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Innovative financing for inclusive agricultural development

FEATURE

Innovative financing for inclusive agricultural development

Heinz Greijn and colleagues describe how, as aid budgets shrink, new ways of financing development are emerging. How inclusive are these new funding modalities of smallholder farmers?

PRACTICE

Voucher grant schemes

Giel Ton reports on the voucher grant schemes that are being used to encourage smallholder farmers to innovate in order to strengthen their position in value chains.

PRACTICE

Smart subsidies and value chain development

Jimmy Ebong and Peniel Uliwa describe how a smart subsidy scheme has enabled farmers and dealers in Tanzania to establish local supplies of sunflower seeds.

PRACTICE

Resolving the grant giver's dilemma

James Blewett and Elisaveta Kostova explain how the Afghanistan Business Innovation Fund has developed a methodology for determining the right size of a grant that will incentivise private investment.

PRACTICE

Guaranteed opportunities

Lisette van Benthum and Ben Nijkamp describe how ICCO's loan guarantee fund is challenging the view that investing in rural organisations and entrepreneurs is too risky.

GUEST COLUMN

Bridging the pioneering gap

Sheikh Noorullah believes that philanthropic capital needs to be invested in pioneering businesses that focus on low-income customers, and in the documentation of knowledge that can help mitigate the risks.

CASE STUDIES

FINANCING SMALLHOLDER AGRICULTURE

This issue of *Capacity.org* contains a selection of articles on innovative financing in the agricultural sector. Here we present brief summaries of some other interesting papers that could not be included in the print edition but can be found on the *Capacity.org* website.

Agrilife

Charles Kiinde

Agrilife is a mobile phone and web-based platform in Kenya where financial institutions and suppliers can obtain near-real-time information on farmers' ability to pay for services. Agrilife serves farmers who are members of producer organisations and who have business relationships with millers or other processors. Once a farmer has delivered his produce to a processor (also key participants in the setup) the information is shared with suppliers and financial and other service providers, and the farmer has immediate access to these services. Service providers use point-of-sale devices for cashless transactions between farmers and merchants and real-time reporting.

The Fair Climate Fund

Gerrit de Gans

Through the Fair Climate Fund, ICCO and Kerk in Actie are working on behalf of poor communities engaged in projects to reduce carbon emissions. These may involve the introduction of renewable energy (biogas, solar or hydropower) or improved cookstoves, or activities that increase Earth's carbon absorption capacity, such as low-carbon farming, agroforestry or reforestation projects. ICCO and Kerk in Actie sell the carbon credits generated by these projects on the carbon market where they can be bought by companies and rich households as emission rights.



Alamy / Joerg Boehling

Public-private partnerships in water supply, Rwanda

Richard Nyirishema and Michiel Verweij

Water supply systems in Rwanda would benefit from a more businesslike approach to management. Existing community-managed systems lack accountability, technical and administrative skills, leading to poor cost recovery for the rehabilitation of water supply infrastructures, and many dysfunctional water points. SNV Rwanda has facilitated the establishment of public-private partnerships between the Energy, Water and Sanitation Authority (EWSA), UNICEF, the Rwanda Utilities Regulatory Agency (RURA) and Aquavirunga, a private company that manages three water schemes. SNV is supporting three actors to prepare for entering these partnerships: the district that owns the water facilities, the private operator who manages the schemes, and water users who have to get used to the idea that they will have to pay for the water they use.

The Indonesia Domestic Biogas Programme

Rob de Groot

In the Indonesia Domestic Biogas Programme (IDBP), Hivos is working with Nestlé to encourage small dairy farmers to invest in biogas digesters as an affordable and sustainable source of cooking fuel using renewable local resources. This programme, which also involves the Indonesian Ministry of Energy and Mineral Resources and SNV, has led to the construction of almost 9000 biodigesters, more than 5500 of them for Nestlé's milk suppliers. The programme is an example of a public-private partnership that is investing in agricultural infrastructure or services that benefit small farmers. The farmers now have access to cheap energy, while Nestlé has been able to strengthen its relationship with its suppliers and to boost its corporate image.

Moving farmers into commercial agriculture: lessons from Uganda and South Sudan

Steve Hodges

The multitude and complexity of the risks in the agricultural sector make it unattractive for commercial lenders and private sector investors. The author suggests three ways to mitigate these risks: conducting comprehensive risk assessments, encouraging banks to engage with multi-stakeholder committees and promoting model farmers.

RESOURCES

Catalyzing Smallholder Agricultural Finance

Dalberg Global Development Advisors (2012)



Commissioned by two private foundations, Skoll and Citi (an affiliate of Citigroup), this report explores the inclusiveness of impact-driven investors (or 'social lenders') in smallholder agriculture, such as Root Capital, Oikocredit and Triodos. The social lender model works through cooperatives or producer organisations, making this an efficient channel for providing finance to small farmers. However, because only about 10% of the world's smallholders are members of such organisations, social lenders can meet only a small proportion of the demand for finance. Meeting the broader demand will require other approaches tailored to the characteristics of each market. The report identifies five 'growth pathways' for deploying investments to address smallholders' demand for finance.

www.dalberg.com

Innovative Financing for Agriculture, Food Security and Nutrition

Food Security Task Force, Leading Group on Innovative Financing for Development (2012)



The Leading Group, which resulted from the UN Declaration on Innovative Sources of Financing for Development in 2005, is a prominent (but certainly not the only) platform where IDF is being discussed. This report presents an inventory of innovative financing mechanisms already in use to promote investments in agriculture, food security and nutrition. The authors emphasise the need for mechanisms that will be able to generate new resources, and that will catalyse private sector investments in agriculture and value chains. The idea is to encourage the development of multiple options on the basis of global, regional, bilateral, national or local initiatives.

www.leadinggroup.org

The inclusiveness of innovative financing

Innovative development financing (IDF), a term first coined during the UN International Conference on Financing for Development in 2002, is becoming the generic term referring to all kinds of arrangements for sourcing or using funds that are not considered traditional official development assistance (ODA). These arrangements may refer to new ways of sourcing funds from taxes on sugar and fats or from national lotteries, issuing bonds on international capital markets for development purposes, or stimulating private sector involvement through commitments to purchase a particular product such as a vaccine. At the meso- or micro-levels, innovative development financing may refer to new ways of channelling funds to smallholders (such as warehouse receipt systems), or financing water supply systems or other types of infrastructure. Sometimes IDF is considered to encompass social impact investments by fund managers, foundations or banks in projects that deliver social and environmental impacts as well as financial returns. Even funding mechanisms that are no longer new, such as public-private partnerships or microfinance institutions, are now often regarded as IDF mechanisms.

IDF is receiving more attention as traditional publicly funded ODA decreases and private sector sources are gearing up to play a more prominent role in financing development. Many IDF mechanisms focus on encouraging the private sector to engage more actively in development. Private companies are important not only as sources of funds, but also as drivers of development and sources of innovative ideas on ways to improve management efficiency. However, they are driven by the need to generate returns on their investments. To what extent does that need limit private financing reaching the poor and marginalised, referred to by Paul Collier as the 'bottom billion'? In other words, what can we say about the inclusiveness of innovative financing solutions by private companies, or of solutions that encourage private sector actors to invest in development? To answer these questions *Capacity.org* issued a call for articles describing solutions that would be relevant for the day-to-day practice of development professionals working at the meso- or micro-levels. The focus was primarily but not exclusively on the agricultural sector.

This issue of *Capacity.org* contains a selection of the articles received, all of which focus on agriculture, as well as brief summaries of other interesting articles that can be found on the *Capacity.org* website. The main conclusion that can be drawn from all of the articles is that there are limitations to the inclusiveness of innovative financing from private sector sources. Up to a point, the inclusiveness can be enhanced through loan guarantee funds, as described by Lisette van Benthum and Ben Nijkamp (page 14). But in order to help marginalised farmers strengthen their position in the economic system and become players that can engage in business relationships, subsidies or grants from public or philanthropic sources will still be needed. These can be delivered as direct funding or as contributions in kind, or packaged as capacity development services, or any combination of the above. There is a lot to be gained from increasing the effectiveness of subsidies and grants.

Grants and subsidies can be effective, but if poorly designed they can be a waste of money or even do a lot of harm by crowding out private sector actors. Jimmy Ebong and Peniel Uliwa (page 10) explain how in Tanzania an ineffective subsidy system was replaced by an innovative financing system that included subsidies to agro-dealers combined with a voucher scheme for farmers.

