

**STAHLBUSH ISLAND FARMS, INC.
INNOVATION AND GROWTH IN SUSTAINABLE FOOD PRODUCTS**

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It was late at night and Bill and Karla Chambers were sitting on their deck overlooking their fields. Simultaneously, they were mulling over the information that their department heads had shared in their latest strategic planning session that morning. The growth prospects for the firm, Stahlbush Island Farms, were as always nothing short of exciting but the constraints on growth seemed more and more binding. Over the last ten years, the firm achieved a compound annual sales growth of nearly 15%. The lines of sustainable and organic products had expanded every which way they could: domestically, globally, frozen, canned, ingredient purees, and retail packaged. The direction for the future was still clear to Bill and Karla — continue to grow dramatically but cautiously. They did not want to lose either operational control or full commitment to the values that had brought them and the business this far. But, they were now wrestling with one of their toughest questions. How to continue the growth at the needed pace to keep up with market opportunities without being stopped by their ever tightening constraints?

The Early Years

The story of Stahlbush Island Farms officially started in 1985, but it was generations in the making. Karla grew up with agriculture in her blood; she is the fourth generation in a family that has been farming in Eastern Oregon for over 100 years. Having the desire to make her own way, she went off to college and continued to build her professional skills through various positions, including being the Associate Director and Chief Administrative Officer for the Development Office at Oregon State University where she led the way to record fund raising levels. Bill had three generations of Oregon entrepreneurs in his family. His early days were formed by business classes held during the family dinner where the instructors were his parents and the material was the decisions and issues they faced in their respective businesses. Bill may not have grown up on a farm or ranch, but he was bitten by the bug when his family bought and ran a cattle ranch. Valuing education both Bill and Karla obtained masters degrees from Oregon State University. Bill earned an MS in Agricultural and Resource Economics and Karla earned a Master of Arts in Interdisciplinary Studies with a concentration of Agricultural and Resource Economics, Business administration (Finance), and Political Science. The two met at OSU, and their adventure together started.

In 1985, Bill and Karla decided, in the midst of one of agriculture's toughest decades, to pursue their dream of making a living from the land. That was the year they bought Stahlbush Island Farms, 365 acres of rich soil located in the very fertile Willamette Valley. Here they could produce over 200 different types of crops; they knew the opportunities were plentiful, but didn't have a plan of how they were going to utilize the resources. They started with wheat and sugar beets for seed. The wheat was sold on the commodity market in Portland and the sugar beets were sold to a seed company in a nearby town. With careful review after their first year, Bill and Karla realized two things. The risk was too high given their initial production model. If they missed one sugar beet crop for whatever reason, they wouldn't be able to meet their debt obligations, even with Karla's continued income from OSU. They also realized they needed to do something different. The weak profitability of the farm suggested that another business approach beyond commodity production was critical for long term success!

That winter, Bill and Karla made out a list of the 10 most successful farms in Oregon . Included on the list were Cate Farms, who had a trucking and grain marketing business to go along with the farm; Eastern Oregon Farming Co., who had an alfalfa pelleting operation; Townsend Farms, who had a berry freezing operation; Hayworth Farms, which had a seed company that included seed cleaning and marketing. After studying these icons, they realized the common thread to these operations was vertically integrating to add value to the raw product grown on the farm. Not seeing an opportunity with wheat, they started experimenting with different crops. It wasn't long before they found they could grow vegetables for seeds. One of those crops was pumpkin seeds. In the fall of 1988 Bill and Karla looked at the pumpkin meat left lying on the ground after they had harvested the seeds. It was clear that if they could extend the shelf life of the raw product, they might be able to sell it. That winter also saw the arrival of Bill and Karla's second of four children. The timing was fortuitous as it allowed Karla, while on maternity leave, to help Bill develop a business model and marketing plan to utilize the otherwise wasted byproduct of pumpkin meat.

The research conducted to complete the marketing and business plans revealed three major potential customers. In May of 1989 Bill decided to take a trip to visit these three companies: Mrs. Smith's, Sara Lee, and Country Home Baker's. All three were receptive a new supplier in the market and were interested in receiving samples of the product. This led to a conundrum: sales could not be obtained without a sample; the sample could not be produced without a plant; the plant could not be built without financing; financing could not be obtained without sales. A solution was found by borrowing against the success of the last four years on the farm. They invested \$400,000 to convert an existing pole barn into a food processing building and installed their first processing line. It was a simple line by food processing standards, but it was a Herculean task for Stahlbush. Neither Bill nor Karla had experience in the food industry, let alone with food processing. They had to learn from scratch what they needed to do, they had to quickly understand and navigate the regulatory waters, and they had to find someone who could be their food technology expert. Any one of these tasks would have been a formidable task, and they had three of them to manage.

Their first processing facility was completed just in time to make samples in the fall of 1989 for distribution to customers they didn't have. The samples went out, closely followed by calls from Bill to the identified buyers. The roll of the dice paid in full. Mrs. Smith's signed an order for over 2 million pounds to be delivered in the fall of 1990. So Stahlbush Island Farms was launched on the scene as an industrial ingredient supplier. At the time, Bill was running the operation with six employees and Karla was helping as much as she could while still working at OSU. It wouldn't be until November of 1990 that Karla resigned from OSU to work at Stahlbush fulltime.

The next turn in the company history was driven by the opportunity to more fully utilize the processing plant that set idle most of the year. Bill realized that if they could find something else to run through the plant that would cover the variable costs of production and contribute to covering the fixed costs, Stahlbush would be in a much better position. Thus, they launched on a quest to capitalize on over capacity while remaining true to their values and core business. After extensive discussions with existing and potential customers, as well as R&D work to understand the chemistry of various potential products, Stahlbush expanded their puree product line to include carrot, corn, pea, red table beet purees. While conducting the work to extend their product offerings, the company developed a deep commitment to quality. Through the close work with customers, the endless tests for quality and food safety, and the continual tweaking of

processes and procedures, Stahlbush developed a system and culture to produce customer oriented products that were of the highest standard.

