ARIES

Agriculture, Rural Investment and Enterprise Strengthening Program in Afghanistan

ACDI / VOCA – ARFC Program Brief No. 5

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The Financial Integration, Economic Leveraging, Broad-Based Dissemination Leader with Associates (FIELD-Support LWA)

The ARIES Program is a sub-award under the FIELD-Support Leader with Associates (LWA) cooperative agreement — a single, 5-year award created to both advance the state-of-the-practice in microenterprise development and microfinance as well as assist USAID missions and other operating units to design and implement innovative, integrated, market-based approaches to sustainable economic growth with poverty reduction.

Through sector assessments, program design, technical evaluations, and implementation of multi-year projects, FIELD-Support allows USAID Missions and other operating units to pursue their strategic objectives to:

- Strengthen livelihoods and food security for marginalized groups, youth, women and other vulnerable populations such as people affected by HIV/AIDS and natural disasters;
- Foster enterprise development, job creation and broad-based economic recovery in conflict and post-conflict situations as well as other fragile environments;
- Extend the reach of microfinance and develop more inclusive financial systems;
- Upgrade and improve the competitiveness of value chains in which microenterprises participate; and
- Facilitate institutional strengthening and policy reform for broad-based economic growth.

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ACDI / VOCA–ARFC Program Brief

The following is one in a series of Program Briefs highlighting the experiences and lessons learned under the USAID Agriculture, Rural Investment and Enterprise Strengthening (ARIES) Program. A $100 million, three-year initiative, ARIES aims to create a strong private sector foundation for a sustainable, market-driven rural finance system in Afghanistan. ARIES targets USAID's Alternative Development Program (ADP) regions in the East, South and North of Afghanistan, as well as Herat Province in the West.

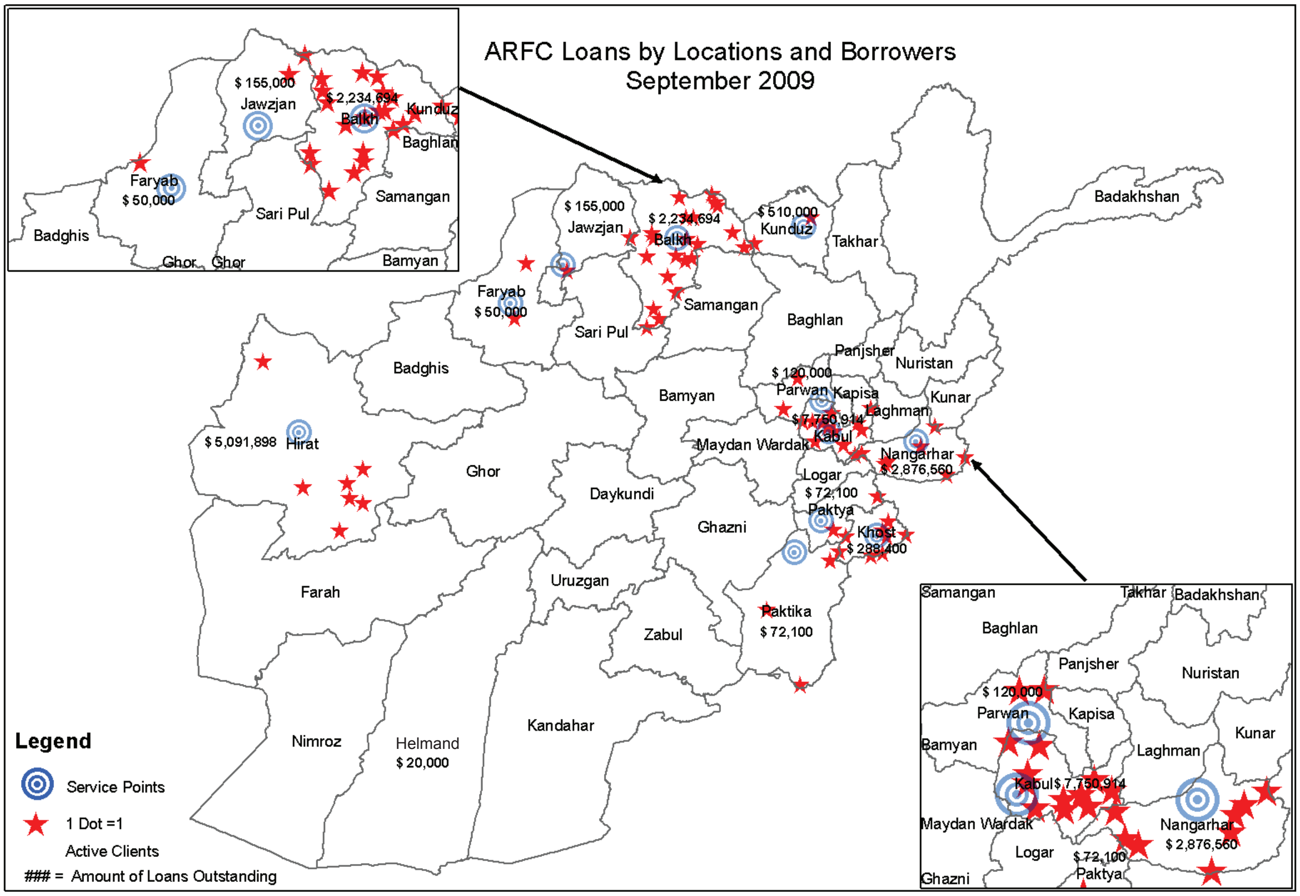
The ARIES Program is managed by the Academy for Educational Development (AED) in partnership with ACDI/VOCA, the World Council of Credit Unions (WOCCU), the Microfinance Investment Support Facility for Afghanistan (MISFA), FINCA Afghanistan (FINCA/A) and ShoreBank International (SBI). Each partner focuses upon a different component of the financial landscape, from household micro-loans of less than $200 to loans of over $2 million to larger scale SMEs. In addition, WOCCU's affiliate in Afghanistan also offers savings services to members.

