HOW TO SUPPORT VALUE CHAIN FINANCE IN A SMART WAY?

Policy statement of the European Microfinance Platform Rural Outreach & Innovation Action Group

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INTRODUCTION

This policy statement focuses on 'good practice' of donors and financiers in the field of value chain finance (VCF). While in a growing number of publications[1], the lessons learned and best practices of value chain finance for practitioners in developing countries have been described, much less is published about how 'northern' actors can best support these interventions. It is this aspect that the Rural Outreach and Innovation Action Group of the European Microfinance Platform aimed to address. Northern actors include donor organizations and NGOs that offer grant aid, as well as financial institutions focusing mainly on debt finance. This document is the result of a discussion with members of the Action Group during its meeting at 29th November 2010 in Luxemburg (member-list is attached). The Action Group was coordinated by Terrafina Microfinance.

Photo: Rural Outreach and Innovation Action group panel session at European Microfinance Week 2010

1 Special reference is made to: "*Agricultural Value Chain Finance – Tools and Lessons*" by Calvin Miller and Linda Jones – FAO 2010 and to: "*Value Chain Finance – Beyond microfinance for rural entrepreneurs*" – Royal Tropical Institute & IIRR 2010.

IDENTIFICATION OF PARTNERS AND CHAINS

1. ***Safeguard both the connection and the distinction between financial services and value chain development.*** Financial service providers (FSP), whether MFIs, credit cooperatives or banks, rarely conduct value chain finance on their own. At the bottom of the pyramid, *value chain development (VCD)* interventions are required to link primary producers (farmers) to value adding markets. Invariably it involves the transformation of a local supply chain into a value chain that meets the requirements of these new markets. While the development and finance aspect are closely linked, it is prudent to clearly separate the two organisationally. Both fields of intervention differ in nature, with VCD focussing on the creation of appropriate marketing channels and market links and VCF focussing on financial service provision in a sustainable manner. While *VCF* may rely upon some grant finance in the inception phase, it has to move towards a sustainable form of local debt financing. For *VCD* activities, after the grant funded start up phase, ongoing services to chain actors will have to be paid out of value added within the chain in order to reach sustainability. Hence the conditions for achieving sustainability are quite different.

2. ***Select promising partners from a value chain development point of view.*** As long as a producer organisation maintains a supply-driven approach, a value chain strategy may be difficult to pursue as this implies adjustment of production to the requirements of new markets. It requires entrepreneurial spirit to venture into new products or crops for local or international markets. Hence, the success of a VCD strategy crucially depends upon the selection of the right partners. Rather that waiting for partners to apply for funding, a more pro-active approach may be needed to scout for partners and promising sub-sectors. This may require scouting and reconnaissance studies by the donor, prior to partner selection.

3. ***Identify an effective lead partner in chain finance.*** An active player in the chain, such as a farmers' marketing organisation or a processing company, can take the lead in streamlining the value chain, thus providing a degree of '*chain governance*'. Such a party could also play a role by providing embedded finance to suppliers, and/or establishing a working relationship with a FSP for financing producers and input suppliers. Compared with financial institutions, value chain actors possess easier access to information about other value chain participants, particularly with regards to the willingness and ability of potential clients to honour contracts. Embedded finance arrangements must be checked however for 'fairness' vis-à-vis the primary producers. It should also be checked whether such arrangement could hamper up scaling to larger numbers of producer groups. A donor can perform a constructive role in designing symbiotic business relationships leading to a balance of powers and equitable distribution of benefits among the partners in the chain. Through transparent pricing mechanisms for goods (up) and financial services (down), with related monitoring, the risk of 'predatory' exploitation of a dependency relationship can effectively be prevented.