Grant schemes also need to be well targeted. A study by Giel Ton (page 8) concludes that by issuing vouchers, input subsidy programmes run the risk of benefiting farmers who already use the inputs rather than those who do not, but can be expected to start doing so as a result of the vouchers, which is a waste. Grants need to be of the right size in order to work as an incentive and not distort markets by creating unfair competition between those who receive the grants and those who do not. James Blewett and Elisaveta Kostova (page 12) describe the Afghanistan Business Innovation Fund's competitive grant scheme, for which they developed a method for determining the right size of grant that will incentivise private sector investment in companies that supply products and services for small farmers.

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Cover photo
Flickr / Gates Foundation

ECDPM's representative in the Editorial Board, Niels Keijzer, has been replaced by Eunike Spierings. The board would like to thank Niels for his dedicated contribution to the work of the board and the meticulous and constructive way he provided feedback on authors' contributions.

Innovative financing for inclusive agricultural development



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As government aid budgets shrink, new ways of financing development are emerging, involving partnerships between development agencies and private sector companies. This article explores the inclusiveness of smallholder farmers of these financing modalities.

- the changing roles of development agencies, the private sector and governments to ensure the inclusiveness of investments in agricultural development.

Private sector investments in development

Policies encouraging the private sector to invest in development are not new. In the early 1990s the concept of public-private partnerships (PPPs) emerged with a view to co-financing and implementing large-scale public projects in infrastructure, water supply, energy, etc., that governments found difficult to finance with public funds alone. Private sector involvement was, and still is, also considered important for increasing efficiency and innovation in the provision of services that in many countries used to be the exclusive domain of state-owned companies. These include water supply, health and education services, etc.

The PPP concept has been applied in many countries around the world, but unfortunately not always with satisfying results. Many of the failures are associated with governments that lack the multidisciplinary and specialised expertise that is required to reconcile the interests and expectations of governments, private sector actors, NGOs and civil society organisations. Nevertheless PPPs remain relevant. In the agricultural sector, for example, PPPs are considered useful for financing agricultural infrastructures such as irrigation schemes or storage facilities, or providing services that will benefit smallholders.

Over the last decade the call for private sector involvement in financing development has received a new impetus from two sides: from the United Nations and from the private sector itself.

The concept of innovative development financing (IDF) has its roots in the UN system. It was first mentioned during the UN International Conference on Financing for Development held in Monterrey, Mexico, in 2002. Until recently IDF discussions focused on the macro-level sourcing of funds for

development in unconventional ways, in addition to traditional official development assistance (ODA). The emphasis was on the sourcing of funds including from the private sector. Increasingly the use of funds to catalyse private sector investments is receiving attention especially for agricultural development. Recently, an expert committee of the UN Leading Group on IDF compiled an inventory of innovative financing mechanisms in agriculture, food security and nutrition, focusing on mechanisms that could catalyse private sector investments in agriculture and value chains.

Finally, the concept of impact investment emerged in the mid-2000s from the community of socially oriented private companies, investors and private foundations. Impact investors are fund managers, development finance institutions, foundations, banks and even insurance companies and pension funds that invest in companies, organisations and funds with the intention to generate measurable social and environmental impacts as well as financial returns. One example is Acumen, a non-profit global venture fund that receives donations, makes debt or equity investments in companies that generate social impacts and recycles the returns to make new investments. Other examples are Root Capital and Oikocredit. Many impact investment funds are related to established global companies including Citigroup, Morgan Stanley, Deutsche Bank, Credit Suisse and Shell. In 2007, these and other investors and organisations formed the Global Impact Investing Network (GIIN).

Rationale for private sector involvement

Proponents of more private sector investments in development refer, with differences in emphasis, to two key roles of the private sector: as a source of funds and as a driver of development.

The private sector as a source of funds
 Faced with shrinking ODA budgets, development agencies, NGOs and

Traditional aid budgets are becoming tighter, and development agencies are looking for alternative sources of finance. At the same time, an increasing number of companies are taking their corporate social responsibility approaches to the next level. New financing modalities and cross-sector partnerships are emerging that differ from the traditional model based on subsidising development interventions with public money.

This article examines three aspects of private sector investments in development:

- the various concepts used to encourage private investments in development, their background and underlying rationale;
- the challenges facing the private sector in reaching out to smallholder farmers; and



Private sector investors focus on the 10% of farmers who are members of producer organisations.

governments are seeking to align themselves with commercial companies and the foundations affiliated with them. It is hard to estimate the potential size of private sector investments but expectations are high. The figure of US\$500 billion within the next decade has been mentioned, which is substantially more than the US\$134 billion ODA provided by members of the OECD's Development Assistance Committee in 2011.

The motives for private sector actors to engage in development can be attributed to various mixes of profit and philanthropy. Illustrative is the steadily growing group of impact investors. A recent survey by J.P. Morgan of 99 major impact investors revealed that they expect to commit US\$9 billion in 2013, US\$1 billion more than in 2012. Whereas impact investors seek returns on their investments that may be lower than market rates, other private investors may occasionally be willing to fund projects without an immediate link to market return. One example is Nestlé, which is supporting a Hivos programme in Indonesia that aims to encourage smallholders to install biogas digesters by offering interest-free loans (see the article by Robert de Groot on the *Capacity.org* website). Most of the farmers who benefit supply milk to Nestlé. For Nestlé, the programme is a

way to help farmers access to cheap energy, strengthen relations with its suppliers and boost its corporate image.

The private sector as a driver of development

The second reason for catalysing private sector investments concerns the role of private actors as drivers of development. From a capacity development perspective, the private sector as a driver is crucial for the sustainability and scalability of interventions. Development solutions that are inadequately aligned with market dynamics and that depend entirely on aid or public funds tend to be difficult to sustain and scale up. Many projects have become expensive islands of change, while others have even had a detrimental effect because they provide subsidised goods and services and so undercut private sector providers (see the article by Ebong and Uliwa, page 10).

Development agencies are therefore increasingly seeking solutions that can be embedded in value chain relationships and include creating business relationships and investment opportunities for private actors. Private actors involved may encompass the whole value chain, ranging from multinationals to local suppliers, merchants, processing industries, service providers, artisans, etc. If successful, these solutions

can become self-propelling, so that the value chain in which they are embedded starts functioning on its own and grows in a self-sustaining way. Gradually, as the chain matures, the role of the development agency as a catalyst ends. It can then withdraw, leaving implementation and scaling up to the chain actors themselves.

The elusiveness of inclusiveness

Although the private sector is indispensable as a driver of development and increasingly important as a source of finance, it faces major challenges in its efforts to reach out to farmers at the bottom of the pyramid. Commercial banks, for example, show little interest in financing smallholders. The considerations of such financial institutions are illustrative of the factors that also discourage other private sector actors, including input suppliers and buyers, from investing in inclusive development.

There are many reasons why it is difficult for commercial banks to realise a return on their investment when working with smallholders. The transaction costs are high compared with the size of loans. Many smallholders do not have bank accounts or the education required for record keeping and financial management that are essential when entering into a loan agreement with a

bank. Legal frameworks are often inadequate. For example, smallholders often do not have land titles that can serve as collateral for loans. In other cases, collateral is difficult to enforce if the borrower defaults. Weather-related risks tend to be high. Yields are often low because of poor infrastructure, the lack of extension services and inadequate access to inputs.

All of these factors mean that banks look for other, less risky opportunities to generate a return on their investment. For local banks, for example, it is far easier to invest in government treasury bills than in smallholders. The commercial banks tend to work only with the large farmers that are already well positioned in value chains.

As indicated above, return on investment is not the main motivation underlying the operations of all lenders. Driven by social motives, impact investors target the less privileged households, farmers and businesses. But there are limitations to the inclusiveness of the social impact investment model as well. A recent report by Dalberg, a consultancy, *Catalyzing Smallholder Agricultural Finance*, concluded that:

- Social lenders (referred to as a subset of impact investors) have proven to be successful in meeting the financial needs of many smallholders, although their outreach is limited considering there are 450 million worldwide. The report estimates the total market demand for financing by smallholders at US\$450 billion. With disbursements of US\$350 million in 2011, social lenders are satisfying only a tiny fraction of the demand.
- Even if the social lending model were to be scaled up, outreach will remain limited to the 10% of the world's smallholders who are members of farmers' organisations.