These early days formed practices that have served Bill and Karla well over the years. First, they determined the acres to plant of the produce they would grow based almost entirely on signed sales contracts. Every winter and early spring, the sales force was in full stride trying to settle their contracts for that year. The second practice was a commitment to quality. Bill and Karla knew they could get samples of their pumpkin from other processing facilities in the Willamette Valley, but they didn't want the risk of not being able to replicate the sample they sent out. Therefore, they were committed to developing their own capacity, ensuring that they can replicate the sample products they send out to potential customers. Finally, Bill and Karla adopted the decision rule of looking at the business on a marginal basis. They were willing to expand into new products and new lines if they can contribute to covering the company's fixed costs and fit with the firm's core competencies.

Since 1990, the company has seen phenomenal growth. They turn 15 different types of fruits and vegetables into purees and individually quick frozen (IQF) pieces. In addition to expanding their industrial ingredient product line by increasing the number of purees and adding IQF products, they launched the Stahlbush Island Farms brand of frozen fruits and vegetables in 1998, and in 2003 they expanded their retail offerings to include the Farmers' Market™ brand of canned products. They sell products in all 50 states and 16 export markets. They farm over 4000 acres and contract an additional 20 producers to meet the growing demand for their products. They went from six employees in 1990 to over 150 full time equivalent employees. They have seen enormous growth in sales in a time when the fruit and vegetable processing industry experienced a tremendous recession. While over 22 fruit and vegetable processing plants closed in Oregon since 1985, Stahlbush continually pushed their revenues upward, especially in the last ten years. The launch of their two retail lines certainly had a lot to do with their continued growth.

<<Table 1: Ten Year Sales Data >>

The Foundation

From the beginning, Bill and Karla were committed to running a progressive operation; an operation that was not bound by tradition or history to do things a certain way. That was one reason they collectively decided to embark on their own adventure instead of fitting back into one of their families' operations. Simply put...

Stahlbush Island Farms is an environmentally friendly farm and food processor committed to sustainable agriculture and exceptional quality.

Their vision to achieve this mission is through a commitment to customers, quality, sustainability, innovation, people and integrity. Their commitment is spelled out clearly and concisely in their mission and vision statements and corporate values.

<<Figure 1: Mission/Values Statement>>

<<Figure 2: Stahlbush Island Farms Values>>

Bill has noted on occasion that they produce only what their customers' want. Their customers define the product, including what quality means. In fact, the vast majority of what they produce is sold before the seed goes into the ground. The extra is in anticipation of additional demand or insurance against the risk of having a low yield. Part of the commitment to their customers is to deliver the highest quality on a consistent basis. But it's not just about delivering what the customer wants today. Karla, a fanatic customer oriented driver said, "We not only listen to our customers; we try to be ahead of them, anticipating their needs by standing in their shoes."

Having strong and long roots in production agriculture, and having four children they would like to pass their farm onto, Karla and Bill have always been very mindful of their environment, as well as the people that work for them. That is why they were committed to sustainability before many consumers and the agricultural industry ever knew what it was. Their view has been "sustainable practices sustain and improve the health and vitality of the entire farm environment: soil, water, air, plants, animals, and people" (www.stahlbush.com). While the agricultural industry in general has wrestled with what sustainable means, the Chambers have developed their own definition and have promoted sustainable farming by educating consumers. Included in their efforts, Stahlbush published a web page on sustainable farming for the consumers benefit.

<<Figure 3: Sustainable Farming Practices>>

The Chambers have continually looked for ways to protect the land, the people that work it, and the product that comes from it. Given their commitment to this way of production, the decision to launch their Stahlbush Island Farms retail brand of sustainable products in 1998 was a change in marketing practices only. They had already developed and adopted sustainable agricultural production practices. They extended that effort in parts of their operation to include producing some product under organic production practices, meaning the elimination of synthetic chemicals applied to the ground and plants. They sell their organically produced product to their industrial ingredient customers and through their Farmer's Market™ retail line. The differences between sustainable and organic production practices are highlighted in Table 2.

<<Table 2: Sustainable vs. Organic Production Practices>>

They were the first farm to be certified sustainable by the third party Food Alliance (<http://www.foodalliance.org/>), and they are certified organic as well (see Stahlbush Island Farms Agricultural Certifications).

In addition to leading in the adoption of sustainable agriculture, Stahlbush had developed a reputation for being innovative. Bill once told a class of agricultural economics students, "I am not a profit maximizer; one of my values is to be innovative, it's what makes business fun and interesting. As it turns out I think that it might have been the profit maximizing strategy." It was this mentality that led them to adopt numerous technical applications on the farm to help reduce their long-run average costs while delivering what their customers want. For example, they adopted a series of GPS systems to be able to pin-point plantings of perennials and to be able to trace their finished products back to a specific area of a field. They even used GPS to guide their

tractors, allowing for straighter, tighter plantings and more night time operations. This allowed the crews to use more mechanical cultivation methods as opposed to chemicals. Also, by being able to plant at night with the same level of accuracy, the farm can accomplish the same amount of work with half the equipment.

As much as the farm is driven by the customer and innovation, Bill and Karla know that they would not be where they are without the help of a group of talented people – from their managers all the way to their seasonal field labor. In response, Bill and Karla have developed their company to help better the employees' lives through the benefits they offer. They have also been committed to developing more full time positions in order to retain good help. For example, they developed a year round schedule of activities on the farm to help retain their labor crew managers. During the winter months, these folks are kept employed by working on capital improvements in the fields like installing trellises and drip irrigation systems and then planting perennial crops like blueberries and cane berries. They are committed to seeing their employees grow, even if that growth leads the employee to leave Stahlbush Island Farms to pursue other opportunities. They also spend time every quarter celebrating all their employees by having an all company lunch. This has been a chance for Bill and Karla to show their appreciation for every single worker they consider as the Stahlbush family.

