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Revolutionising finance for agri-value chains
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1. Context

After many years of declining investment, there is a renewed interest in agricultural financing. The rapid rise in food prices in 2008 has gained the attention of the public sector, and the high prices and consequently increased market potential has generated interest from the private sector. The agro-food sector has undergone changes that have influenced new models of production and marketing involving: a focus on demand rather than on producer-defined agricultural goods; a global, liberalized and fragmented marketplace with little seasonality and high product diversity; food safety and traceability requirements; and higher quality standards in conjunction with the enforcement of basic environmental regulations. This evolution requires a better understanding of the whole set of transactions within each value chain and that of the agricultural sector within which it operates.[1]
Financial services providers often see high risks because they lack an understanding of the agricultural sector and food markets, and have no way to evaluate the risks in agricultural value chains.[2] To most financial institutions, the cost of directly lending to small-scale farmers in remote rural areas is prohibitive and they are reluctant to finance rural entrepreneurs, citing high transaction costs and risks related to agriculture such as crop failure, diseases and market fluctuations as a justification.[3] The result is a serious and long-lasting rural finance gap that keeps the economic potential of agriculture underused.

2. Addressing the rural finance gap through agricultural value chain finance

Increases in finance and investment are needed at all levels of the food chain, especially to increase the access to finance by smallholders.[4] To be successful, the value chain finance approach requires a solid financial entity with appropriate institutional infrastructure, a clear commitment to rural finance, a supportive enabling environment, and a viable market of value chain activities that are suitable for this type of financial product.

2.1. Some concepts

A <u>value chain</u> consists of a series of activities that add value to a final product, beginning with the production, continuing with the processing or elaborating of the final product, and ending with the marketing and sale to the consumer or end user. The inter-dependent linkages of the chain and the security of a market-driven demand for the final product can provide suppliers, producers, processors and marketing companies with more secure access to procurement and sale of products. This reduces costs and risks of doing business and improves access to finance as well as other services needed by those within the value chain.

<u>Value chain finance</u> is the provision of finance throughout the series (or chain) of transactions that result in the product arriving at market. Fundamentally, the value chain framework hinges on *market orientation, without which the resulting financial services would fail.* At its most basic, the value chain methodology requires that financial institutions take into account the financial potential of the entire value chain and not just the creditworthiness of a single individual. With this shift in focus, the financial institution can more accurately measure and mitigate the risk. Once a financial institution establishes

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[1] Calvin Miller and Linda Jones. Agriculture value chain finance. Tools and Lessons. FAO and Practical Action Publishing. 2010
[2] Jennifer Bernhardt, Stephanie Grell Azar, Janette Klaehn, Technical Guide. *Integrated Financing for Value Chains- Credit unions fill the agricultural lending gap and create market linkages. WOCCU, 2009.*
[3] KIT and IIRR. 2010. *Value chain finance: Beyond microfinance tor rural entrepreneurs*. Royal Tropical Institute, Amsterdam; and International Institute of Rural Reconstruction, Nairobi.
[4] Calvin Miller and Linda Jones. Agriculture value chain finance. Tools and Lessons. FAO and Practical Action Publishing. 2010

the market-oriented logic for an investment, it leverages pre-existing relationships and *information* between value chain actors to assess risk and more effectively evaluate an individual farmer's ability to service a loan. It also (via specific assessment tools) provides access to multiple borrowers over multiple growing or producing cycles, achieving economies of scale and reducing overhead costs.[5]

Numerous financial instruments have been adapted or developed to use in financing value chains: (a) those based on the commodity itself; (b) those based on accounts receivable; (c) finance based on fixed assets where the commodity itself serves as guarantee; (d) different products that help reduce risk; and (e) other products that improve the credit supply. These include various trade finance instruments, warehouse receipts, factoring, etc. and risk mitigation products related to the product such as forward contracts and guarantees.
Another tool to reduce risk is insurance –indexed insurance, farm insurance, livestock insurance, health insurance; all help to improve the credit supply. The same occurs with futures contracts, which are very important and useful in AVC finance systems

Value chain financing is an approach to identify where the financing needs are, where are the financing gaps, who can provide the financing, and what are the ways to improving access to financing. **Value chain finance is an approach that takes a systemic viewpoint, looking at the collective set of actors, processes and markets of the chain as opposed to an individual lender-borrower within the system.** Decisions about financing are based on the health of the entire system, including market demand, and not just on the individual borrower. While much of the emphasis in a value chain finance approach is on the health of the chain and its value-adding transactions and linkages, a well-rounded assessment of all borrowers is still critical.

The small-scale businesses of asset-poor farmers at the beginning of the chain are intimately connected with larger businesses of traders, food processors and supermarket chains at the end of the chain. Thus, it is crucial to address the financial gap that hampers growth, limits agricultural development and result in a loss to the financial sector, which ignores millions of potential rural clients.