It is not only impact investors who face difficulties in reaching out to the 90% of smallholders who are not organised into



Building collateral: A farmer delivers his produce to a warehouse.

producer groups. The examples of innovative financing featured in this issue of *Capacity.org* demonstrate similar limitation in terms of inclusiveness. With the exception of voucher grant schemes (see the articles by Ebong and Uliwa, page 10, and Ton, page 8) most interventions target smallholders who are members of producer organisations.

Alternative aggregation points

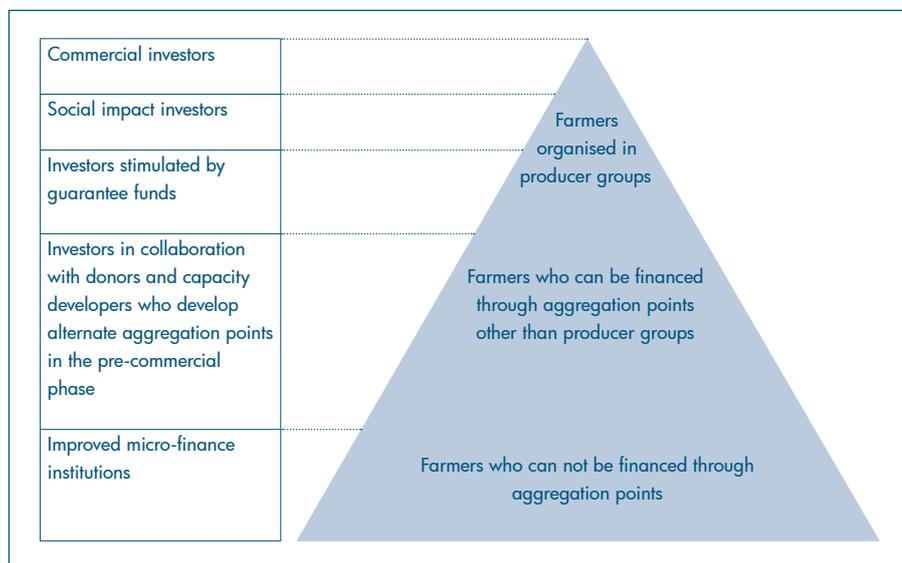
It seems safe to assume that for the 10% of the farmers who are already organised the

prospects for them to engage successfully in value chains, attract commercial financing and benefit from increasing global demand look promising. The role of development agencies is to engage in partnerships with private sector actors to develop interventions to accelerate this process whereby innovative development financing mechanisms can be of tremendous help.

It is far more complicated to develop strategies to support the 90% of smallholders who are not members of producer organisations. Engaging suppliers, lenders and buyers in partnerships with these smallholders is challenging. Innovative funding mechanisms need to be embedded in much wider value chain development strategies that involve, among other things, the use and development of aggregation points or aggregators – points in the chain where private actors can reach out to farmers as a group, thus reducing the risks and transaction costs of working with smallholders. An aggregator may be a producer organisation, a cooperative, a buyer who has contracts with many farmers, a collection hub, a warehouse, an input provider or any other intermediary that can liaise between value chain actors, lenders and groups of smallholders.

A core message of the Dalberg report is that social lenders focus on the small proportion of farmers that are aggregated into producer organisations and that inclusiveness could be improved by channelling finances through alternative

Inclusiveness of various sources and mechanisms of financing for smallholders.



aggregators in the value chain such as warehouses, input suppliers or buyers. One example of an aggregation point that is different from a producer group is a warehouse receipts system. The system addresses the problem that smallholders are often forced to sell crops soon after the harvest when prices are low because they are in need of cash and they lack access to credit. In a warehouse receipts system the farmers can store their harvest in a secure warehouse. The warehouse issues a receipt that the farmers can take to a bank or supplier to get credit, while the stored crop is accepted as collateral.

In many cases viable points of aggregation are difficult to find, however. The only option is to finance farmers directly. But, as we have seen, for most lenders this is not a viable option due to the high transaction risks and costs. Unfortunately, most microfinance institutions do not provide alternative options because they focus on very small loans for petty trade and are unable to provide smallholders with the terms and deal sizes required. Hence the majority of smallholders are hardly serviced by any of the lending institutions. As a result their capacities to become integrated into and strengthen their positions in value

chains are severely constricted. The Dalberg report suggests two strategies. The first is to introduce improved microfinance institutions that are better equipped to service smallholders. The second strategy is to search for new ways to finance smallholders directly in rural areas where mobile phone technology is penetrating rapidly.

Mobile phone technology can significantly reduce transaction costs and improve the efficiency – and by extension is also the most inclusive – of all financing mechanisms. Mobile phone technology combined with web-based platforms is becoming increasingly important as high-tech aggregator in establishing links with suppliers, lenders and buyers (see the article by Charles Kiinde on the *Capacity.org* website).

Developing the honey value chain in Ethiopia

Paulos Desalegn and Piet Visser

In 2006 SNV launched the Business Organisations and their Access to Markets (BOAM) programme in Ethiopia to promote the development of the honey chain. As a result of this intervention, between 2008 and 2011, Ethiopian honey exports increased from zero to 400 tonnes (mainly to the EU). The honey was exported by six BOAM-supported processors who sourced the honey from 8000 producers, whose household revenues increased by up to 83%.

SNV recently launched a follow-up, the Apiculture Scaling-up Programme for Income and Rural Employment (ASPIRE), involving 60,000 beekeepers, that aims to boost production to over 15,000 tonnes over a period of five years. The target group is diverse. Most are subsistence beekeepers who are not organised around aggregation points and it will be a challenge to include them in interventions to upgrade the honey value chain. At the other end of the spectrum, the most commercially advanced honey producers are aggregated into outgrower groups that are linked to the process through a nucleus farm. Between these two extremes are many semi-commercial beekeepers, with different levels of aggregation in producer organisations.

The ASPIRE programme, which is financed by the Netherlands government (€6.6 million) and SLM-GIZ (€0.3 million), supports processors, the Ethiopian Apiculture Board, banks, local investors and international social investors to deliver to each category of beekeepers the right mix of services and financing they need to make the transition to the next level. ASPIRE will provide grants to honey processors, associations, cooperatives and others to develop, test and scale innovative business and service models. The aim is that by 2017 the value chain will have matured to a level that all actors – processors, beekeepers and their organisations, input suppliers and local retailers and wholesalers – have adequate access to financing from multiple sources, including commercial banks, social investors, microfinance institutions, etc.

Financing options	Encourage or make attractive to sell to business linkages	Starter loan package with guarantees, services, inputs and business linkages	Repeated access microfinance with services, inputs and business linkages	Commercial finance with services
Processors				
Outgrowers		graduation to commercial		
Semi-commercial farmers	graduation to semi-commercial			
Subsistence farmers				

Upgrading the position of beekeepers in the honey value chain and the type of financing/support at each level.

A longer version of this case study can be found on the *Capacity.org* website.

Co-creating inclusive development

The Dalberg report suggests that smallholders can be divided into two categories – the 10% of farmers who are organised and the 90% who are not. This is an important point of departure for development agencies, private sector organisations and governments, which will have to develop new ways of working together, and adopt complementary roles, in their efforts to achieve inclusive development.

Before investing in smallholders becomes a viable option in the business models of commercial and impact investors a lot of investments need to be made in activities that belong to the pre-commercial phase of value chain development. These include identifying possible aggregators and strengthening them, seeking relevant actors to co-invest in and make use of these aggregators, and testing and supporting the scaling up of improved microfinance models (see box). These are all components of value chain development that do not generate a financial return. This is the pivotal work that needs to be done by specialised capacity developers, either government agencies or NGOs. The financing of these types of intervention will remain largely dependent on governments, donors, foundations and other private funds that are driven by philanthropic and social motives. The active involvement of commercial and impact investors however is important if smallholders are to make a successful transition from the pre-commercial to the commercial phase. Inclusive development is a process of co-creation. <

Links

- Dalberg (2012) *Catalyzing Smallholder Agricultural Finance*. Dalberg Global Development Advisors.
- Leading Group (2013) *Innovative Financing for Agriculture, Food Security and Nutrition*. Report of the high-level expert committee to the Leading Group on Innovative Financing for Development.
- Saltuk, Y., Bouri, A., Mudaliar, A. and Pease, M. (2013) *Perspectives on Progress: The Impact Investor Survey*. J.P. Morgan/Global Impact Investing Network (GIIN).