Finally, Bill and Karla are unyielding in their integrity. They would like to be known as the type of people someone could trust doing business on a handshake; that is if the business culture of today would allow it. They once told an interviewer, "If we don't want it on our plate then it is not acceptable to us as a product for our customers." This isn't a blind faith they have in their product. They have spent immeasurable effort in developing measurement systems, tracking systems and record keeping practices to meet and exceed USDA standards. They have tested their soils, their produce, and their finished products for chemical residues and various quality standards, standards that are set by the market and are more stringent than USDA requirements. They have kept detailed records of these tests and their operations that allow them to trace every production run back to where it was grown, how it was grown and when it was harvested.

Planning Session - Opportunities Everywhere

The mission, vision and values of Stahlbush Island Farms were crafted by Karla and Bill, but not without input from their management team. Tracy, the National Sales and Marketing Manager for Consumer Products, joined the team after 15 years in sales for companies like General Mills and Cascadian Farms. Their Global Sales Manager for Industrial Ingredient Products, Barry, has been with the company since 1994 and has developed strong relationships with buyers around the world. The operations team included Kim and Jonathan, the plant manager and quality control manager. In 1990 Kim joined the team fresh from earning her graduate degree in food science. Prior to graduate school, she spent 10 years with the USDA. She helped build the production capacity to meet the unyielding quality standards set by Stahlbush Island Farms. Jonathan, after working for over 20 years with companies like ConAgra and Cargill, joined the team last year to run the QC Lab. There are three farm managers like Scott, an energetic, innovative young man playing with cutting edge technology in one of man's oldest professions. Supporting Scott and the other farm managers, as well as the processing plant was a crew of outrageously skilled mechanical engineer types led by Glen a former engineering manager for HP. Tina, a former grain trader for Cargill, was the procurement manager who

managed the relationships with contracted growers. Last but not least there was Jon, who joined Stahlbush in 1995 as the Comptroller and gained the respect and trust of Karla and Bill to the point of being named CFO.

<<Table 3: Manager, Titles, Experience>>

Over the years, Karla and Bill developed a low-walls culture and structured their organization and management meetings to promote quick and easy communication from top to bottom. On a daily basis, the management team met for the “9:17 meeting.” This was where all departmental managers connect with one another and everyone is quickly brought up to speed on all issues. They convened at 9:17 a.m. sharp to highlight the importance of specificity and intentionality. Also during the meeting, they reported daily on their production performance and had a “cutting” – a tasting – of the product that was run the day before in the plant. These managers were then responsible to go back to their divisions and communicate the pertinent information to their crews.

In addition to the 9:17, the core management team has lunch together every Friday. This meeting is where they discuss the larger issues the company faces. This crew was the same group responsible for the planning of the company’s goals and direction for the coming year. This planning was typically done at a two meeting once a year. It was just this morning that their team met for the first day of the annual planning meeting. As Bill and Karla stood looking out on their fields that night, as if trying to see their future, they reran the morning’s meeting.

Before Bill and Karla entered the room that morning, their talented and creative management team was already assembled. It was apparent that the energy level was sky high as the room was abuzz with talk about the progress and opportunities each manager had to report. What else would Bill and Karla expect? They built this high powered team of professionals with tremendous talent and experiences to help them sustain their annualized growth targets.

Bill started off the morning’s session: “Good morning, I want to thank you all for being here and on time as usual. I know you all have very important tasks to take care of in your respective departments, but as you all know, the direction of this organization is set with significant input by you all. Karla and I want to thank you for approaching this with the dedication that you have. Our efforts today will help set the course of where Stahlbush Island Farms is headed this coming year. From the various conversations we have had around our weekly managers’ meeting, I know there are a lot of great things to report, and even more exciting ideas each of you have as we move forward. Our challenge is going to be deciding which of these opportunities we should focus our attention on next year. The plan for today is to hear reports from our consumer products line, industrial sales group, processing, farm operations and the fabrication shop. As we talked about in leading up to this planning session, each of you will cover the highlights of where your department has been this past year and present your ideas for consideration in the coming year. Let’s start by hearing from Tracy.”

“We have seen phenomenal success in our retail lines, both the Stahlbush Island Farms frozen vegetables and Farmer’s Market™ organic canned products. The Stahlbush Island Farms line of sustainable product is projected to have a 100% increase over 2006 sales growth; this is in spite of our product commanding a premium price point that is just under organic. Our organic Farmer’s Market™ brand has also doubled in sales in first quarter ’07 over ’06. Granted, these two lines only account for 20% of our total sales, but I think we could drive that percentage much higher.” Tracy’s confidence was based on the current numbers, but also what she thought

brought about this performance. Both lines started with impeccable quality standards, using only the best of the best raw products, resulting in a better tasting product to the ultimate consumer. Also, both lines were positioned to appeal to people's desire to eat healthy while taking care of the environment. The sustainable line was intended to appeal to a broad line of consumers and the Farmer's Market™ line to appeal specifically to the organic consumer.

“And, our new packaging design for the Stahlbush Island Farms frozen line is really resonating with our retail customers and consumers alike. The new design kept the ‘natural’ wording, the fruit and vegetable art, and the Kraft brown paper. We shifted the origination from Oregon to USA to open up our markets. We also dropped our chemical residue testing language, both by dropping ‘no detected pesticide residue’ on the front, and any product or soil testing claims on the back. I know we are still committed to testing our ground and products, but this wording change was necessary as it left too many questions in our consumers’ eyes. Also, we enhanced our environmental position by shifting the wording ‘Earth Friendly Agriculture’ to ‘Certified Sustainable’. And our ingredient statement has been enhanced – with only fruit and vegetables in the list, it is important to highlight that. We have certainly improved on our brand message that has resonated with consumers. As a result, there is serious interest out there in our product.”

