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Using Value Chain Relationships to Leverage Bank Lending: Lessons from Croatia

Expanding lending to the agriculture sector is dependent upon taking innovative approaches to collateral, and examples are emerging to show that an agricultural value chain can be leveraged to promote and strengthen bank lending.

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INTRODUCTION

Croatian banks are beginning to recognize agricultural businesses and family farms as an attractive market segment. However, they will not lend without significant collateral. Banks typically look for collateral coverage of 1.5:1 for loans, and also frequently require third-party guarantors, although it seems unlikely that these could be collected on if needed. Banks will also take bills of exchange and insurance instruments. Interest rates are typically in the 8–9 percent range. Expanding lending to the agriculture sector is dependent upon taking innovative approaches to collateral, and examples are emerging to show that an agricultural value chain can be leveraged to promote and secure bank lending.

In Croatia, economic development and donor attention are largely focused on meeting European Union production and quality standards, so assistance is targeted to firms and cooperatives that can produce at the volumes necessary to cover the expenses associated with greater quality and quantity, rather than to small-scale farmers and agricultural processors. Unlike many emerging economies, Croatia has a sophisticated banking market, including 34 commercial banks, a state development bank, and an active leasing market. To date, the banking market has been particularly focused on consumer credit, and banks are also establishing small and medium-sized enterprise (SME) lending departments and products. However, SMEs still have difficulty meeting bank collateral requirements,

although they have been able to utilize value chain relationships to overcome some of the risk that has kept terms and collateral requirements on agricultural lending so unfavorable. This note documents several innovations used to overcome collateral constraints, thus facilitating access to finance and unleashing the potential of Croatian agricultural sector. These are all clients and relationships that have been supported by USAID's Agribusiness Competitiveness Enhancement Project/Raising Incomes in Economically Distressed Areas project.

These are examples of strong, constructive value chain relationships which benefit all parties—the smallholders receive market prices for their output, and the processors get the volume and quantity of product that they require for operations.

CASE 1: ENSURING PRODUCT SUPPLY FOR LURA DAIRY

Lura is the largest milk processor in Croatia and buys about 50 percent of the total milk produced. It does business with 25,000 Croatian dairy farmers. Lura is focused on bringing the quality of the milk it buys up to European Union standards and is working with larger dairy farmers as well as those poised for more growth to achieve this.

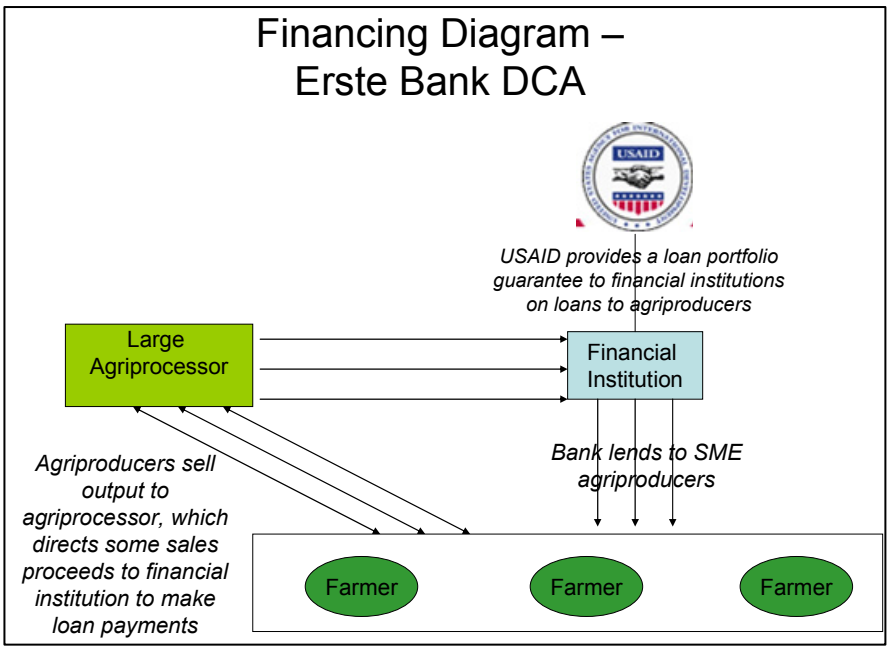
Strategy:

- Decrease the number of suppliers;
- Increase the quality and quantity of milk produced by each supplier;
- Facilitate improved farm production through a special credit program for farmer-cooperants, based on long-term contracts with the farmers;
- Provide flexible business programs for farmer-cooperants (barter transactions); and
- Complement the national Program for Development of the Dairy Sector (national government assistance program).