4. ***Facilitate the orchestration of a promising VCF strategy.*** In a donor's portfolio a great diversity of VCF modalities may be observed. No model can be singled out as a 'best' solution, as this depends critically upon the circumstances and maturity of the value chain concerned. Financing of famers by a processing firm (embedded finance) may be a very good solution in a situation where no external finance is yet available.. But over time it may be better to separate this function or leave it to specialized financial institutions. Hence, to follow this example, not only is it important to recognize the benefits and the limits of embedded finance, but also the projected evolution of such an arrangement in time. The level of vertical integration in the chain is another strategic issue, where the gain in control needs to be balanced against the risk of multiple roles in the chain (each with their own field of expertise). A donor or debt financier can play a constructive role in discussing with their partners the merits and demerits of one strategy versus another. Ultimately there should be agreement on the trajectory to be followed, preferably laid down in a strategic or business plan.

5. ***Create conditions for synergy between grant and debt finance.*** The investments of donor grants in these programs come to fruition when producer groups are ready for sustained debt finance by (local) financial institutions. In order to ensure that donor investments are made in subsectors and with partners, that Financial Service Providers (FSP) also recognise as being promising, it is vital that FSPs are consulted at a very early stage of the chain development process. Efforts should be made to develop a joint VCD-VCF strategy. Only through local finance delivery is a route towards full sustainability created. The *graduation process* towards local financing also offers an exit route for donors of grant programs, and is their best guarantee for substantial social and economic returns.

DESIGN AND ASSESSMENT

6. ***Support "chain actor driven" design.*** The creation of a successful value chain is an act of entrepreneurship. While a donor/financier can play a supporting role, the detailed design of the value chain strategy must come from a leading chain actor. For design and assessment of interventions it makes a big difference where the initiative originates. In a *producer-driven* initiative, the major challenge is to turn a supply chain into a value chain (i.e. to adjust supply to demand in a new market). In a "*buyer-driven*" model, the challenge is to identify competitive production areas and to make products conform to its needs. Sometimes a professional facilitator is used to link producers and consumers in a chain. Whatever the entry point, a vital characteristic of a promising VCF approach is that a leading chain actor is prepared to invest time and resources in the relations with suppliers (primary producers) and off takers higher up in the chain. Sharing information and building up trust is both a precondition and a good test (indicator) for a genuine VCF approach.

7. ***Acquire knowledge on the value chain.*** Effective interventions require an appreciation of the structure and the dynamics of the value chain. Ensure a *value chain analysis* is conducted and that the study involves an *analysis of the value added potential* in the chain. This will reveal whether benefits can accrue to primary producers by organising the chain more efficiently and whether the cost of chain organization and financial services can be recovered from the product margins. Avoid interventions where the prospect for long term sustainability has not been demonstrated. Market studies should be conducted not just for the commodities involved, but also for the financial services throughout the chain, with the aim of identifying the stakeholders and understanding the dynamics of competition. Donors and financiers can make a major contribution to knowledge management in VCF, based upon their global experience and their connections to knowledge centres.

8. ***Work towards clear separation of roles.*** The roles of value chain actors, facilitators and financial service providers should be clearly defined, especially in emerging value chains where their functions are not yet institutionally separated. If the finance function is performed by a chain actor, such as a farmers' marketing cooperative, their separation in terms of institutional capacity, governance and accounting (cost centres) should be given attention. Another reason for a clear demarcation of tasks is the need to build capacities without threatening the viability of the actors concerned. An MFI or bank cannot be expected to take over responsibility for capacity building and chain organisation, even though these interventions are vital for risk management. These functions are better performed by a chain facilitator with a designated budget and intervention program. A donor or financier can play a guiding role in this respect.