<< Figure 4: Before and After SIF Package >>

In addition to improving the position of the frozen vegetable line, Tracy's audacious personal goal of changing consumers' relationship with pumpkin drove her to push the entire Farmer's Market™ line as not just for pies, but as ingredients for soups, muffins, and the like. “The recent national exposure of our Farmer's Market™ line in the Nutrition Action Magazine generated over 100 calls per day on the product, and I have recently had interest from renowned food critics from leading national magazines. I expect to see something from them soon, which will help sustain the 100% growth, maybe even push it higher. And our current 3% market share in frozen foods through natural foods outlets with our vegetables could be much higher – I would like to see it at 30%. Everyone from retail buyers to consumers loves these products. I am checking on the viability of taking the frozen vegetables to conventional grocery stores, especially with the explosion of organic offerings in the conventional chains.”

Tina pipes in, “These are fantastic numbers and I love your eagerness, but where would the raw produce come from in order to fill your dreams for these product lines? Conventional groceries and 30% market share in natural stores – I can't find enough product to match that kind of demand! I have half of all our production coming from our farms and the rest from our 20 contract growers. And you know that there are some products like the blueberries that we can't get others to grow for us given our requirements for growing the product and the large investment and lag time from first planting to the first crop. Scott, how are we doing on adding more production acreage to the mix each year?”

Scott quickly calculated the numbers in his head. “We are converting approximately 40 acres a year to blueberries and another 30 to cane berries of some sort. These acres are coming out of row crops, so we have to find that product somewhere else. We did add 130 acres to our farms in May 2006, but I don't see us doing that on a regular basis. If we were to add the acreage to cover these higher demands for our products, I suspect that we would need well over 1000 acres. With land in the Willamette Valley going between six and twelve thousand dollars an acre,

that wouldn't be cheap. Besides, some of that ground would need to be organic in order to fit the Farmer's Market™ line.”

“And if we are limited in the supply of our raw inputs, or better yet the growth in our supply,” Barry interrupts, “we only have one other option to fuel the expansion in the retail lines. We would have to take product from our industrial sales. Granted the margins are nearly double in the retail line, but are we prepared to short those who brought us to the dance?”

“That is true. We do have a question about where to get our product,” admits Tracy. “But I am telling you that there is a great opportunity still for these products. We recently increased our price as a way to slow the brand adoption while getting into additional stores. I am afraid that if we don't keep the momentum of adding accounts and overall stores, our overall market share potential will suffer, not to mention the open door it gives our competitors. If we wanted to play it safer, I guess we could just look at extending our offerings. For example, the Farmer's Market™ line could use a cranberry sauce product. This would lock that line into more of the holiday mindset, but we could move trucks of this stuff through stores in that short time frame. And, the cranberries could be sourced from producers on the Oregon coast – we all know they are looking for better markets!”

Bill and Karla steal a glance at each other as they listen to the groups back and forth discussion. They both know that the original business of industrial sales had been really beneficial for them, but they also see great opportunities in their new consumer packaged goods. Sometimes they feel managing these new product lines is like grabbing a tiger by the tail and they are just along for the ride, and mindful there are teeth at the other end of the tiger . But they are aware the growth needs to be managed somehow or they could lose a key aspect of the company's revenue – industrial ingredient sales. With this in mind, Bill changes the direction of the group. “Thanks for the update and ideas on the retail line Tracy. Barry, given that you are responsible for the other revenue stream, how about you take the next spot?”

Barry, a long time employee with Stahlbush, has been here before. As a former finance person, he understands the economics – the highest return wins the allocation of resources. On the other hand, he loves his work, especially when it involves working with international accounts. He loves it so much that he learned Japanese and studied Mandarin. The industrial ingredient line is a good business, and he would hate to see it be significantly reduced because of limited resources, especially when his background tells him that there are other resources that could be tapped. There are people – investors – that would love to pour money into the Stahlbush operation. That would mean, of course, Bill and Karla could lose some if not all control of the company.

Barry is ready to make his best pitch for his product lines. “We continue to have a strong presence in the market. Our relationships with our long-standing buyers are great and we have 12 potentially new accounts across the globe. This strong position is due to our proven value proposition of quality, traceability, and customer orientation. Our industrial customers see our quality as really having three legs. First, they recognize our growing season does produce a superior product with respect to taste, appearance and nutrition. Second, our customers know of our commitment to the best production practices that will protect and even enhance the product quality that we start with. Finally, the microbiology of our product is superior to other suppliers. Our customers also know that we are already in compliance with the Bioterrorism Act of 2003 given our long history with and commitment to traceability. They know we can trace our product back to a specific location on the farm where the raw product was grown. Not many companies, if any at all, have that type of assurance to offer buyers. And, for those in the US, we still have

the advantage of being able to respond to our customers' needs quickly. The bottom line is we are strong in both domestic and international markets, and we have the relationships and reputation to grow in every market we sell to."

He paused to let his ideas of the potential settle with the group. "One market that holds great promise is the Asian markets for baby food. We are at the front end of most Asian countries adopting baby food in glass jars. The quality and traceability of our product really plays well in these Asian markets, even more so when you consider the restrictions processors put on baby food ingredient suppliers and the food safety concerns from unethical food processors, especially in the shadow of the melamine debacle. If we move now, we could ride that wave for years. I would like to see our industrial sales grow 30%, and I think with the burgeoning Asian baby food market and the explosion of Chinese imports this is realistic. And, if we can figure out how to bring strawberries back in a big way, we have old customers lined up to buy that product too."

Karla nods in agreement: "Yeah that would be great. But strawberries are still the one crop we haven't been able to mechanically harvest and it is simply too costly and too difficult to find pickers during that season. What level of strawberries we have are likely to continue declining for this single issue of labor availability. Which is a shame; we can grow some of the best strawberries in the world!"