2.2. Actors

Flows of finance, information and services are not limited to the actors within a chain. Often other individuals and institutions surrounding chain actors are involved, like moneylenders, savings and credit groups, microfinance institutions (MIs), banks, equity funds, which surround the chain actors. Those actors may provide financial services such as loans, pre-financing, shareholdings, factoring, leasing arrangements, and so on to the chain actors. Also, they provide non-financial services like input supplies, farm labour, transport, grading, processing, storage, packaging, advertising, research, training, advice, organization, and so on. Many of these chain supporters provide services to the chain actors for a membership fee. Other chain supporters do not have to be paid by the chain actors, at least not directly. These include research and extension services, standards organizations, and non-government organizations (NGOs).

3. Value chain finance and innovative ways of delivering financial services

The development and business communities involved in the African agriculture and agribusiness sectors have recently experienced a tremendous resurgence of interest in promoting value chains as a way to add value, diversify rural economies, and contribute to increasing rural household incomes in most developing countries. Value chains are increasingly recognized as a means to reduce the rural poverty prevalent in the region. However, and from a development perspective, governments and support agencies must ensure that the financial systems in their countries are able to meet the demands arising from the growth of modern agro-food value chains.[6] The renewed focus on agriculture and agribusiness, as priority sectors for spurring economic growth in Africa, calls for developing value chains that integrate producers and markets to make the agricultural sector more responsive to consumer demand.
The best innovations in AVC finance depend on the chain, the capacity of the different stakeholders in the chain, the interests of the stakeholders and the socio-economic and political context. Some

[5] Luis Jiménez Galarza, WOCCU; Brooke Jones, for The SEEP Network. *WOCCU Value Chain Finance Implementation Manual: Increasing Profitability of Small Producers*, 2009.
[6] KIT and IIRR. 2010. *Value chain finance: Beyond microfinance tor rural entrepreneurs*. Royal Tropical Institute, Amsterdam; and International Institute of Rural Reconstruction, Nairobi.

examples include DrumNet in Kenya, a large project with four areas or companies operating together: (i) a buyer firm, which makes the contract; (ii) groups of producers trained in farmers' schools and in cooperatives; (iii) an inputs retailer; (iii) and an organization that provides finance. DrumNet serves as an information management center and every step of the process is controlled with a messaging system using mobile phones and SMS. Electronic money transfers are used to speed up access to credit, and the program facilitates training and market access for small farmers who face major problems of access, both to services and in geographic terms. In general, the DrumNet model creates efficiencies, helps farmers to penetrate markets and improves their access to services.

In India, BASIX offers training, finance and market access and has close links with many chains and agricultural commodity exchanges. Small farmers, many of them with properties of only half or one hectare, can make future sales through service kiosks. These are integrated sales in which farmers use purchase contracts to obtain credit.[7]

Agricultural value chain finance offers an opportunity to reduce cost and risk in financing and reach out to smallholder farmers, expand the financing opportunities for agriculture, improve efficiency and repayments in financing, and consolidate value chain linkages among participants in the chain. The specific opportunities that financing can create within a chain are driven by the context and business model and the relative roles of each participant in the chain.

For financial institutions, value chain finance creates the impetus to look beyond the direct recipient of finance so as to better understand the competitiveness and risks in the sector as a whole and to craft products that best fit the needs of the businesses in the chain. Value chain finance can help the chains become more inclusive, by making resources available for smallholders to integrate into higher value markets. Finance that is linked with value chains is not new and some types of trader finance, for example, have been around for millennia; what is new is the way it is being applied more systematically to agriculture, using innovative or adapted approaches, tools and technologies.[8]

There are additional benefits to bringing in formal financial entities to finance value chains. By providing poor and low-income people with access to formal finance, a financial service provider can reduce the liquidity and production constraints that weaken the negotiating power of smaller producers. As a third party, the institution can also: facilitate consensus building and align the incentives of different value chain actors, increase value chain competitiveness, and improve end products.

4. ICT uses for inclusive agricultural value chains

It is essential to improve access to reliable and timely information critical to take advantage of market opportunities. Lower costs of ICTs, such as mobile phones and the networks needed to connect them, have facilitated critical information to farmers, small traders and business people in production systems management, market access services, and financial inclusion.[9] ICTs are among the most effective drivers of agricultural growth and transformation in ACP countries and inclusive agricultural value chains.

Market access ICT services comprise any service that provides beneficiaries, especially farmers, with access to information on pricing of agricultural products (inputs and outputs) and on finding and connecting to suppliers, buyers or logistics providers, such as storage facilities and transport companies. Such services include simple pricing services, virtual trading floors (matching services or full commodity exchanges) and holistic trading services. Market access services also cover ICT solutions that help the typically larger upstream and downstream firms, such as processors or exporters, to manage their operations and the quality of their produce better – here called downstream administration.