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Financing innovation at the smallholder level

Voucher grant schemes to promote innovation

Grants are widely used to encourage smallholder farmers to innovate in order to strengthen their position in value chains. Based on a systematic review of the effectiveness of a number of grant modalities, this article focuses on voucher grant schemes.

To become attractive suppliers to agribusiness and urban markets, smallholder farmers often first need to innovate, i.e. to adapt their production practices in order to supply the volumes and comply with the quality standards that these markets require. To do so, they need an effective innovation system, which refers to the network of smallholders, private companies and public sector institutions involved in generating and disseminating new technologies

and innovation processes. Many countries have introduced grant schemes to promote innovation in the agricultural sector through subsidies to farmers and/or farmer groups.

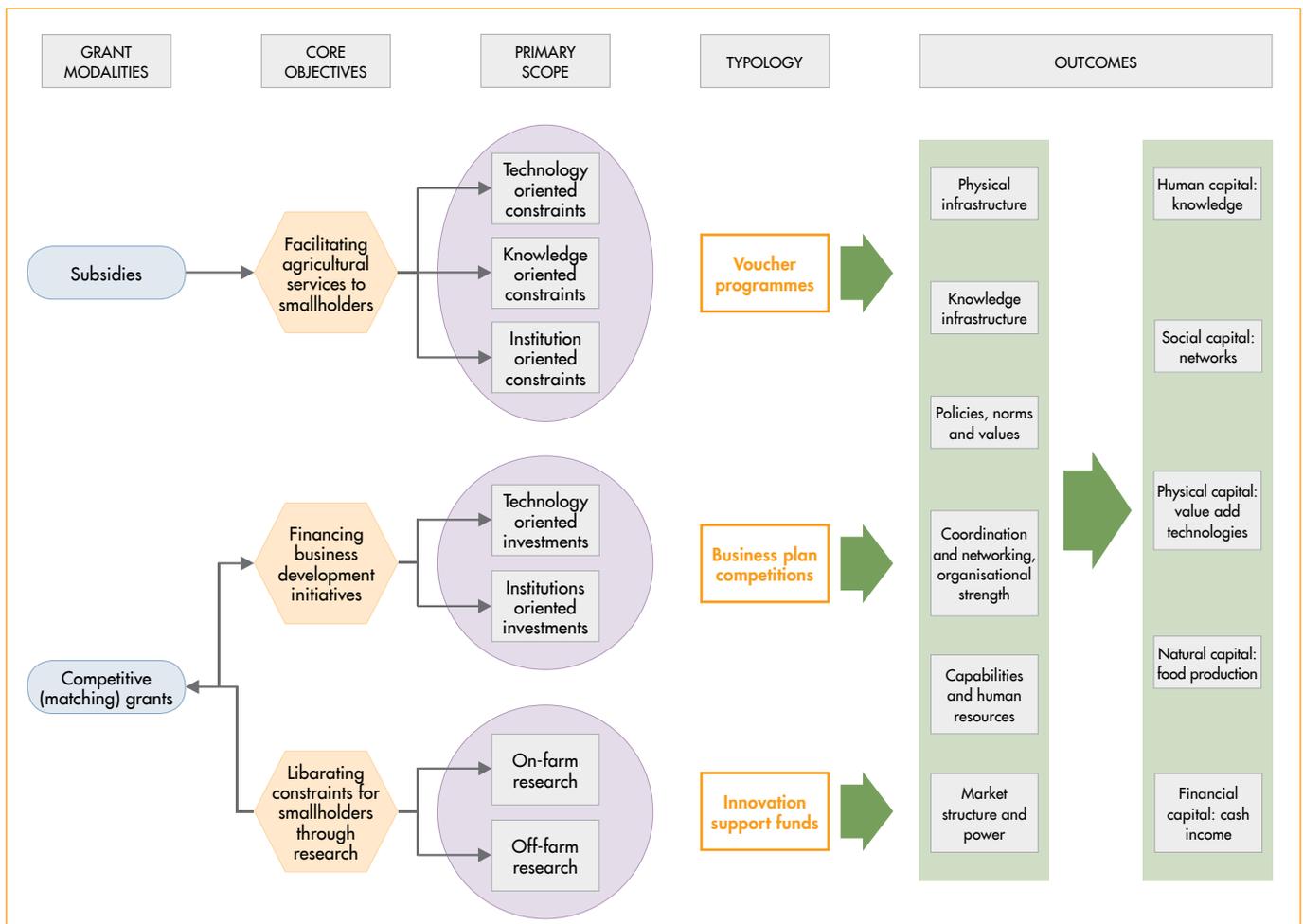
Innovation grants are needed when farmers and companies are reluctant to invest because they cannot be sure that the benefits of investments in better seed, farming practices or value-adding processing, for example, will actually pay off. To break this deadlock, an increasing

number of governments and donors are introducing grant schemes to co-finance and/or subsidise innovation processes.

Facilitating innovation

Innovation grant schemes for smallholder farmers have different objectives, with different disbursement modalities, and fall into three categories:

- *Voucher programmes* are a way to distribute subsidies for inputs, new



Typology of innovation grant schemes.



Reuters / Antony Njuguna

A Malawian farmer checks her tobacco crop before bringing it to market.

technologies and/or services to trigger innovation in agriculture.

- **Business plan competitions** co-fund smallholders and/or enterprises that source from them on the basis of a solid business plan for an innovative venture.
- **Innovation support funds** offer grants to NGOs or community-based organisations to enable farmers to experiment and provide support for farmer-driven innovation.

Within each of these categories there are wide variations, in particular in the degree of involvement and decision making by farmers. In some schemes, the beneficiaries are free to decide how they use the grant, while in others they are relatively passive recipients with little say in how the grants are to be used.

The three types of grant facilitate innovation in different ways. Competitive grant schemes and innovation support funds tend to work through intermediary institutions such as farmers' groups, farmers' unions, multi-stakeholder platforms or decentralised extension systems where the representatives of smallholder farmers have decision-making authority. Because the focus of this issue of *Capacity.org* is on innovative financing for inclusive development, this article focuses on voucher grant schemes that target individual farmers.

Voucher grant schemes

In voucher grant schemes, governments or donors distribute vouchers to farmers as a way to subsidise the costs of inputs, technologies and/or services that could trigger innovation in agriculture. For example, voucher programmes may be used to subsidise the distribution of quality seeds and fertiliser, to distribute tools and seeds to farmers following conflicts or natural

disasters, or to allocate heifers as part of a dairy expansion programme.

While in the absolute sense the level of innovation might seem to be rather low, at the local level such vouchers may imply major changes in the socio-institutional and technical aspects of the agricultural system around smallholder farming. Other voucher schemes focus on the provision of services to farmers, such as extension support or business development services.

The Malawian input subsidy programme

In a recent systematic review of the effectiveness of innovation grants, a group at Wageningen University and Research Centre looked at studies of the impacts of voucher distribution programmes. A number of these studies analysed the Malawi Agricultural Input Subsidy Programme, which was introduced by the government of Malawi in 2005–2006 to improve smallholder productivity, increase food and cash crop production, and reduce vulnerability to food insecurity. The studies of the Malawi programme provided evidence that the vouchers have indeed led farmers to adopt new practices that have enhanced innovation and the increased use of farm inputs.

The voucher scheme contributed to the growth of agro-input 'markets'. The vouchers could only be used for specific goods or services. They provided an effective demand for inputs for agro-dealers to come in with their investments and establish outlets in remote areas. Although the vouchers encouraged the entry of agro-dealers in rural areas, there were also victims of these dynamics when, for political reasons, the voucher scheme bypassed established dealers in favour of newcomers.

Compared with subsidies in the form of cash, there is a risk that vouchers may limit

farmers' choice of inputs. Vouchers also tend to promote 'one-size-fits-all' seed varieties or technologies. In many developing countries farmers conduct their own experiments, such as cultivating several varieties of seed at the same time on the same plot in order to select the most promising one for the next season. These endogenous innovation practices might be lost due to the inflow of cheap varieties provided through a voucher scheme.

Such negative effects can be avoided by organising the scheme in such a way that the vouchers offer farmers access to a broader menu of goods or services. Vouchers that may be exchanged at seed fairs, for example, may be an effective way to widen the choice of seeds available to farmers and provides opportunities for them to obtain both external certified seeds and improved local varieties. The same venues could also be used to provide smallholders access to other technologies, such as oxen for traction, storage facilities, etc., that could help to trigger innovation.