"Okay," Barry admits, "regardless of the strawberry supply, there is still great international potential for our industrial ingredients. We have been getting great sales leads from our reputation in the market, the directories that will list us for free, and our Internet presence. If we were to increase our promotion by displaying our product at more international trade shows, especially those targeted at the Asian markets, we could really push the sales volume by 30%."

In chorus, Kim and Jonathan reminded everyone that the production line is nearing capacity, and in some seasons, there is no way to run more products through the plant. Tina also highlights that the amount of product to grow the industrial sales by 30% would mean an additional 300 acre per year increase in their acres under ownership or contract.

Barry confidently throws his trump card: "I have faith we could find more producers who are struggling in the commodity market to grow crops for us with a relatively high degree of certainty that they have a profitable market to sell to. As for the limitations in production capacity, we could work with some of our partners from overseas – perhaps our Japanese partner. They have the wherewithal and strategic alignment to invest in expanding our production lines; maybe even add a new one or two. That would mean we could fuel our growth in plant capacity through relationships with partners who want to see us succeed because that means their business does well."

Bill and Karla have toyed with this idea of outside investors before, and have considered whether their current Japanese partners Ajinomoto would be a good fit. What would that mean to their current operations? Would that change where their company and products go in the future? Would it open up even more opportunities? They just weren't sure. Besides, Bill and Karla are committed to building a sustainable business that remains innovative and flexible. How would a partnership help or hinder that commitment?

"I know the product with the best margin will get our focus for expansion, but there are lots of opportunities in the industrial sales area," admits Barry. "Perhaps there is another way to go. If the capacity and capital were available, we could copy the retail product lines for the food service industry! I know this move would cannibalize the industrial ingredient line. I also recognize that would mean a shift in our production practices. We would have to move from

making planting decisions based on contracted demand to projected demand, which also means our inventory may have to increase because the foodservice companies wouldn't sign annual contracts. However, we currently do this type of planning on our retail lines. We could figure out how to do this too."

Kim, the processing plant manager, was excited after listening to all the possibilities. But there is also concern because the pinch of resources is already apparent and her idea is not going to be cheap. "I can see that we have lots of demand that we can still chase with both industrial ingredient products and the retail lines. I have an idea that would potentially open the retail door a bit wider. There is a recent packaging technology we have been looking at that would allow for a radically new consumer package of our current products. This new packaging would further differentiate our products in the market. The estimated equipment and installation would be \$1.5 million. But I share the concern about plant capacity and storage capacity. If we were to build a new plant with the amount of storage that we need, we are probably looking at \$10 million. The demand is there; isn't there a way we can get the money to expand while the opportunity is in front of us?"

Scott, one of three farm managers, shook his head in disbelief. There are so many possibilities, and he and two other farm managers, along with their contract growers, would be responsible for growing the entire amount of raw products needed to meet that demand. He ran the numbers quickly in his head. They have added 40-50 acres of blackberries a year, and 30 acres of blueberries. They could add up to 100 acres of blackberries and 50 acres of blueberries. That is a far cry better than when they started planting these fields. Like so many operations at Stahlbush, they have learned through experience and innovation to increase their efficiencies and decrease overall costs. However, he understands that the current financial constraints have limited the expansion of these crops. Besides, if they planted more acreage to these perennials, they would be losing acreage of vegetable production, unless they buy more acreage, another capital outlay. And more acreage just means more challenges to balance the different crops and certifications that they are under. At least the 70 acres converted each year allows for the crew leaders and other key farm personnel to have a job year round. This constant employment reduced the risk of losing them to other endeavors. Given that it is hard to find talented farm workers and managers, he likes that there is stable work year round. On the other hand, if they expand their acreage, they will have to find more farm managers, an increasingly difficult task to find qualified, competent farm managers.

Scott's attention was jolted back to the table as Bill made another announcement. "Well, we have some tough decisions to make about our product lines. Part of what has allowed us to be so successful and produce the products we produce is our talented machine shop. We have built a great support staff in that shop, and they have answered nearly every production challenge we have thrown at them. As a result, we have some very interesting, useful and valuable intellectual property. We think there is a possibility to capitalize on the technology we've developed and the institutional knowledge we have built by spinning off the machine shop as a stand alone business. I have asked Glen to share a bit about the technology we would roll out if that were to happen."

Glen knew he is already living his dream of building technology solutions for production processes. He considered his job to be a giant play land, only his toys were welders and related tools. With excitement in his voice, Glen began to describe three product lines they had developed. "We started a couple years back building our own cane berry harvesters. We started doing this internally, as many things that Stahlbush takes on, because we thought we could do it

better and cheaper. We have done just that and now have two of our own harvesters and two more being built as we speak. We think there is a great opportunity to manufacture and sell a line of these harvesters around the world, and by working with the farm's harvesters we expect more innovations to come in the following years, making us the premier supplier of cane berry harvesters in the world. The second line we are thinking of rolling out is our mechanical cultivars with sensing systems to detect row crop plants. This technology has already been developed and for the most part perfected here on the farms. It has allowed us to grow our products more efficiently while utilizing less chemicals and field labor. The third line is an improved line of industrial garden implements. We have done some initial R&D work and know we can build a garden tool that will last years longer than what is on the market now. Our interest in this came after our field workers would run through a \$30 hoe in a week or so. Initially, our goal was to develop a hoe for slightly more money that will last for 3 years of commercial use, which is a lifetime for the home gardener. We think we have done just that."

Barry, being a marketing and sales minded person, asked, "Where and how do you think you will sell the berry harvesters and the mechanical cultivars? Would you sell it through dealerships or direct to producers? What about the garden tools, what would your distribution channel be?"

