managers relate to administration efforts and costs associated with the cooperative model.

Citizen Shareholder Corporations

Citizen shareholder corporations involve citizens, mainly from a particular region, as shareholders. While it can be the legal structure of a single firm, some citizen shareholder corporations in the German organic food sector serve as intermediary organizations which pool citizens' capital and invest it into regional SMEs. We considered two intermediary organizations and two SMEs which received financial support from the citizen shareholder corporation.

The main motive of SMEs to cooperate with the citizen shareholder corporation was to seek an alternative to a bank credit. However, the capital received from the citizen shareholder corporation only serves as one financing component amongst others. Another important aspect for capital seekers turns out to be the cooperation with like-minded people on the basis of trust and security. Being part of a network of other farms and firms that also receive funding, allows benefiting from their experiences. Compared to other community financing models, advertising for investors is done by the intermediary organization. This is considered a further motive for choosing this model as it reduces effort on the part of capital seekers.

Investors in a citizen shareholder corporation expect to receive a financial return. Nevertheless, they accept that financial benefit may only be offered in the long term. One shareholder corporation entitles investors to a discount on products from partner farms/firms through a membership card. This is appreciated by investors.

As citizen shareholder corporations serve as intermediary between capital seekers and investors, there is no direct relationship. However, some individuals have close relations to capital seekers and their wish to support the particular farm or firm has been a reason to invest in the citizen shareholder corporation. The intermediaries interviewed mentioned the aim to increase the direct contact between capital seekers and investors. They organize field trips and participate in farm festivals. In order to make their partnership more visible, citizen shareholder corporations use labelling of products of associated farms or firms.

A main challenge of this financing model is the acquisition of new investors. Reasons are seen in the relatively negative reputation of shareholder corporations in general, and in the low sales skills of intermediaries' staff. Furthermore, administrative efforts on the side of intermediaries are very high, and costs are partly transferred to investors.

Putting a lot of effort into public relations and building on existing strong networks such as 'Slow Food' are considered success factors for community financing through shareholder corporations.

Discussion and Conclusion

Our results reveal both differences and similarities among community financing models related to motives of capital seekers and investors, relations between the aforementioned as well as particular challenges and success factors.

One important difference is constituted by the type of financing model itself and concerns the relation between capital seekers and investors. While the use of profit participation rights and cooperatives usually implies a direct contact between capital seekers and investors, citizen shareholder corporations and crowdfunding are characterized by a more distant relationship, as an intermediary organization or crowdfunding platform are between investors and capital seekers. This also reflects in the efforts associated with community financing. Intermediary organizations and crowdfunding platforms take over many administrative tasks and reduce efforts on the side of capital seekers. In contrast, emitting profit participation rights or founding a cooperative increases the work load for capital seekers and usually requires legal advice.

The emphasis on increased efforts provides a clear link to capital seekers' motives. Community financing is often considered to be more than a funding alternative, as it can improve bargaining power towards and increases independence from banks. Apart from these financial motives, marketing considerations play a major role, particularly in crowdfunding and profit participation rights. Being integrated in a network of like-minded people and firms in the context of citizen shareholder corporations provides a further benefit. These results correspond with previous research on motives for community financing in the German agricultural sector (Wenz et al., 2018).

With regard to investors' motives, supporting organic and/or local food systems clearly outweighs financial yield expectations. This clearly corresponds to the idea of impact investing. However, conceptualization of community financing as impact investing only applies to a limited extent. While the financing models considered in this study appear to fit this logic, other financing models such as community supported agriculture (CSA) or sponsorship cannot be considered as an investment. Furthermore, community financing in the agri-food sector is typically not accompanied by impact assessment.[3] However, as stated above, investment opportunities at local scale enable investors to directly observe impacts (National Advisory Board Germany, 2014). An online survey among capital seekers prior to the case studies revealed that a large part of investors come from the same region as the capital seeking firm (Behrendt et al., 2018). In addition to geographical proximity, relational proximity also appears to be relevant as it facilitates communication and makes more formal assurance schemes such as an impact assessment redundant (Schäfer, 2019).

Our results suggest that the role of social relations is twofold: On the one hand, where farms or firms can draw on a customer base or circle of supporters, already existing relations provide the basis for successful community financing. On the other hand, the use of community financing models can result in new and/or closer relations between capital seekers and investors.

Community financing is still a niche in the German organic food sector (Doernberg et al., 2016; Schäfer, 2019) and its current contribution to more sustainable food systems can be regarded as rather low. While personal trust

[3] The citizen shareholder corporations under the *Regionalwert* trust are an exception because they promote an integration of social and ecological criteria into accounting processes (Hiß, 2015).

based on personal relations appears to be a major success factor, our results do not explain how impersonal, systemic trust arises (Thorsøe and Kjeldsen, 2016). Yet, systemic trust might be crucial for an increase of investments into sustainable food systems. Consider, for example, the case of citizen shareholder corporations where the negative image of corporations constrains financial contributions. In order to increase the potential impact of community financing, this aspect may be worth further investigation.