9. ***Exploit chain opportunities for risk mitigating measures.*** Agricultural lending is challenging, not just for MFIs but also for established banks. As a consequence, the share of agricultural lending in the portfolios of financial service providers, even those operating in rural areas, is usually limited. Agricultural loans often show relatively higher portfolio at risk. When MFIs or bankers express reservations with respect to expanded investments in agriculture and agribusiness, their concerns must be taken seriously. The very essence of a VCF approach is that it exploits opportunities for risk mitigation and risk management that do not exist if borrowers are financed in isolation. These opportunities are related to:
   - Building strong *horizontal linkages*, especially at the level of farmers and their organisations
   - Building strong *vertical linkages* throughout the chain, through information flows and contractual arrangements
   - *Turning a supply chain into a value chain* in which the process becomes demand-driven and up stream organisation (farming, processing, branding) is adjusted accordingly
   - Appropriate *financial instruments, insurance* and *collateralisation* mechanisms
   - The creation of *chain intelligence*, i.e. knowledge about the various chain actors and the markets in which they operate
   - Creation of a degree of 'chain governance', e.g. through support for a leading chain actor

A chain is as strong as its weakest link. A VCF approach detects 'the weak links' and addresses them. The success of lending to primary producers in the agricultural sector depends crucially upon the full array of risk management measures put in place. Donors and financiers can see to it that this is consistently done.

10. ***Base interventions on a solid assessment of the needs for capacity building.*** For each of the above opportunities in a value chain approach to finance, corresponding capacity building needs may be identified. Especially in emerging value chains it is likely that all of the above intervention areas needs to be addressed. While financial service providers will not take prime responsibility for these interventions, their involvement is crucial to arrive at a joint strategy. Moreover they also need to build up their own capacity to deal with these issues, to develop appropriate products and to appraise clients from a value chain finance point of view. Capacity building of producer organisations should not just focus on the advantages of the product(s) advocated for the value chain, but also address the need for diversification, so as to ensure food security and avoid over-dependency of farmers upon one crop.

11. ***Maintain the perspective for growth towards maturity in the value chain.*** In the evolution of a value chain involving small farmers, two important steps can be distinguished. First their effective linkage to more attractive markets, which requires their ability to produce the exact product specifications required to meet that demand (inclusion barrier). Second is the transition towards sustainable local finance delivery (access barrier). A donor can play an important role in facilitating the graduation towards sustainable value chain finance, by giving support for the array of interventions needed to develop the chain. The success of graduation in value chain finance is measured by the degree in which it is taken care of by local MFIs and formal financial institutions. The development of credit worthiness of chain operators for debt financing is a vital step in this process. Donors and financiers should both support such medium range perspective.

ENGAGING FINANCIAL SERVICE PROVIDERS

12. ***How can links be facilitated with local financial institutions?*** Donors that are probing for ideas to facilitate value chain finance can facilitate negotiations between leading chain actors and financial institutions and provide both with training and technical assistance. FSPs that are not yet active in VCF need assistance in understanding value chains and how to manage risks associated with lending to the agricultural sector.

13. Involve the financiers in risk mitigating measures. There are many ways is which banks or MFIs (FSPs) can be involved in risk mitigating measures. Examples;

NATURE OF THE RISK	RISK MITIGATION MEASURES
Production risks arise from a variety of factors (input supplies, lacking or late credit, low quality standards, inappropriate storage and packing, weather risks, diseases etc.).	The FSP is informed about the capacity building and extension services for the producers, to ensure supply in adequate quantity and quality. The FSP can also be involved in credit delivery for different actors in the chain (e.g. input suppliers, storage facilities, trade) and appropriate insurance.
Supply risks: The risk that contractual supply obligations by producers (farmers) are not honoured. A frequently observed problem in contract farming is 'side selling', which derails the built-in repayment mechanisms for farm credits.	Coherent producer organisations (farmer cooperatives) and/or group solidarity systems (mutual guarantees based upon savings) are methods to convince the FSP that contracts are honoured and risks of 'side selling' are minimised. Reliable supply allows for collateralisation through warehouse receipts, in which the FSP becomes a party.
Finance risk: The risk of non-repayment of credit provided to farmers or other producers. This risk is born by the FSP or by the chain agent acting as retail-finance provider for farmers or by both.	Non-repayment of credit to chain actors can greatly be reduced by incorporating a lead actor that is considered trustworthy. Such arrangements are strengthened when a leading actor (co-signatory) is able to absorb risks (equity capital, member savings) and when contingency arrangements are ready for unavoidable risks (such as crop failure). If finance is provided in a tripartite arrangement, not only is the efficiency of credit delivery improved, but also the risk of non-performing loans minimised.
Marketing risks relate to the inability to sell on time, in the right quantities and at acceptable quality. Fixed contracts throughout the chain help to stabilise turnover, especially when dependence upon one market can be avoided. Also product standards and certification reduce marketing risks.	Sales or export agreements are a strong asset in negotiations with FSPs. Especially when the FSP is also financing the downstream actors, confidence in the chain is enhanced. Fair trade channels offer good opportunities, even for small producer groups.
Price risks arise from fluctuations in market prices in the period between e.g. the farm contract and delivery. They are born by producers/farmers or by the buying chain actor, depending upon the type of contract used.	Through direct linkage to ultimate consumer markets fair and relatively stable prices can be promoted. Information technology is used reduce these risks to the minimum. Transparency of contractual arrangements is needed for assessment of the risks by the FSP. Forward contracting and futures are examples of more advanced price stabilizing mechanisms in VCF.