Glen's excitement did not wane, but he had to admit they were on the front end of the project. "I am not sure of the details. In fact, I admit that I am the innovation and production arm and I would be relying on Bill and others to build the business and marketing structure. But I am confident that we can figure out how to get these fantastic products built and sold."

"There they are. All the ideas we have to sort through regarding the direction for next year," Bill noted. "We certainly have a 'good problem' that will require more of our creativity and skull sweat. Let's start by getting each of these ideas listed out and the requirements for each." The rest of the day was spent mulling over each of the ideas as a team. They looked at every angle and asked every question. Bill and Karla tried to exhaust the discussion on each opportunity and built a solid understanding with the team about what were the costs, returns and risks associated with each viable business move.

ROI

When the first day of planning drew to a close, it was late afternoon and the management team was exhausted. They scrutinized every detail from every angle, so much so that some in the room thought their eyes would cross at times. It was a productive day. As everyone got up to leave the room, Bill and Karla asked Jon to stay for a couple of minutes. Even though there were two groups of managers carrying on separate conversations in the room, Bill asks Jon, "After today's discussion, are you clear on what projects we want to run numbers on and which numbers we want run?"

Jon, a veteran of this process with Stahlbush was not caught off guard. He had gathered operation data and sales projections in preparation for the meeting and had begun working out the pro-forma financial statements and projected return on investment for each idea listed. He knew some of the numbers would change based on the day's conversation but felt comfortable that he could make the changes and have ROI numbers to report at the next days meeting. Jon assured Bill and Karla, "I have already started on the numbers and will be running them tonight. It is very real for us to take a look at the rough numbers in the morning. What are the decision rules you want to use this year in analyzing these options?"

Bill answers, “Karla and I have decided to raise the bar again this year. We want a 15% rate of return for any working capital investments. As for investment options, we want a minimum of a two year simple payback. Given that we are looking to be debt free in four years, and the capital available is limited, we will have to pick and choose. That may mean our list of investments for this year’s growth must give us a one year simple return instead of two. Of course, there are the long term projects we have committed to, specifically the perennial plantings. In allocating our dollars, we need to set aside for our perennial plantings and then determine how far the rest will go over the whole set of opportunities we have.”

<< Table 4: Financial Information >>

Jon acknowledged the instructions and headed off to rework his numbers. As he walked to his desk he could not help but marvel at what he was asked to do. Bill and Karla will not pick an investment that cannot be recouped within two years, maybe even one year. And they were looking at 15% or more return on additional working capital outlays. These numbers would never be found in an accounting or finance class set of general guidelines.

Owners’ Reflections

For Bill and Karla, their planning day was exciting. They loved working with the talented team they have assembled. They were good people with great minds and energy to boot. As their day wound down, after a call from their oldest son who was away at college, after dinner with the three other children at home and helping with their homework, Bill and Karla found time on the porch to reflect on the day’s planning session and the path of their business. Karla looked at Bill and asked him if he ever thought they would be in this position. Bill chuckled, “It has been an interesting path we’ve been on. When we started with pumpkin seeds, I don’t think I would have envisioned this. But our commitment to the land, our people, our customers, it has all paid off for us. I could see this coming ten years ago. I just didn’t expect it to arrive this fast. How about you?”

Karla looked out over their fields, “I am with you: I didn’t expect it at first, but could see this coming as we built the business. We have built a solid company with amazing talent working in it. Now, we are pushing the envelope again. We have the goal of being debt free in four years while maintaining a staggering annualized growth rate of nearly 15%.” After a slight pause, Karla chuckled and said, “You know some might say we are crazy!”

Bill appreciated the humor given the day’s events. “I suppose they would and that is okay. I don’t mind being called crazy if we can build our legacy. A legacy for our kids – something for them to come back to if they want, or something that can give them the jumpstart to do what they want in business. And we are definitely on track to building a legacy in agriculture. We have drastically changed our production practices, and we are starting to help other producers change theirs as well. We have 20 farmers that we have a direct influence with, and I hope how they grow our products permeates how they grow crops on their other acreage.”

Karla agreed. “Well, now our question is where do we go from here? Are we prepared to get involved in another company by spinning off the fabrication shop? That will take lots of energy, not to mention cash. But there certainly is an opportunity, or three, out there to capitalize on if we do. Then there is the question of our retail lines. Do we keep building them, or do we look for a way to harvest our equity? We could likely sell the Farmer’s Market™ line and get

that capital infusion we seem to need. That would also expedite the elimination of our long-term debt.”

Bill settled back into his chair. “I know we have some great opportunities before us and that our problems are good ones to have. One of my biggest concerns is keeping the talented team we have, especially if we spin off the fab shop and Glen gets to spread his wings. I know our managers understand where we are with respect to investments. But how do we keep their energy and enthusiasm high if we aren’t able to let them chase their ideas. If we had more cash, we could do more; we could allow our work family to really grow through implementing their ideas.”

“That certainly fits our values system,” Karla noted. “I know the team is loyal and I think they will stay with us. But as you said, that isn’t what we value. How can we invest in these people, helping them to learn and grow? That is going to be tough to balance with our financial constraints and commitments to the company.”

Bill, with hesitation, brought the conversation back to a topic with many miles. “Well, there are other ways to increase our cash position. We can always take on investors. Both of us have been getting a steady stream of venture capital types looking for a place to invest millions of dollars. That option means we could lose control of the company, but the company could do so many more things if the investment money was there. I can see the benefits; I just don’t see how that fits in with our values. Would that really develop a legacy for agriculture or our children? I have my doubts.”

“True, having more money would allow the company to do so many things,” agreed Karla. “We could use the money to capitalize the fabrication shop spin-off or buy more farm ground or build a second processing plant. But I share your concern about outside investors. Would they align with our goals, objectives, and values? I don’t want to relax our position on long-term debt. Three generations of agricultural producers before me survived in agriculture because they had no debt, and when opportunities came along, they had the cash to invest. Maybe another option would be to take on a partner, like Barry talked about today. Maybe one of our partners would be interested in investing in a production line, allowing us use our limited cash on other projects.”