Some ICT innovations include SMS messages via mobile phones to provide farmers with weather forecasts, government contacts, and information on recommended chemicals and pests. Radio services and phone help desk in remote areas with access to the agricultural information in local languages. National Farmers' Information Service (NAFIS) in Kenya converts text into audio in English or Swahili. Farmers use landlines or mobile phones to place requests for voice-based information. The Talking Book in Ghana is a hand-held audio computer that records locally produced agricultural and literacy information for Ghanaian farmers to play back in their own language on livestock, fish farming and health. Network and Knowledge System (LINKS) in Kenya and Ethiopia collates data on livestock

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[7] Proceedings of the conference "Agricultural Value Chain Finance". Edited by Rodolfo Quirós. 2011.http://www.fao.org/fileadmin/user_upload/ags/publications/AVCF_2011e3.pdf

[8] Calvin Miller and Linda Jones. Agriculture value chain finance. Tools and Lessons. FAO and Practical Action Publishing. 2010

[9] Calvin Miller, V.N. Saroja and Chris Linder. ICT uses for inclusive agricultural value chains. FAO. 2013

sales and prices for dissemination through SMS messages. M-Farm in Kenya is a non-subscription mobile phone service that gives farmers information about market prices across the country through text messages. Livestock Identification Trace-back System (LITS) in Bostwana uses radio-frequency identification (RFID) technology to capture data on individual cattle, and transmits this information directly, and error-free, to a central database.

5. The way forward

The situation for banks involved in agricultural finance is no different from that of other businesses. Getting the business model right is key to the long-term survival. Understanding and using collateral management, structured finance and credit support techniques should be part of a banker's arsenal.[10]

It is critical to understand how policy, laws and additional infrastructure support from governments, multilateral agencies and large donors can improve the availability and success of ICT implementation for agricultural value chains. More in-depth studies of the technologies being used or developed, how they interact with various types of management information system (MIS) and communications system, and how these connections can be improved may also be supported, along with more in-depth evaluation, of the few interventions that have reached significant scale and some level of viability.[11]

One of the most important lessons is that innovation plays a vital role in promoting integration and efficiency in agricultural value chains. Moreover, by using a facilitation model with support and training, an AVC can incorporate small agricultural entrepreneurs. However, agricultural value chains cannot provide all the financial services required by farmers and other actors in the chain.[12]

The key to success related to agricultural value chains finance are: (i) continuous market-based information on the chains is important for all those involved; (ii) Partnerships based on mutual interests with interrelated systems reduce risk; (iii) Reduced transaction costs; (iv) Finance within or toward the chain is an essential element to strengthen the AVC; (v) Structuring of financial products appropriate to the chain and its stakeholders is fundamental.[13]

6. Objectives of the Briefing

Building upon earlier CTA work for the international conferences on *Making the Connection: Value Chains for Transforming Smallholder Agriculture*[14] and *'ict4ag'*[15] *which has been* a key milestone in promoting the application of ICTs in the agricultural sector and will place a particular emphasis on value chains, advocacy and policy development, this briefing will discuss the new context of value chain finance in Africa, the different value chain business models, the innovative applications of ICTs, all of which provide the potential for value chain finance to shape African agriculture. More specifically, the briefing will consider the concept of agricultural value chain finance and how it fits with different value chain business models. The briefing aims to: (i) highlight the key opportunities in value chain finance for smallholders; (ii) provide space for sharing experiences and innovations on VCF; and (iii) facilitate networking among development partners.

This Briefing will feed into the CTA/AFRACA conference on *Revolutionising finance for agri-value chains* to be held in Nairobi on 15-17 July 2014.

Target group

Policymakers and representatives of EU Member States, civil society groups, research networks and development practitioners, and international organisations.

Available material

Input and comments before, during and after the meetings will be included in the Briefings blog: http://brusselsbriefings.net. A Reader and Highlights in printed and electronic format will be produced shortly after the meeting.

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[10] Lamon Rutten. *De-constructing agricultural finance: how re-thinking the model can improve the method. Models of agricultural value chain financing. Perspective of chain members*. Proceedings of the conference "Agricultural Value Chain Finance". Edited by Rodolfo Quirós. 2011.

[11] Calvin Miller, V.N. Saroja and Chris Linder. ICT uses for inclusive agricultural value chains. FAO. 2013

[12] Proceedings of the conference "Agricultural Value Chain Finance". Edited by Rodolfo Quirós. 2011.

[13] Ibid.

[14] CTA International Conference 2012. http://makingtheconnection.cta.int/

[15] CTA International Conference 2013. http://ict4ag.org/en/