In general, a strong confidence building measure for FSPs is when all trade transactions pass through the bank (FSP) concerned, thus providing real time information on chain performance.

CHOICE OF AID INSTRUMENTS – IMPLEMENTATION

15. Donors to coordinate and avoid crowding out with grants. A donor should be very careful with grant funded interventions in a financial market so as to avoid the risk of market distortion. Grant funding should be avoided where debt financing for the same purpose is already practiced. Subsidies should be limited to parties and situations where the market parties (including local MFIs and other FSPs) are not yet active and where prospects for sustainable long term VCF seem to be promising. Wherever more then one donor intervenes in a value chain, their efforts must be well coordinated and harmonized so as to avoid distortions or confusion for actors. In view of the fact that VCF is an emerging field of development cooperation, donors can gain a lot from collaboration in knowledge management and sharing of experience.

16. Before considering financial interventions, consider non-financial alternatives. Direct support by donors to the finance requirements of (commercial) chain actors should only be considered when no alternatives exist. Possible alternatives;

- Brokerage of contacts with MFIs and other financial institutions
- Workshops bringing together stakeholders to see whether solutions can be found within ordinary business relationships
- Technical assistance to producer organisations or lead actors in the chain, allowing them to meet the requirements of viable and sustainable chain operations (including related financial services)
- Brokerage contacts with exporters (or importers in Europe), providing financiers with the comfort of well established market outlets, providing sufficient value added potential at the local level

17. Facilitate the use of appropriate financial instruments. Value chain facilitators are usually funded with grants, also when they facilitate financial services. MFIs are funded in accordance with international best practice standards. For the financing of private chain actors grants are not appropriate, unless they are tied to grant worthy activities (training, certification etc.). In general for private companies debt financing is to be preferred. However, in some cases, early interventions in an emerging value chain may be considered highly uncertain and risky for a commercial actor. Debt financing may not be adequate under such circumstances and other instruments such as quasi-equity instruments may be considered more appropriate.

SMART AID? - MONITORING AND EVALUATION

18. Consider the parallel with 'good donor practice' for microfinance. Value chain finance can benefit from the experience of microfinance, as this sector has developed in the past decades into a mature industry, with global standards for performance indicators, benchmarks and 'good practice'. Value chain finance as an entry point for development aid is a relatively new endeavour, in which best practices are still in the process of being documented, analysed and evaluated. Hence, for donor policy the parallel between VC-finance and microfinance is worth considering[2].

Diagram: Smart Aid criteria for donors in microfinance

Source : CGAP, Donor peer reviews

The justification for the comparison lies in the fact that in both fields (social) enterprises are supported that aim to achieve viable and self sustaining operations. In both cases the role of donors is not just to kick-start the finance process, but also to build the capacity of the institutions involved and to allow effective and sustainable financial service delivery. Donor involvement should be temporary, connected with a clearly defined exit strategy.