Bill had flashes of their last partner. “I suppose that is possible. We just haven’t had good luck with partners like that. The last company we tried to partner with on production ended up producing a lower quality product than what we demanded and they tried stealing our recipes and clients. I would be really concerned whether this potential partner would really share our values and commitments. I am really reluctant to go down that path again.”

A New Day

As the second day of their planning session arrived, Bill and Karla had some heavy decisions to make, but not before getting more input. Their team was talented and had brought to the table several great ideas to expand the business. Bill and Karla were confident that the team would provide great ideas on which ideas were right to pursue. That was what the second day was about. Of course, these decisions had to be made in the context of the company’s values. In addition, the situation was complicated more by Bill and Karla’s commitment to debt reduction. How do they decide where to go from here? Does something have to give? Can it give while they maintain their commitment to their values and beliefs?

TABLE 1: TEN YEAR SALES DATA

Year	Industrial (\$ 000's)	SIFI Retail (\$ 000's)	Farmers Market (\$ 000's)	Total (\$ 000's)
1997	7,486	0	0	7,486
1998	7,619	106	0	7,725
1999	8,529	259	0	8,788
2000	9,001	287	0	9,288
2001	9,910	343	0	10,253
2002	11,861	751	130	12,741
2003	13,563	1,089	590	15,242
2004	15,855	1,374	1,137	18,366
2005	16,433	1,552	1,127	19,112
2006	18,329	1,932	1,614	21,875

TABLE 2: SUSTAINABLE VS. ORGANIC PRODUCTION PRACTICES

<u>Standard/Criteria</u>	<u>Food Alliance</u>	<u>Organic</u>	<u>Notes</u>
Conserving Soil Resources	Required.	Required.	
Conserving Water Resources	Required.	Required.	
Nutrient Management	Required.	Chemical use is restricted to “natural”, approved products.	Organic Certification requires that no unapproved products are applied to the land for 3 years prior to harvest of the certified crop.
Pesticide Use	Integrated Pest Management (IPM) required. Decision-making process and appropriate use of pesticides is reviewed, in addition to specific chemical standards.	Chemical use is restricted to “natural”, approved products.	Organic Certification requires that no unapproved products are applied to the land for 3 years prior to harvest of the certified crop.
Wildlife Conservation	Required.	Not specifically addressed, but included in definition of “natural resources of an operation”.	
Fair & Safe Labor Practices	Required.	Not required/addressed.	
Continuous Improvement	Required. Continuing Education is part of the application.	Not required/addressed.	
Genetically Modified Organisms (GMO)	Not accepted.	Not accepted.	

TABLE 3: MANAGER, TITLES, EXPERIENCE

Manager	Title	Year Hired	Previous Employment	Years in Industry
Kim Baglien	Plant Manager	1991	USDA	27
Tina Galloway	Procurement Manager	2002	Cargill	15
Jonathon Gordon	Quality Assurance Manager	2005	Con-Agra	27
Tracy Miedema	Retail Sales Manager	2005	Cascadian Farms General Mills	15
Scott Pohlschneider	Farm Manager	2003	Family Farm	17
Glen Schmidt	Maintenance Manager	2005	Hewlett-Packard	20
Jon Soule'	CFO	1998	Chalk Hill Winery	13
Barry Westfall	Industrial Sales Manager	1994	Klamath Falls Mushroom Watson Turkey Products	22

TABLE 4: FINANCIAL INFORMATION**Stahlbush Island Farms Financial Statements** (\$ in 000)

Income Statement	2006	2005	2004
Net Sales	\$ 23,511	\$ 20,174	\$ 19,574
Cost of Sales	\$ 18,350	\$ 16,703	\$ 15,947
Gross Profit	\$ 5,162	\$ 3,470	\$ 3,626
SG&A	\$ 2,132	\$ 2,108	\$ 1,802
Operating Income	\$ 3,030	\$ 1,362	\$ 1,824
Other Income (Expense)	\$ (541)	\$ (204)	\$ (309)
Net Income	\$ 2,489	\$ 1,158	\$ 1,515

Balance Sheet

Cash	\$ 18	\$ 12	\$ 28
Accounts Receivable	\$ 5,203	\$ 4,502	\$ 4,507
Inventory	\$ 8,558	\$ 6,543	\$ 5,507
Other Current	\$ 8	\$ 38	\$ 13
Total Current	\$ 13,787	\$ 11,095	\$ 10,055
PP&E	\$ 21,925	\$ 19,913	\$ 16,805
Accumulated Depreciation	\$(11,372)	\$(10,137)	\$ (9,039)
Net PP&E	\$ 10,553	\$ 9,776	\$ 7,766
Other Assets	\$ 629	\$ 495	\$ 427
Total Assets	\$ 24,968	\$ 21,365	\$ 18,248

Note Payable	\$ 3,000	\$ 1,500	\$ 3,000
Book Overdraft	\$ 3,726	\$ 3,931	\$ 1,782
Accounts Payable	\$ 2,324	\$ 1,446	\$ 581
Current Portion LTD	\$ 1,079	\$ 837	\$ 851
Other Current Liabilities	\$ 404	\$ 602	\$ 509
Total Current Liabilities	\$ 10,532	\$ 8,316	\$ 6,723
Long Term Debt (net)	\$ 5,368	\$ 6,352	\$ 5,985
Total Liabilities	\$ 15,899	\$ 14,667	\$ 12,708
Capital Stock	\$ 560	\$ 619	\$ 440
Retained Earnings	\$ 8,508	\$ 6,079	\$ 5,099
Total Equity	\$ 9,068	\$ 6,698	\$ 5,540
Total Liabilities & Equity	\$ 24,968	\$ 21,365	\$ 18,248

Selected Additional Information

Depreciation & Amortization	\$ 1,268	\$ 1,112	\$ 1,190
Interest Expense	\$ 650	\$ 400	\$ 186
PP&E Investment	\$ 1,277	\$ 2,456	\$ 1,601
Perennial Crop Development	\$ 768	\$ 680	\$ 657

FIGURE 1: MISSION/VALUES STATEMENT

Stahlbush Island Farms, Inc. Mission/Vision Statement

We are committed to the **Customer**.