Complementary measures

Various studies have shown that the adoption of innovative practices can indeed lead to increases in yields. However, the evidence that the farmers use the extra income to invest in farm assets is less convincing. An explanation for this is that a rapid increase in the production of a crop in an area can lead to very low prices on the local market. Most studies therefore note that voucher schemes need to be complemented with effective measures to stabilise markets and to provide the necessary infrastructure, including storage facilities, roads and regional trading networks. Such complementary measures can have a moderating effect on prices, preventing them falling too far and too fast when increased yields lead to a surge in supplies on local markets.

Finally, the studies underlined the need for effective targeting mechanisms to ensure that voucher schemes benefit the non-users of inputs and technologies. Without them, the vouchers will be used especially by farmers who already use them, substituting part of their cash expenses with government subsidy support, without actually facilitating agricultural innovation. There is also always a risk that the vouchers may be deliberately allocated in ways that strengthen existing power relations, favour exclusive clans or influence party politics. It is important that schemes have transparent mechanisms and 'ritual' in the distribution of inputs as a way to build more robust local institutions. <

Link

- This article is based on Ton, G. et al. (2013) *Effectiveness of Innovation Grants to Smallholder Agricultural Producers: An Explorative Systematic Review*. Evidence for Policy and Practice Information and Co-ordinating Centre (EPPI-Centre), Institute of Education, University of London, UK.



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Kick-starting seed markets in Tanzania

Smart subsidies and value chain development

Farmers in the Handeni district of Tanzania were dependent on the local government and an NGO for free or heavily subsidised sunflower seeds. A smart subsidy scheme has enabled the farmers and dealers to establish local supplies of high-quality seeds.

The government of Tanzania is working to reduce rural poverty by supporting small farmers and businesses. The Rural Business Support Programme (MUVI), which is funded by the International Fund for Agricultural Development (IFAD), is being implemented by Match Maker Associates, a Tanzanian consultancy firm. Launched in July 2010, this four-year programme focuses on two value chains, citrus fruits and sunflower oil, in four districts in Tanga region.

The MUVI programme has succeeded in transforming the sunflower value chain, and in the process has increased the incomes of thousands of farmers and other actors in the chain. The programme has involved an innovative subsidy scheme, combined with the introduction of improved seeds and training for farmers in good agricultural practices.

Ineffective seed supplies

For farmers involved in the sunflower value chain a major constraint was their limited access to good quality and affordable seeds. Often farmers recycled their own seeds, which had led to low productivity and poor yields, and in turn to low incomes, so that many rural households were unable to afford a decent standard of living.

Farmers in Handeni district obtained seeds from three sources. The first was through a district scheme, in which the authorities procured seeds from Kibo Seeds and distributed them to farmers under an agricultural input subsidy scheme. This scheme was inappropriately conceived because it created dependence and was unsustainable in the long run. Perhaps unsurprisingly, when the district failed to pay the company for its seeds, the scheme collapsed.

The second source was World Vision Tanzania, an NGO that was also supporting sunflower subsector. World Vision provided subsidies covering the cost of seeds, but that

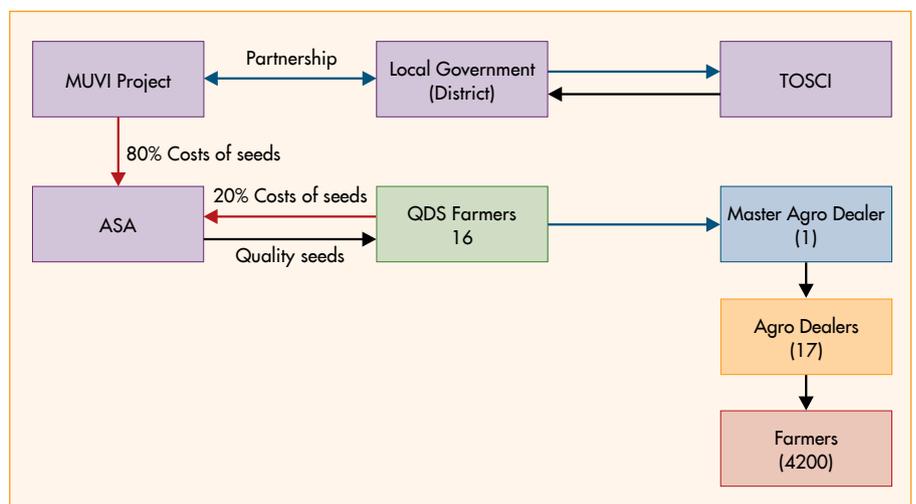
scheme faced many challenges. World Vision was offering seeds not as a way to promote rural businesses but as livelihood support, and the seeds were only available to farmers in the limited areas where the programme was being implemented.

The third source of sunflower seeds was through private agro-dealers who travelled to Arusha and Morogoro to buy them, and then sold them in Handeni. These dealers faced stiff competition from both the World Vision programme and the district scheme and their business eventually collapsed. In addition, the long distances to sources of seeds meant that the dealers were unable to ensure consistent and timely supplies. The traders complained about the low demand for quality seeds, which meant that travelling long distances to buy seeds became unprofitable.

In order to address this problem, MUVI adopted a two-pronged approach, involving the introduction of a smart subsidy scheme to stimulate both the supply of and the demand for quality seeds, enabling farmers to access quality seeds from agro-dealers in the first year, and the local production of seeds certified as Quality Declared Seeds (QDS).

MUVI helped to improve the agro-dealers' system of sourcing and supplying sunflower seeds and other inputs by introducing a voucher scheme to cover the costs of transportation, and facilitating linkages between dealers to enable them to obtain quality seeds. As a result, the dealers were able to supply farmers with seed on time and at a price they could afford.

In MUVI's voucher scheme, a 'master' agro-dealer obtained certified seeds (a variety known as 'Record') from the Agricultural Seeds Agency (ASA) in Morogoro. The seeds were made available to farmers via a network of dealers at the ward level, set up by the MUVI programme. The master dealer was able to buy the seeds at TZS 2000 per kg, and sold them to other dealers at TZS 2500 per kg, who in turn sold them to farmers at TZS 3000 per kg. At each stage along the chain the transportation costs, calculated at TZS 500 per kg, were subsidised by MUVI. In 2011, a total of 3.5 tonnes of Record variety seeds were distributed to and planted by farmers. MUVI also collaborated with the ASA to provide training for farmers in good agricultural practices (GAP) in order to increase yields.



The Quality Declared Seeds (QDS) model.



Flickr / GAT / Neil Palmer

Quality Declared Seeds

The QDS model involved engaging lead farmers and supporting them to produce certified quality seeds that they sell to agro-dealers, who in turn sell them to other farmers. To implement this model, the MUVI programme engaged the Tanzania Official Seeds Certification Institute (TOSCI), which inspects and tests samples of seeds for their purity and germination rates and issues a certificate. At the same time, staff of Sokoine University of Agriculture trained 39 farmers in QDS production methods, and set up a QDS production system.

Introduced as a temporary measure to stimulate the demand for and supply of quality seeds, the subsidy scheme seems to have worked well. The supply of quality seeds has improved. The agro-dealers proved to be an effective way to supply and distribute quality seeds in a timely and sustainable manner. In 2011, as well as the supply of seeds from the ASA, 16 local farmers produced 7.36 tonnes of QDS certified seeds, all of which were sold within three months. In 2012, production fell because of low rainfall, but production in 2013 is expected to reach 27 tonnes.

In just two years the demand for sunflower seeds in Handeni district increased from 6 tonnes to nearly 11 tonnes. Farmers now have access to quality seeds from the ASA as well as the QDS seeds produced by local farmers. The demand for the locally produced QDS seeds is high because they are cheaper, and yields are comparable with those of other certified varieties available from the ASA and Kenya Fedha, a local variety. In some cases, locally produced QDS seeds are even better than those imported from elsewhere, with farmers reporting higher germination rates and higher yields.