2 For further exploration of these criteria reference is made to: "Donor Guidelines on Good Practice in Microfinance" of CGAP, and to Smart Aid criteria and related scoring methodology of donors (as shown in the above diagram).

Questions related to Smart Aid[3] can be approached on the institutional level and program level. This document deals with the latter, and follows the major steps in the project cycle. The smart aid questions on the institutional level are attached (Appendix). Guidelines for portfolio management, as stated below, together will contribute to strategic clarity, which is the first requirement for Smart Aid at the institutional level.

19. ***Agree on key performance indicators.*** Unlike the microfinance sector, few generally agreed performance indicators for value chain finance have emerged yet. Indicators to be considered;
    - Increased involvement of target primary producers (numbers)
    - Increased sales volume of primary producers
    - Increased value added (incomes) of primary producers
    - Credit worthiness (graduation towards commercial debt funding on all levels)
    - Quality of credit portfolios
    - Sustainability of the financial services concerned

20. ***Target and monitor return on investment.*** Similar to interventions in the microfinance sector, grant support for value chain finance should be assessed as an investment that produces a social return. The social returns can be measured in terms of agreed key performance indicators. The ratio between total donor investment and total increase of value added (income) for primary producers may be used as one indicator for the efficiency with which these objectives have been achieved.

21. ***Plan your own exit.*** The realisation of self-sustaining operations and credit worthiness should open the door for local FSPs to fully take over VCF. This is the natural exit strategy for donors, as far as grant-funded programs are concerned. The conditions for exit, and the performance indicators used to assess it, need to be well defined in the business plan underlying the intervention.

Luxemburg, 29th November 2010

3 The Smart Aid criteria should not be confused with the SMART Campaign supported by e-MFP, which deals with client protection principles for microfinance. In general, the social performance dimension is not dealt with in this statement, as it is the focus of a separate Action Group in e-MFP.

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APPENDIX

SMART AID ISSUES IN VALUE CHAIN FINANCE
QUESTIONS FOR SELF ASSESSMENT BY DONORS & FINANCIERS

Key questions on Strategic Clarity

- What is the approach of our organization on VCfinance? Do we have an organisational policy or guideline?
- What is the niche where we can make a difference?
- Are our interventions in VC-finance in line with emerging good practice?
- Does an agency-wide commitment exist towards this policy and good practice principles?
- Is compliance with this policy and good practices checked at all stages of the project cycle?

Key questions on Staff Capacity

- Do we have staff with value chain development and finance expertise to ensure quality of design, implementation, and monitoring of programs?
- Do we have a focal point(s) with experience and responsibility to provide technical advice to program developers and managers?
- Do we make resources available for technical expertise to be involved in the design of VC-development/VC-finance programs?
- Do we have VC specialist staff in countries/regions where it is most needed?

Key questions on Accountability for Results

- Do we have the systems in place to ensure the transparency and performance-based management of VC-finance programs?
- Do we have systematic tracks and reports on performance indicators for VC-finance programs or components?
- Do we use performance-based contracts?
- What are the performance indicators?
- Do we have any measure for cost effectiveness or “return on investment”?

Key questions on Knowledge Management

- Do we have systems to create, disseminate, and incorporate learning from our own experience and from others?
- Do we have mechanism(s) in place for exchanging learning on our VC-finance programs and latest developments throughout headquarters and field offices?
- What expertise is contracted from outside?

Key questions on Appropriate Instruments

- Do we have appropriate instruments for VC-finance that are used in a flexible manner and adapted to market needs?
- Are we able to work directly with private actors (companies)?
- How do we manage the support for VC-development and for VC-finance: are they sufficiently separated and yet well coordinated?
- Is the nature and use of instruments consistent with our strategy and with the requirements for supporting VC-development and VC-finance?
- What role can we play in unleashing funding for agricultural investments?
- How could brokerage and alliance building functions best be organised?

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