VALUE CHAIN FINANCE
Understanding & Increasing Access

A Concept Paper

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Understanding & Increasing Access

A Concept Paper

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NOTE TO REVIEWERS

This paper is a work in progress. It is intended to be a starting point for AMAP Financial Services researchers, as well as others working on value chain finance issues, to take an apply and adapt as they see fit. It is fully expected that ideas in this concept paper will be altered and evolve as readers apply their own experiences and understanding to this information, and as we learn more about when and how finance issues are addressed in value chains. Experts coming from a value chain background will likely react to and use this information differently than those from a financial services background.

Changes from earlier drafts include dropping efforts to splice value chain finance into the value chain framework. This is due to a certain feedback. One, there was feedback that the ideas were not speaking well to bankers, and that finance ideas were getting lost. Also, using a project framework tended to over-emphasize donor interventions which could lead to heavier handed interventions than might be called for.

The discussion of why value chains are a microenterprise concern has been removed. I am not sure if this discussion increases understanding or if it detracts from the rest of the paper. I am thinking it detracts. Allyn Moushey also has offered a different discussion around vulnerability language that might be helpful.

Also, it is now recognized that it is too soon to come up with prescriptive guidelines for supporting value chain finance. These guidelines will need to emerge from documentation of field experiences, currently in progress, when we can document interventions that have been made and what has worked and has not worked. E.g., for example, under AMAP we are currently reviewing projects supporting warehouse receipts financing. Lessons learned from that study will help inform more formal guidelines.

After a few different approaches of using, adapting, and even discarding ideas in this concept paper, around mid 2008, we can come together and see how these ideas, and others, are playing out in practice. At that point we will be in a better position for deciding whether there can or should be one definitive guide for addressing value chain finance.

Comments, contributions, and alterations are welcome. It has worked very well with previous drafts to have persons meet with the author in person with their comments. That mode is leading to useful discussions and increased understanding on both sides.

CONTENTS

ACKNOWLEDGMENT **II**

NOTE TO REVIEWERS **II**

CONTENTS **III**

I. BACKGROUND **1**
VALUE CHAIN FINANCE & MICROFINANCE PROVIDERS 1
VALUE CHAIN FINANCE FOR OPERATIONS & UPGRADING 3

II. DATA COLLECTION & ANALYSIS **5**
INFORMATION SOURCES 5
INFORMATION ANALYSIS USING THE "4-A FRAMEWORK" 6

III. ADDRESSING FINANCIAL CONSTRAINTS **10**

IV. SUMMARY **11**

V. RESOURCES **12**

I. BACKGROUND

The value chain is a progression of value adding activities, beginning with raw material and ending with the sale of the finished product or service.[1] The value chain approach can be used to both promote economic growth as well as reduce poverty, at least the degree of poverty. This is done by intervening in value chains in which a large number of poor households are or can be engaged.

As the USAID Economic Growth Strategy points out, the key to ongoing growth is increasing productivity at the firm level, including producers of all sizes, "from the family farm and the vegetable seller with a handcart to the largest global corporation". For the most part, microenterprises and resource poor households will be engaged in activities at the lower end of a value chain, the farms and handcart vendors, and possibly at the level of supplier and processor. Yet, increasing productivity at this level can have impacts both on overall value chain productivity, as well as at the household level.

However, constraints within the entire value chain have to be considered, or increased productivity at the farm level, for example, could simply result in over-production and increased poverty. When microenterprises are seen as part of the entire chain, it then becomes more apparent how helping the entire chain become competitive will increase the economic well being of microenterprises. This is not a "lift all boats" assumption, but rather a recognition of the inter-dependence among value chain actors. In some cases, after a value chain analysis, it may become apparent that the best way to help those households and microenterprises at the lower end of the value chain is to intervene at a higher level of the value chain. That is, the main constraint to their productivity might be a policy issue. Or, the main constraint might be financing for the manufacturing sector related to this value chain, etc.

Effectively addressing the constraints and productivity potential of microenterprises requires addressing the entire value chain of which the microenterprises are a part. For donors and practitioners most familiar with microenterprises and microfinance, addressing the needs of microenterprises as value chain actors will require obtaining a new perspective or expertise and probably forming new alliances with financial and industry specialists more familiar with other actors and issues in the value chain.

The purpose of this concept paper is to discuss value chain finance in more depth than it has been previously been discussed. This paper presents a conceptual framework for thinking about financing issues in the value chain, including direct versus indirect financing, the uses of financing, and a framework for analyzing and addressing constraints to finance.

VALUE CHAIN FINANCE & MICROFINANCE PROVIDERS

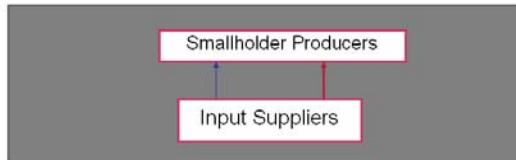
Finance can reach value chain actors in two forms:

1. INDIRECT. From outside the value chain, through financial institutions, or family, friends and other informal sources.