The subsidy scheme has performed its function of kick-starting the market for seeds by boosting both supply and demand. The subsidies have been phased out and the actors involved in the chain are now covering the costs of inputs (seeds) themselves. The production system is still vulnerable in two respects, however. First, even with high-quality seeds, farmers require adequate rainfall if they are to obtain reasonable yields, but in this part of Africa the risk of crop failure due to drought is always high. In the second year of QDS production, TOSCI certified only 900 kg of QDS seeds, much less than the 18.9 tonnes expected. Recognising that all farmers would benefit from insurance cover against unreliable weather conditions and climate change, MUVI will pilot a weather index-based crop insurance scheme in the 2013–14 seasons, and expects to roll it out in 2014, which will see farmers having their loan burden insured in the event of serious drought.

The second vulnerability is related to finance. Because few agro-dealers have collateral it is very difficult for them to obtain loans from banks, and the loans from microfinance institutions are too expensive. With the increased incomes they earn from the sunflower business, agro-dealers are expected to build their asset base so that they can finance their own seed requirements.

Lessons learnt

In interventions of this kind, it is important to identify the interests of all actors in the chain and what each one has to offer. Solutions, knowledge and resources do not necessarily have to come from outside. Local actors are often very knowledgeable about the options they have to improve their

situation and given the opportunity they are willing to change. Through dialogue with and between local actors, home-grown solutions to local problems may emerge that are very effective.

In Handeni district, the key actors were the private agro-dealers. In an environment where many government and NGO programmes had already struggled or failed completely, agro-dealers were seen as instrumental in the establishment of a sustainable system for delivering seeds to farmers. Agro-dealers know the market because they live close to farmers and are aware of the types of seed and traits that farmers prefer. They can therefore inform seed producers about what is in demand in their area so that they can supply what will sell well, thus ensuring the efficient allocation of scarce resources. The ‘right’ triggers – subsidies to cover transportation costs and appropriate linkages to sources of quality seeds – were needed to get the system going, and the agro-dealers performed a key role in matching demand and supply. Of course it is crucial to target the subsidies in such a way that they demonstrate the commercial viability of the service but do not distort the future market.

With the support of Sokoine University, the farmers involved in the production of QDS seeds soon dispelled the notion that quality seeds had to be brought in from outside. Some farmers reported that the germination rates of QDS seeds produced locally, and their yields, were higher than those of imported and local varieties.

The MUVI programme has demonstrated that a substantial part of the financial and human resources could be mobilised locally. Local governments and other agencies such as TOSCI, the ASA and Sokoine University had publicly funded budgets but were unaware of how best to invest them. The local agencies also had manpower to provide extension that could be tapped through appropriate partnerships. Innovation and creativity are needed to persuade government agencies to buy into and invest in a programme.

For interventions such as the MUVI programme to succeed, political goodwill is essential, and the local government has provided it. Handeni district has now prioritised QDS sunflower production and the district agriculture development plan for 2013–14 has incorporated all activities and costs of QDS production, including procuring seeds, QDS farm inspections, organising the collection of seed samples to be tested by TOSCI, as well as extension support to QDS farmers. The sustainability of QDS sunflower production in Handeni district seems to be assured. <

Links

- Match Maker Associates Ltd: www.mma-ltd.com
- Rural Business Support Programme – Muungano Ujasirani Vijiini (MUVI): www.muvi.go.tz

Resolving the grant giver's dilemma



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The Afghanistan Business Innovation Fund (ABIF) is a US\$6.9 million challenge fund that is financed and supported by the UK Department for International Development (DFID) and AusAid, implemented by Landell Mills. The fund operates within a market development strategy that seeks to incentivise private sector investment by addressing market system constraints on inclusive growth. The fund is currently operating across seven sectors selected because of their particular concentration of target beneficiaries allied with growth and innovation potential.

ABIF does not target smallholders directly but finances medium-sized Afghan companies that supply products and services for smallholder farmers and entrepreneurs.

ABIF has completed two competitive rounds, and has awarded 23 grants, committing the whole grant fund and contributing to investment projects of more than US\$28 million. The grants are disbursed when the grantees achieve implementation milestones.

During the first round seven projects were selected, while the output of the second round has been much higher resulting in at least 16 approved grants. Of the first round projects, all are making substantial progress although two have experienced significant delays.

As the projects launch new products and services, early development results are appearing. The investment projects could ultimately benefit up to a million individuals by improving either their income opportunities

The Afghanistan Business Innovation Fund operates in a high-risk environment where other finance providers are reluctant to venture. The fund has therefore developed an innovative methodology for determining the right size of a grant that will incentivise private sector investment.

as producers or workers, or the value they derive from purchases as consumers.

The grant giver's dilemma

The ABIF wants investors to invest now, rather than in the future, in productive assets that will benefit the Afghan economy. The core questions are: what is the minimum grant required to work as an incentive, and when does an incentive become a subsidy?

Understanding the interplay between investment risk and future returns is the key to determining the incentive/subsidy threshold. A grant functions as an incentive when the amount is sufficient to offset the additional risk of investing in Afghanistan. But if the grant more than offsets that risk, public money is used unnecessarily. This is not only a waste but it can also have a harmful effects. One of the main criticisms of public sector grants to the private sector is that even allowing for the competitive challenge fund process, a grant operates as a subsidy favouring one company over another, distorting fragile markets and reducing competitive forces.

On the other hand, few dispute that grants are powerful incentives to encourage recipients to behave in a certain way. If the financial incentive is big enough, grants can be used to induce grantees to follow a desired course of action such as accelerating investment, reallocating limited capital, or changing the location of investment. The dilemma facing grant-giving projects is how to capture these benefits without falling into the subsidy trap.

Conventional matching grants continue to be a popular challenge fund design choice. The matching grant approach follows the idea that the public and private sectors are equal partners in financing investment projects. The argument is that by putting up 50% of the required investment, the partners share the risk but the grantee retains ownership of the project.

However, in this transfer of public money to the private sector, there is no objective basis for selecting 50% as a contribution. It is rather an arbitrary decision; the donor could just as easily select 25% or 75%, or any other proportion.

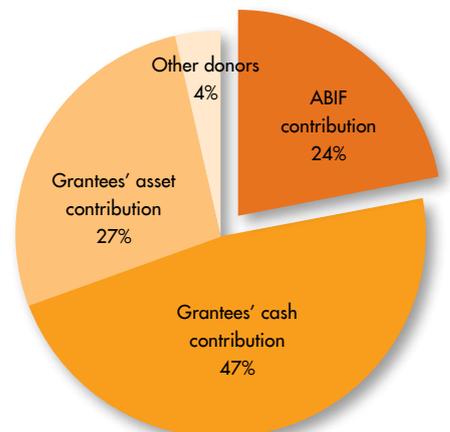
Likewise, the amount that is counted as the grantee's contribution also rests on policy decisions. For instance, some grants are matched on a cash-for-cash basis, while others also allow some or all classes of asset contributions as well as cash. In practice, the seemingly fixed 50/50 contribution masks wide variations. From a value for money point of view, the matching grant approach results in efficiency losses because almost always 'too much' public money is given to the grantee.

Some funds have refined the approach, and allow varying proportions of grant contribution. While negotiation of lower contributions does increase grant allocation efficiency, it does not systematically maximise value for money. Meanwhile, increased management discretion can reduce the transparency of the process of awarding grants.

Tipping point

ABIF has taken a step forward in this process by moving from cash matching grants to variable risk-compensating grants. The approach maximises grant allocation efficiency and maintains process transparency.

Instead of setting an arbitrary fixed or target grant contribution and regarding any amount lower than this benchmark as a good result, ABIF looks at the risks and



ABIF investment financing, rounds 1 and 2.

returns of individual projects to identify the investment decision tipping point at which a grant is sufficient to make an investment happen.

The tipping point in an investment decision is when the expected rate of return is greater than the cost of the capital invested to generate the return. There are normally two sources of finance for an investment equity (the investor's own money) and debt (money borrowed from others). The cost of capital is largely driven by the finance provider's sense of risk. The higher the risk, the higher the cost will be.

Unsurprisingly, the cost of capital in Afghanistan is high. Projects generating returns that would make them viable investment opportunities in other countries are not justified in Afghanistan, since they simply cannot generate the returns required by the finance provider. This, in a nutshell, is why there is so little investment in the country. But ABIF offers an additional source of finance at zero cost. When the grant is mixed with expensive equity or debt, the average cost of capital is reduced. This risk-determined approach allows ABIF to identify the right mix of grant, equity and debt to make a project viable (see box).