This Program Brief focuses on the ARIES effort to stimulate lending to small and medium-sized enterprises (SMEs) with ACDI/VOCA through the establishment of an independent finance company, the Afghan Rural Finance Company (ARFC). For more on ARIES support to SME finance, see ARIES Program Brief No. 3, which discusses the creation of an SME wholesale window within MISFA. An overview of the entire ARIES Program is available in Program Brief No. 1.

Activity Profile

Goal: ARIES' objective in supporting ACDI/VOCA's establishment of ARFC has been to advance upper tier SME investment in USAID's target ADP areas. This activity complements ARIES's efforts to promote SME investment at the middle tier through the establishment of an SME window within MISFA. ARIES' SME finance support complements its efforts to stimulate microfinance in rural areas through support of MISFA's microfinance wholesale lending, as well as WOCCU's and FINCA's retail microfinance lending. The primary targets set for the ARFC were to disburse a cumulative total of 57 loans worth US $19.8 million, by the end of the ARIES program in December 2009.

Implementing Partners: ARIES' partner in establishing the ARFC is ACDI/VOCA, a US-based, non-profit economic development organization that employs a value chain approach to enterprise development and finance.



Funding Level: The ARFC is supported through a $25.6 million grant from ARIES to ACDI/VOCA; of this, $17.5 million is allocated to loan capital and the remainder to cover project costs.

Role within ARIES: ARFC supports the upper tier of SME financing with loans ranging from $20,000 to over $2 million. Within the overall ARIES scale, this is the highest level of loan products supported. The program's microfinance partners provide loans of $100 to $2,000, and the MISFA SME window offers loans from $5,000 to $100,000.

Overview

The ARIES vision for upscale SME financing was to create a significant number of sustainable jobs linked to growing value chains in the USAID/Afghanistan Alternative Development Program (ADP) regions. The initial strategy for this involved the creation of agriculture-related cooperatives. However, a study by ACDI/VOCA in early 2007 quickly determined that this approach would not be viable within the project's three year timeline.

As a result, the ARIES strategy transitioned to direct investment in existing cooperatives and other private sector agriculture-related firms. The ARFC was established in February 2007 to implement this revised strategy. This allowed activities to commence almost immediately, and it was more appropriate to the ARIES Program timeframe than the lengthier period which would have been required to develop local capacity. It was also more appropriate to the local conflict context, which called for rapid interventions.