The Borleni farm is one example of this strategy at work. Milk production is a family tradition for the Borleni family, which had 48 dairy cows, 80 hectares of land, and an average production of 5,500 liters of milk per cow. The family wanted to increase its herd to 200 cows and build a new barn, but already had a $175,000 loan, with almost all assets under lien. After being turned down for a loan of $840,000, the family asked Lura, which bought all of its milk under a long-term contract, for help.

Finance Structure:

- The existing $175,000 loan was taken over by Lura through a debt swap. Farm assets were released from the lien, and the Borleni family will make loan payments *in kind* to Lura; that is, part of the proceeds from milk supplied to Lura will be applied to repay the loan.
- New credit from Erste Bank was structured in two parts:
  - $200,000 loan at 6.49 percent interest rate and 0.75:1 collateral coverage, with Development Credit



Authority (DCA) guarantee

– $600,000 loan, also at 6.49 percent, collateral coverage 1.3:1. These terms are lower than the market, which would be 8.5 percent interest rate and 1.5:1 coverage. They largely reflect the bank's perception of the strength that Lura brings to the loan repayment structure.

Benefits:

- The Borleni family is able to finance herd expansion and new fixed assets. Reduced risk resulting from its proven purchaser and the DCA guarantee is reflected in lower interest rate and collateral coverage requirements.
- Lura has a stronger supplier that is better positioned to meet its quality and quantity requirements.
- Erste Bank has new, less risky earning assets.

This credit structure was also used to finance the growth of four additional family farms.

CASE 2: DEVELOPING BANK CREDIT FOR FARMERS SELLING TO SIZIM

Sizim is a medium-large swine producer and feed processor. In total the company produces 30,000 tons of feed and 30,000 hogs per year. The company also relies on more than 100 smaller farmer/producer cooperants to fatten swine and to produce the grain that Sizim processes into swine feed. Using contractual relationships, Sizim supplies inputs to local farmers, including seed, protection agents, fertilizer for grain production, and piglets and feed for hog production. Contracts specify the quantities to be delivered, prices, deadlines, and procedures.

Challenges:

- Expansion of cooperant farm facilities to more economical size operations.
- Upgrade of cooperant farm facilities to meet quality standards for Danica, a large Croatian meat processor and Sizim's primary buyer.

Finance Structure:

Sizim found support for the farmers for developing business plans and feasibility studies. Sizim also entered into long term contracts with the farmers.

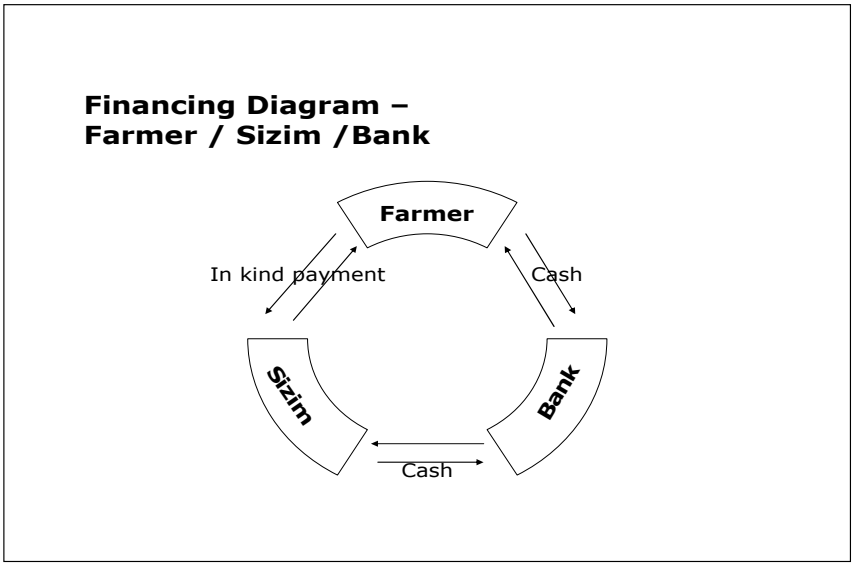
Based on these plans and contracts, Erste Bank committed the first loan package for one farmer:

- $50,000 for new facilities.
- Interest rate 7–7½ percent per annum.
- 10-year repayment period.
- Collateral coverage at 1.5:1.

Sizim itself also provided this farmer with equipment valued at $18,750, plus 70 sows for breeding stock. These loans are payable in kind—fattened pigs.