The process depends on an initial assessment of investment risk in Afghanistan. Then, using a financial model to assess the investment costs and returns, ABIF determines the grant value necessary to provide an effective incentive by offsetting enough of the risk to make the investment viable.

This approach does require marginally more work than others, as estimating country risk is an essential component of the model. But once the cost of capital is estimated, no additional due diligence effort is required. In all cases, applicants need to prepare a robust business plan and financial model to demonstrate that their business idea is commercially sound. The defining step in the ABIF approach is that the



Investing in the future: Afghan farmers planting fruit trees.

Flickr / isafmedia

financial model is also used to calculate the forecast internal rate of return (IRR), which is then compared with the investor's target returns, the decision tipping point at which the investment is justified. The difference between the forecast and the target returns determines the amount of grant.

The approach in practice

One of ABIF's grantees is Trio, a company that imported and had developed expertise in growing fruit trees from certified rootstock. Their original proposal was to expand their orchard business, but sensing the market development potential, ABIF encouraged them to set up a nursery business so that thousands of farmers could benefit from access to new high-yielding varieties. When determining the amount of grant to Trio and other applicants, ABIF considered three key variables: the weighted average cost of capital, the investment project budget, and operating financial forecasts.

Trio and other companies have shown how a grant can incentivise investment-led sustainable systemic market change, and achieve impact at scale. So far, Trio has imported 250,000 saplings, of which 50,000 have been sold, 100,000 will be sold later this year and the remaining 100,000 have been planted to provide the mother rootstock for future years. The company's future profitability now rests on supplying farmers with high-yield certified varieties of fruit

trees and helping them to achieve the best returns on their investment.

ABIF's investment projects have shown that the risk-compensating grant approach can work in practice, despite the poor business planning capacity of many applicants. Evidence is emerging that the approach is delivering significant benefits and value for money to DFID and AusAid, but there are wider implications for the relationship between donors and private sector partners.

By regarding the grant as an integral part of a rational investment decision and applying tools that have been tried and tested in private sector investment decision making, the ABIF approach provides a rational basis for managing the interface between public grant and private finance – complementing rather than competing with private sources of debt and equity.

The ABIF approach to the transfer of public funds to the private sector represents a significant refinement of the challenge fund model where private sector partners with commercial objectives are frequently integral players in the achievement of development goals. <

Link

Afghanistan Business Innovation Fund (ABIF): www.imurabba.org

A longer version of this article can be found on the Capacity.org website.

The risk-determined approach

This approach brings several benefits:

- it justifies not only the principle of public sector grants to private sector enterprises, but also the amount of grant awarded;
- it brings the discipline of private sector investment decision making to the allocation of public funds, improving the quality and reducing the implementation risk of the investment project;
- it turns a grant from a competing to a complementary source of finance, avoiding displacement of commercial finance providers;
- it reduces the amount of public grant used to incentivise each investment project, allowing a wider portfolio;
- it boosts development returns by allowing more projects to be funded, increasing the value for money delivered by each project.



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Establishing lender–borrower relationships

Guaranteed opportunities

Banks and social investors are often reluctant to provide financial services to producer organisations, rural microfinance institutions or small businesses because they are perceived as too risky. ICCO's guarantee fund is challenging that view.

It is often difficult, if not impossible, for producer organisations, rural microfinance institutions (MFIs) or small and medium enterprises (SMEs) in developing countries to access financial services from local or international banks or even social investors. Start-up businesses in particular have no proven track record or tangible assets they can use as collateral, and so are perceived as being high risk.

ICCO, a Dutch cooperative, is convinced that many financial service providers perceive the risk of investment in producer organisations, MFIs and SMEs as being unrealistically high. In 1999 ICCO's business unit, ICCO Investments, therefore created a guarantee fund that aims to reduce the risk of lending to this group of clients. Each guarantee serves as partial collateral for a loan, allowing the financial service provider and the producer organisation or entrepreneur to get to know each other, build trust, and explore win-win opportunities for both sides.

ICCO's guarantee fund

The fund works with local banks and social investors such as Oikocredit and the Triodos Sustainable Trade Fund to provide partial, shared-loss guarantees on loans to small organisations and businesses that would otherwise be regarded as too risky. Experience has shown that after one or more loan cycles, both the lending bank and the borrower have learned to trust each other, and the bank is more willing to continue the relationship without such guarantees (see box).

By 31 December 2012 the fund had achieved a leverage of 2.74 on its portfolio. In other words, for every €1000 temporarily invested (guaranteed) by ICCO, banks and investors had provided financing (loans) amounting to €2740.

In principle, ICCO does not provide 100% guarantees. For guarantees in place on

31 December 2012 the average was 43% of the value of the loan. The fund provides mainly shared-risk guarantees, and only in exceptional cases first loss guarantees. With 'first loss' the guarantor accepts to take any loss up to a maximum pre-set amount. Only if the loss exceeds this pre-set maximum, do others share in the risk.

The reasoning behind ICCO's 'shared-risk-policy' is the wish to work only with those banks that are committed to sharing the risk of investments. If the fund were to provide 100% guarantees, there would be no risk for the lending bank, except for reputational risk and the time invested. If the fund were to offer first loss guarantees, there would be little incentive for the bank to recover the last part of the loan or to pursue repayment in full.

Which form of guarantee works best?

The fund provides guarantees in various forms – a framework agreement or a bilateral contract between ICCO and the lending bank, a guarantee in the form of a deposit or a standby letter of credit (SBLC)¹ – depending on the level of trust between the lending bank and ICCO. If a bank has not previously worked with the fund and is not aware of ICCO's reputation or financial

position, it might require an SLBC from ICCO's bank in order to secure the guarantee provided. Supplying an SBLC, however, requires (part of) the guaranteed amount to be 'frozen' in ICCO's bank account, and the SBLC fees to be paid by ICCO.

Alternatively, if ICCO and a local bank or social investor have worked together for some time and numerous loans have been repaid, they may choose to work through a framework agreement specifying the target group of borrowers, the type of loans, standards regarding the guarantee percentage, etc. Such a framework agreement can greatly simplify the process of arranging the guarantee. ICCO has entered into framework agreements with Oikocredit, currently ICCO's largest loan guarantee client, and with the Central American Bank for Economic Integration (CABEI).

Since the early years of the fund, ICCO has worked with a number of local banks in Africa and Asia. Some of them have required ICCO to deposit the value of the guarantee in a jointly controlled account, which in some cases has led to practical problems. In some African countries, for example, it is difficult to recover the funds once the loan has been repaid. In other cases, despite contractual agreements, banks have used the deposit

Building a track record

COLDIS is a farmers' cooperative in southern Madagascar that buys cloves from small producers to sell in bulk to companies in the Netherlands and Hong Kong. The cooperative was created in 2009 by TIAVO, a microfinance association, to help its members access new markets. The cooperative had found a buyer in the Netherlands for its cloves, but to pay the producers upon delivery, it needed temporary credit to bridge the period between payment to the producer and receipt of payment from the Dutch client.

Since this newly created cooperative had no tangible assets that could serve as collateral, local and western banks felt that lending to COLDIS would be too risky. ICCO then introduced the cooperative and its business to the Triodos Sustainable Trade Fund (TSTF), which indicated its interest in offering a loan, but because COLDIS had no track record of its ability to repay a loan, the risk was considered too high. ICCO then offered to provide a partial guarantee, to which the fund agreed.

In 2009 ICCO offered a 50% guarantee, with a maximum of €250,000, allowing COLDIS to obtain a €500,000 loan from TSTF. Despite some problems, the cooperative was able to repay the loan in full and on time. In subsequent years, TSTF provided further loans under similar conditions, partially guaranteed by ICCO, and all were repaid in full. In the process, a relationship of trust between TSTF and COLDIS was established. By 2012, TSTF was willing to offer the cooperative a loan of more than €1 million, requiring a guarantee of 20% only (maximum €215,000).

without informing ICCO or requesting its approval. In such situations, it is difficult for a Dutch organisation to force the bank to disclose evidence of the rightful use of the deposit. The fund therefore no longer provides guarantees in the form of deposits in foreign banks; standby letters of credit have proven to be an acceptable alternative.

Establishing trust

The amount of time and effort ICCO needs to put into contracting and monitoring the guarantees are to a large extent also determined by the level of trust, but this time that of ICCO in the lending bank. If ICCO knows the bank as a partner that can be trusted, it will base its investment decision and do its monitoring based on the bank's information. In cases where a relationship of trust has not yet been established, ICCO Investments will need to do the full investigation and monitor the borrower's progress throughout the period of the guarantee. Over time, when trust has been established, ICCO is able to rely on the bank's information. This reduces ICCO's transaction costs significantly.