The ARFC's objective is to support the creation of sustainable employment through long-term value chain financing. Its portfolio includes investments in both agricultural and non-agricultural rural SMEs, and in construction and service sector firms. As of September 30, 2009, the ARFC had 66 active clients, most of whom were located in urban and peri-urban areas outside of Kabul. As all are linked to growing value chains, the client firms have significant potential to create jobs in the ADP areas. For example, the ARFC's single largest commitment, which is a $4.3 million loan to the Omaid Bahar Juice Processing Facility in Kabul, is expected to create or support approximately 10,000 full, part-time and seasonal jobs and suppliers' livelihoods.

The ARFC is registered as an Afghan non-profit, limited liability company with the Afghanistan Investment Support Agency (AISA). ACDI/VOCA currently has sole ownership of ARFC. The ARFC Board of Directors comprises two expatriates from ACDI/VOCA and three Afghans.

Operations: With ARIES support, ACDI/VOCA provides the ARFC with a comprehensive technical assistance package, as well as leadership for the ARFC Board of Directors. Currently the ARFC is led by an expatriate management team, and its management will be nationalized over the medium term.

In strategic collaboration, the ARFC has worked closely with other USAID projects, particularly the Alternative Development Program — East (ADP-E) and the Afghanistan Small and Medium Enterprise Development (ASMED) program. These "sister programs" identify and support SMEs that require grant funding and technical assistance, while ARFC provides financing to those SMEs determined to be "investment ready." ARFC also sources deal flow through direct marketing channels independent from USAID project activities.

Areas of Operation: ARFC is headquartered in Kabul; it does not have branch offices. Initially, ARFC had service points in the ADP and other regions managed by Southern Development Company, an Afghan firm, with the aim of establishing an indigenous structure. Subsequently, USAID projects proved to be more cost efficient sources of potential SME clients for originating loans and the previous approach was abandoned.

Financing instruments/products offered

The ARFC offers operational working capital loans via lines of credit as well as short, medium and long term amortizing loans for equipment and business expansion. All loans require the firm to directly invest at least 20% in addition to grants provided through other USAID initiatives, such as ASMED. *Sharia*-compliant financing options are available at costs that compare to ARFC's established annual interest rates.

Performance

As of September 2009, the ARFC had disbursed a total of 84 loans worth a cumulative amount of $19.2m. The ARFC portfolio has an outstanding balance of over $13.8m. Its portfolio at risk is currently 5.1%, with only one write-off to date and a total impairment provision of $400,000. Eight loans fully repaid. The ARFC is almost operationally self-sufficient, with revenues covering 97% of its operational expenses.

ARFC had 66 active borrowers, as of September 2009, with clients all of the ADP regions, as well as in Herat Province and Kabul. Approximately 70% of ARFC's loan clients are sourced through other USAID projects.

Achievements:

With the aim of increasing incomes and creating sustainable employment through long-term value chain financing, ARFC has supported or created nearly 35,000 full time, part-time and seasonal jobs and supplier livelihoods[1] in the ARIES target regions, as of September 2009. Once the apex Omaid Bahar juice plant is operational in late 2009, an additional 10,000 farmers will also be impacted. With the aim of diversifying its risk as a sole provider of large loans to SME borrowers, ARFC has recently co-financed two loans with the Afghanistan International Bank (AIB) and it is actively seeking similar loan participation opportunities with other financial institutions.

Challenges, Adjustments and Lessons Learned

As with all ARIES partners, though the goals have remained the same, the road to achieving them has evolved. ACDI/VOCA and its implementing partner, the ARFC, have faced significant hurdles, particularly as a result of Afghan's limited private investment capital, as well as the ongoing security concerns. The following points illustrate these challenges, how the project has adjusted and the lessons learned for others working in this or similar contexts.