We are committed to **Quality**:

- ❖ We will strive to meet even the highest customer standards.
- ❖ Our focus on finished product will start in the field: all employees will contribute to the quality of the finished product.
- ❖ Our ability to consistently provide the highest quality food products allows us to achieve long-term success and contribute to our local economy.

We are committed to **Sustainability**:

- ❖ In order to improve our environment, we will strive to reduce pesticide use, improve soil health, and improve and conserve water resource.
- ❖ We will make responsible business decisions to ensure the long-term success of our business.
- ❖ We will strive to develop successful long-term relationships with customers, suppliers, employees and the community.

We are committed to **Innovation**:

- ❖ In order to continue improving our environment, we will continue pioneering sustainable farming practices.
- ❖ We will embrace change and new technology to improve our work environment and increase efficiency.
- ❖ We will meet our customers' changing needs by defining and creating new products and services.

We are committed to **Safety**:

- ❖ We will create and maintain a safe and healthy work environment.
- ❖ Our products will meet all food safety requirements.
- ❖ We will protect our environment and our community by minimizing our use of chemicals, and using them appropriately in the safest possible manner.

We are committed to **Integrity**.

FIGURE 2: STAHLBUSH ISLAND FARMS VALUES

Stahlbush Island Farms, Inc. Values

- ❖ Be a customer-driven organization and focus on customer needs,
- ❖ Be leaders in sustainable agriculture and produce food with minimal environmental impact,
- ❖ Be innovative and early adopters of technology,
- ❖ Maintain a work environment that is flexible, responsive and accepts change,
- ❖ Provide safe, highest quality food products,
- ❖ Maintain a safe and clean work environment,
- ❖ Use technology to remain highly competitive in a global market,
- ❖ Ensure that all employees are treated, and treat one another, with respect,
- ❖ Be community leaders,
- ❖ Be profitable.

FIGURE 3: SUSTAINABLE FARMING PRACTICES

At Stahlbush Island Farms, we use Sustainable Farming Practices. At its heart, Sustainable practices sustain and improve the health and vitality of the entire farm environment: soil, water, air, plants, animals, and people. As a family farm, this is second nature to us. Our families have farmed in Oregon for over 100 years, and we work every day to preserve the land for future generations. Below you can read about the specific agricultural practices we employ.



We preserve natural buffer zones around rivers to prevent erosion and provide animal habitat

Rotation of Crops

At Stahlbush, we rotate our crops to avoid growing the same crop on the same ground two years in a row. Our rotation includes a number of vegetable crops and a dryland rotation crop such as wheat. A good crop rotation helps us break disease and insect cycles, further control weeds, and improve overall soil health. This helps us further eliminate pesticides.



A healthy little frog, living amongst the rhubarb

Cover Crops

At Stahlbush, we plant cover crops following harvest of the primary crop. We use several different grasses and legumes including Wheat, Annual Ryegrass and Common Vetch. These plants grow and cover the ground over the winter months and are worked back into the soil prior to planting primary crops again in the spring. Cover crops build soil organic matter, help in weed control and generate soil nitrogen. Cover crops are key in improving soil tilth.

Growing Nitrogen

Some cover crops, specifically legumes, are chosen for their ability to generate nitrogen in the soil. If we can grow nitrogen naturally, and improve organic matter at the same time, we can reduce the need for synthetic fertilizers. In one study, we found that one cover crop produced over 120 units of nitrogen.

Clean Ground Water

Stahlbush is committed to clean, healthy ground water. We have done extensive work with Oregon State University to understand nitrogen movement in soil. Our goal is to totally eliminate any nitrogen leaching into the ground water. Having a cover crop going into the winter months, and understanding the timing of nitrogen usage, are key in achieving this goal.

FIGURE 3: SUSTAINABLE FARMING PRACTICES (CONT.)

Reducing & Eliminating Pesticides

Stahlbush continues to strive for reduction in the use of herbicides, fungicides and insecticides in growing all of our crops, including sweet corn, squash, and broccoli. In comparison to conventional standards, Stahlbush has significantly reduced the chemical inputs on our crops, including broccoli, strawberries and pumpkin. Our goal is to use mechanization and computer technology coupled with intensive management as a substitute to chemicals. Our farm is constantly working to develop and implement new mechanical means of pest control. If chemicals are necessary we look to the organically approved chemical list first.



An osprey soars over Stahlbush Island Farm fields below

Soil Residue Testing

Stahlbush has adopted one of the strictest soil residues testing procedures in agriculture. We test the ground our products are grown on for over 20 chemical residues. We are specifically looking for products such as DDT, chlordane, dieldrin, endosulfans, heptachlor, etc. Soil samples are sent to outside, independent laboratories for testing. If soils exceed our internal tolerance they are rejected for production.



Like many wild birds, turkey toms live at the farm

Product Residue Testing

Stahlbush is sending their finished food products to the National Food Laboratory in addition to other outside laboratories to test the finished products for chemical residues. We test for over 200 compounds including organophosphates, organochlorines, and N-methyl carbamates. Our goal is to provide our customers with residue free food products that have been grown in an environmentally safe manner.

FIGURE 4A: SIF PACKAGE EVOLUTION - PREVIOUS PACKAGE DESIGN



FRONT

BACK



FIGURE 4B: SIF PACKAGE EVOLUTION - NEW PACKAGE DESIGN



FRONT

BACK