Through quarterly monitoring and risk assessments, ICCO assesses the total risk of guarantees that may be called. Based on this



calculation, provisions are made for ICCO's balance sheet. For guarantees secured through a standby letter of credit, the guarantee balance is frozen in ICCO's bank account, providing 100% security. The risk assessments and provisions made by ICCO are closely monitored by external auditors.

Because of these provisions, the ICCO guarantee fund is not unlimited in size, and in recent years it has been stretched to its maximum. The future growth of the fund will depend on the organisation's ability to raise additional funds.

Results

Between 2006 and 2012 the fund issued guarantees on 236 loans – 51% to producer organisations and SMEs and 49% to rural MFIs. Of these, 107 (mostly long-term) loans are still outstanding, and 119 have been repaid in full. In 10 cases guarantees were called and paid.

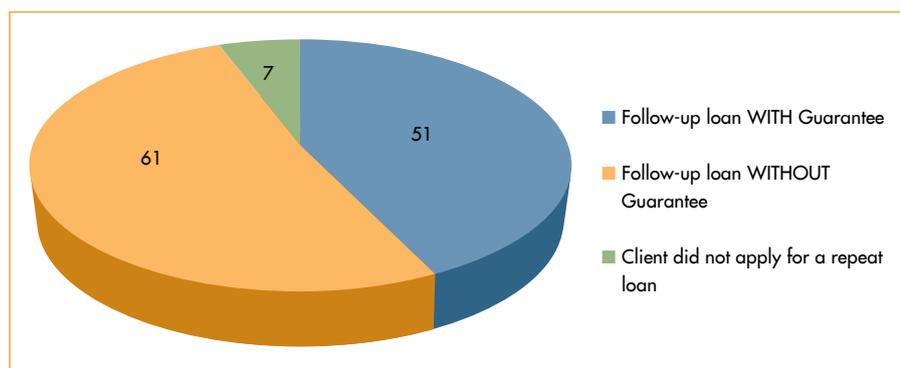
Out of the 119 clients who repaid their loans, seven did not apply for a repeat loan with the same financial service provider, probably because they did not need one or because they had found another provider. Of these 119 repaid loans, 51 clients received a repeat loan from the same provider with a (lower) guarantee, and 61 received a repeat loan without a guarantee.

These results indicate that ICCO's efforts to encourage financial service providers to get to know the market segment comprising producer organisations, rural MFIs and SMEs is successful. Financial service providers are starting to discover the attractiveness of these clients, as proven by the 61 repeat loans they have offered without requiring a guarantee. The fact that so far only 10 out of the 236 guarantees issued by ICCO have been called indicates that lending to (well selected) organisations and entrepreneurs is not as risky as many financial service providers believe. <

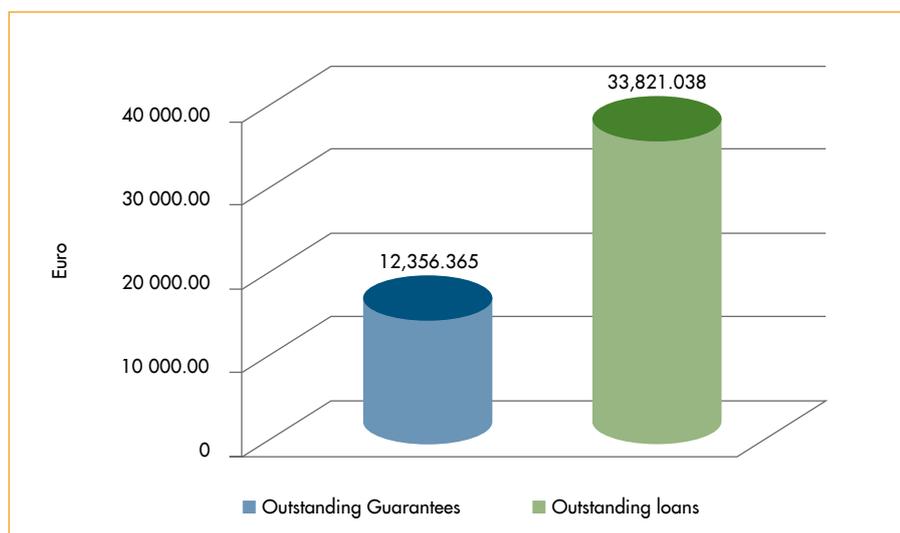
Links

- ICCO Investments: www.icco-international.com
- Triodos Sustainable Trade Fund: www.triodos.com
- Fair & Sustainable Advisory Services: www.fairandsustainable.nl
- Oikocredit: www.oikocredit.coop
- COLDIS: www.coldis.mg
- CABEI: www.bcie.org/?lang=en

Follow-up of the 119 clients who repaid their loans.



ICCO's guarantee portfolio – amounts outstanding as of 31 December 2012 (leverage 1:2.74).



Bridging the pioneering gap



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The impact investment community has been highlighting the lack of investible opportunities in developing countries for some time. There are more late-stage impact funds seeking investment-ready companies with demonstrated social and financial promise, but most opportunities are very early stage and considered too risky from a financial risk/return perspective. A study by the Monitor Group found that of the 84 funds investing in Africa only six were providing early-stage capital.

At Acumen, we use philanthropic capital to address this funding gap when investing in new business models that serve low-income customers. Having invested over US\$80 million in 73 social enterprises over the past 12 years, we collaborated with Monitor to look at the types of funding our investee companies had received. The study found that without philanthropy, many developing-world businesses serving the poor would never have been able to move towards sustainability or scale.

In addition to these funding challenges, another significant challenge is that many entrepreneurs pursue business models in isolation, but without access to past learning and approaches, they often fail.

Resolving this situation requires a two-pronged strategy in which philanthropic funding can play a central role. Philanthropic capital needs to be invested in 1) pioneering firms to support the incubation of innovative businesses that focus on 'bottom of the pyramid' (BoP) customers, and in 2) the documentation and dissemination of knowledge that can help mitigate the risk associated with investing at an early stage and stimulate the flow of capital to these enterprises. At present, there is too little knowledge in the 'system' that can help mitigate the investment risk in pioneering enterprises or help entrepreneurs deal with issues of business model stability and design.

The agricultural sector holds the greatest promise to improve development outcomes. Given the large numbers of farmers in developing countries, and the huge gaps in efficiency and value creation in most agri-based value chains, the sector is a prime candidate for philanthropic and return-based impact funding. Investing in enterprises that focus on small farmers is especially important as it holds the promise of large-scale impact with a successful intervention. Eliminating poverty will remain an elusive goal until serious value-enhancing interventions are made that help strengthen smallholder farmer economics. But the challenges are daunting.

Early-stage agribusinesses

Private institutional investors have traditionally stayed away from agribusinesses because of weak ownership rights and poor enforcement in rural areas, and the prevalence of informal markets. The problems of early-stage agribusinesses are compounded by the high cost of distribution due to the widely dispersed customer base. The cost of developing an enterprise-owned distribution system is often prohibitive, and relying on existing channels can dilute the quality of the customer experience and hence the efficacy of product/service innovation. A closely linked challenge is that of demand creation. Rural BoP communities are invariably conservative, and tend to adopt new products only after several demonstration cycles, which can significantly increase the upfront capital required. Knowledge that captures learning regarding effective BoP rural marketing and cost-effective 'last mile' distribution strategies could be valuable to both early-stage agribusinesses and impact investors.

Channelling capital to pioneering enterprises will yield only limited results in the long run unless significant philanthropic funding is also used to create and disseminate knowledge products describing what has worked, where and why, as well as what has not worked, so that future pioneers can benefit. Such knowledge can help impact investors understand the risks when evaluating early-stage opportunities, and will also improve the chances of success of pioneering entrepreneurs in difficult rural environments. This will create greater value in terms of both financial returns and development outcomes. <

Links

- Koh, H. et al. (2012) *From Blueprint to Scale: The Case for Philanthropy in Impact Investing*. Monitor Group & Acumen Fund.
- J.P. Morgan & Rockefeller Foundation (2011) *Impact Investments: An Emerging Asset Class*. J.P. Morgan Global Research.

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