Challenge: *The original concept of working with agricultural cooperatives to create jobs in the ARIES target regions was not realistic, given the project timeframe, local human capacity and the conflict-affected context.*

Adjustment: *ACDI/VOCA revised the initial cooperative development strategy and established a rural finance company, which permitted a more rapid start-up.*

Lessons learned: *In conflict environments, balancing expediency with effectiveness to achieve development outcomes and project results is a constant struggle. In this*

[1] For example, ARFC's loan to the Balkh Dairy helps to provide some 200 dairy farmers with a market for their milk.

instance, the political imperative to demonstrate rapid job creation results — as alternative livelihoods to poppy cultivation and insurgency — required an approach based on existing Afghan SME businesses rather than building new rural organizations over time.

Challenge: *Given the lack of reliable accounting and business transparency, limited credit history, undeveloped legal system and a nascent legal environment in Afghanistan, it is difficult to identify bankable SME clients.*

Adjustment: *To develop a reliable deal flow, ARFC has developed synergistic relationships with other USAID programs that are more focused on enterprise and value chain development. The ARFC is now expanding its client referral sources to include direct marketing, existing client referrals, partnerships with other financial institutions and other donor referrals. In addition, ARFC has examined local and global market trends, such as the increasing demand for tropical juices, to determine which niches Afghanistan could potentially fill, e.g. pomegranate juice.*

Lessons learned: *Partnership with other, more established USAID projects can be an efficient and cost effective way to initially identify and develop trustworthy business linkages. Moreover, the study of global consumer trends can help identify new markets for local produce.*

Challenge: *Rural and agricultural SMEs in Afghanistan are high-risk clients, as these businesses are seasonal and vulnerable to drought and other environmental disasters. Moreover, electricity, roads and the other infrastructure they require is inadequate and unreliable; and agricultural products are generally not competitive with imported goods.*

Adjustment: *ARFC adjusted its initial focus on rural and agriculture-related SMEs to be more inclusive of other sectors which also have a high potential for the creation and support of jobs, which allowed the ARFC to meet its institutional sustainability targets.*

Lessons learned: *Opportunities for sustainable job creation in conflict-affected environments take time to develop, and program flexibility is required to achieve results.Value*

chain financing of urban and peri-urban firms can also have positive multiplier effects on the rural sector.

Challenge: *The business environment in Afghanistan is challenging. The regulatory framework and contract laws are vague; there are limited records, and there is a lack of clarity on land ownership and titling — all of which hinder business expansion and financing.*

Adjustment: *ARFC depends on careful due diligence by its loan officers, local legal counsel and an understanding of both constitutional and Sharia law in determining the adequacy of borrowers' financial and security condition. Its Board membership includes Afghan directors experienced in business conditions in Afghanistan who assist ARFC in navigating the opaque legal and regulatory landscape. ARFC has also contracted with a loan collection agent for loans that become delinquent.*

Lessons learned: *In conflict environments, where legal frameworks, contractual law, and land ownership and titling are unclear or contentious, it is prudent to seek counsel from trusted, influential and qualified local legal professionals, and to partner with authorities who have power to overcome legal and regulatory hurdles.*

Moving Forward

In ARFC's initial two-year pilot phase, the need for and positive response to its services and products have been well demonstrated. Over the medium to long term, ARFC aims to convert to a for-profit entity, by growing its loan portfolio assets and leveraging its donated equity with private sector investments, to ultimately become a commercial lender to support lead firms. ACDI/VOCA intends to continue to operate ARFC under a revised charter after the end of the ARIES program.

To diversify risk, ARFC will continue to develop partnerships with commercial banks for SME financing, as already evidenced by its co-financing of two projects with AIB. Furthermore, ARFC will continue to concentrate its investments in the ARIES target regions, and to work with USAID partner projects in facilitating loan origination.

ARFC's immediate priorities are the opening of the Omaid Bahar Juice Facility in Kabul, which is scheduled for November 2009. Additionally, ARFC participated in a major SME finance conference organized by AED in Kabul in July 2009.

Agricultural Cooperative Development International and Volunteers in Overseas Cooperative Assistance (ACDI/VOCA) is an international development organization that is dedicated to poverty alleviation and broad-based economic growth. ACDI/VOCA's business model of development is designed to increase incomes and wealth, permitting beneficiaries to fully participate in the global economy.

www.acdivoca.org

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