Given the high relevance of community participation for financing the energy transition (Bauwens, 2016), success factors such as an appropriate regulatory framework and public subsidies (Schäfer, 2018; Heyen and Wolff, 2019) might be transferable to the food sector. In this context, the French case can serve as a model: Contributions to foundations such as *Terre de Liens* which preserves farm land for organic and peasant farmers are tax-deductible (Terre de Liens, 2019). Accordingly, favorable regulations can result in sustainable food systems being an attractive investment object for the general public and hereby contribute to food system transformation.

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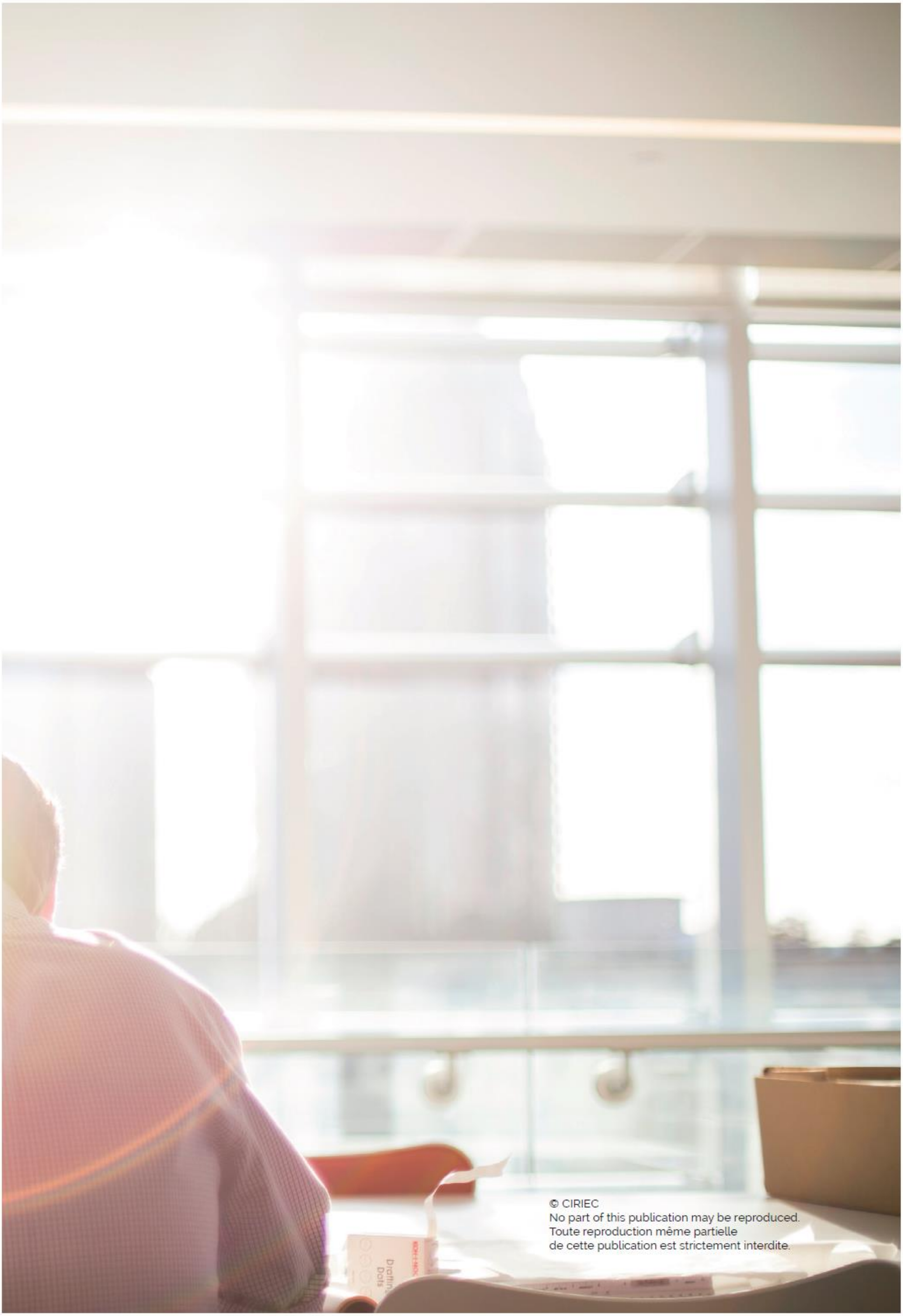

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