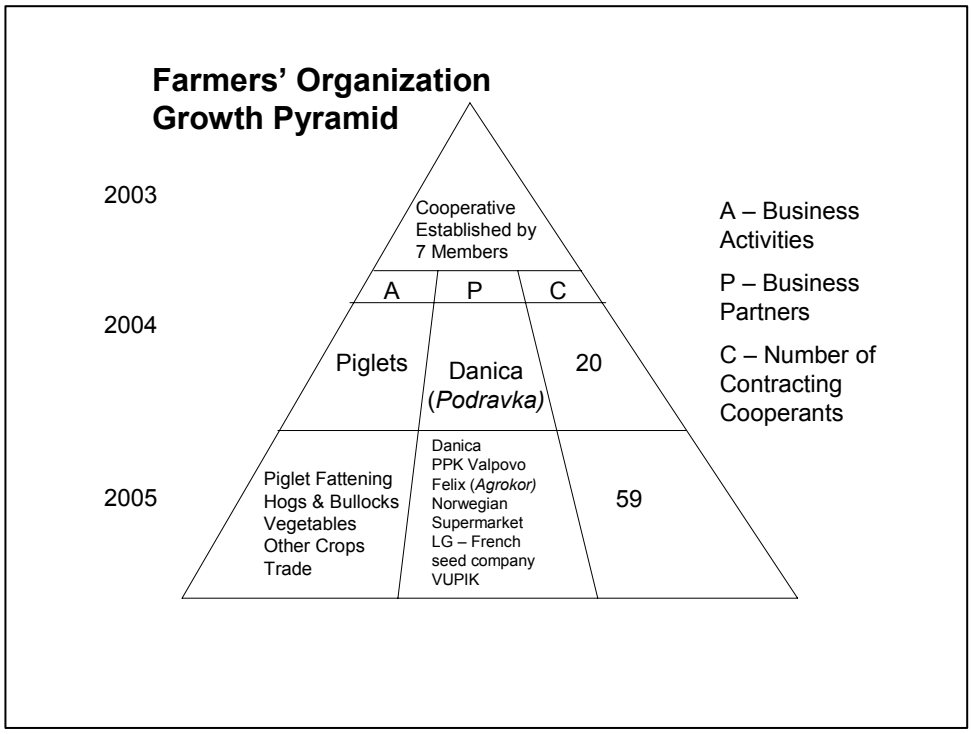
This model will be extended to 10 more farmers in the near future.

As the diagram below indicates, Sizim and the cooperant farmers provide in-kind advances and payments to each other, and each also has loan transactions with Erste Bank.



CASE 3: GAINING ACCESS TO CREDIT FOR COOPERATIVE DEVELOPMENT

The agricultural cooperative AC "Stari Dalj" was founded in December 2003 by seven members. It is located in a traditional swine production area that was devastated during the 1991–1996 war and has been receiving targeted government and donor development assistance. In two years the cooperative expanded its membership substantially, and has sales contracts with major processors and retailers.



Credit Need:

The cooperative needed $18,000 to fund the production season; it did not have any fixed assets.

Finance Structure:

Hypo Alpe Adria Bank committed a loan on standard credit conditions of 8.5 percent per annum and a one-year payment period. The cooperative negotiated to use arable land owned by members as collateral, at a 2:1 ratio.

Innovation:

Historically, rural land has been difficult to value because of relatively few sales transactions. In this case, however, the bank was looking at the strength of the relationships that the cooperative was creating in expanding its product range, client and supplier relationships, and number of cooperants. The bank was willing to accept the local municipality tender prices to value the land in lieu of a land appraisal. This meant that the cooperative did not incur the additional expense, in time and money, of an appraisal. Originally financed with donor grants, the cooperative now uses trade and bank credit.

Progress:

Founded in 2003, the cooperative initially raised piglets that it sold to Danica, the meat processing subsidiary of Podravaka, a major Croatian food processor and packager. By 2005, it had expanded its range of activities, as well as its range of suppliers and buyers, as the diagram above shows.

Jasna Matić, Nada Kožul, and Zoran Cvitić are technical specialists with USAID's Agribusiness Competitiveness Enhancement Project/Raising Incomes in Economically Distressed Areas, implemented by DAI. This microNote *is based on a presentation given at the Broadening Access and Strengthening Input Market Systems (BASIS) Rural and Agricultural Finance Workshop held in Kyiv, Ukraine, in July 2006.*