2. DIRECT. From other actors within the value chain, e.g., from suppliers or buyers

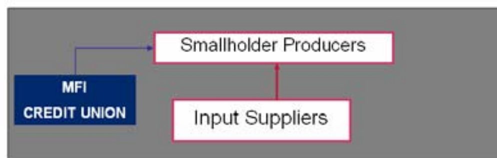
[1] For a more in-depth understanding of value chains, consult: http://www.microlinks.org/ev_en.php?ID=9652_201&ID2=DO_PRINTPAGE

In some cases finance is provided along with other services, e.g., technical advice or inputs, in which case it is referred to as "embedded". Often finance is flowing to and through a value chain both directly and indirectly, and there are advantages and disadvantages to both sources of financing.[2] For example, suppliers and buyers may be optimally placed to understand trends in the value chain and the capacity of the borrower, but financing from these sources may be limited, and may also limit the lenders' investment in their own enterprises, thus affecting their own bottom line and the competitiveness of the value chain. Financial institutions may not have a good understanding of the value chain, and may under-lend or offer products not well suited to the value chain needs. How financing is provided will depend on will depend on pay offs / incentives from within and outside of the value chain.



Two challenges face the microfinance industry when approaching value chain finance. The first challenge is recognizing when finance is not the binding constraint, or the only binding constraint in a value chain. And, the second challenge is recognizing when finance at the micro level (or "microfinance") is not the binding or only binding financial constraint in the value chain.

The financial sector is a key market supporting the development and successful production and marketing within value chains, but it is not the only supporting market. Other supporting markets include, for example, transport; information and communications technologies; and business support services, such as accounting. MFIs will want to know that non-financial constraints are being addressed so that their clients receive optimal return for their products and are therefore better able to repay loans, and benefit from other financial services offered. For example, a value chain that does not have adequate grading services may result in producers not obtaining the highest possible price for a higher quality product. As this suggests, microfinance providers may benefit from the services of industry specialists, who can keep the MFI informed on industry issues. This will be especially important for MFIs with a high proportion of their portfolio in specific sectors.



[2] For further discussion on this see "Value Chain Finance". RAFI Note Number 2. Geoff Chalmers.

Once finance is understood to be just one factor in the competitive functioning of a value chain, it is easier to prioritize interventions, recognizing that finance may not be the binding constraint in a value chain.

In addition to placing finance within the context of other possible services needed, a second challenge for the microfinance industry, when approaching value chains, is the need to recognize the role of financial services at all levels of the value chain. Frequently, because their target clientele is at the base of the chain, at the production levels, microfinance professionals consider only financial needs at that level, in particular finance for production inputs. And, while the types of financing needed at higher levels of the chain may be beyond the capacity of a microfinance institution (MFI) to deliver, any microfinance institution should be aware of other financial constraints within the value chains of the clients they are serving. These MFIs may wish to partner with other financial service providers in order to ensure that the value chain is being adequately financed at all levels, and that products of their clients do not face bottlenecks at higher levels in the value chain.

In addition to both of these challenges, MFIs will need to step back to see the bigger picture and partner with other financial and non-financial service providers.

VALUE CHAIN FINANCE FOR OPERATIONS & UPGRADING

Finance to value chains is used in one of two major ways:

1. To provide cash flow for continued operations (operating finance), or
2. To improve or "upgrade" operations (upgrading finance) in one or more ways.[3]

Financing for continued operations includes, for example, input financing to maintain current production, or a line of credit to support export to existing markets. Financing for upgrading includes finance to improve or change operations. Finance for upgrading can be used in one or more of the following ways:

Process: To improve production processes in order to increase production efficiency and reduce unit costs;

Product: To improve quality and variety of products, increasing value to consumers;

Functional: To move into a new level of the value chain, e.g., moving from production to marketing;

Channel: To move into a new pathway leading to a new end market, e.g., moving from production for domestic sales to production for export; and

[3] For an interesting discussion on upgrading see Lessons Learned on MSE Upgrading in Value Chains: A Synthesis Paper. Elizabeth Dunn, Jennifer Sebstad, Lisa Batzdorff, and Holly Parsons. USAID. April 2006.

Inter-chain: To move into a new value chain, for the production of a different product.

Analysis is needed to determine when and to what degree to make these upgrading changes, beginning with a realistic assessment of the end market demand and supply issues. The value chain analysis will verify whether or not the value chain is competitive, and the type and extent of upgrading needed to achieve or maintain competitiveness. Value chain analysis and mapping will identify where upgrading will have the biggest impact on chain performance, and the degree to which this upgrading opportunity is constrained by a lack of finance.

Different types of upgrading will require different levels of investment and will likely yield different benefits. For example, product upgrading may require less investment and yield greater net profits than process upgrading. Financial products will vary depending on the type(s) of upgrading being pursued.

Upgrading, which can require substantial capital, only makes sense when the investment will result in a financial return in a reasonable period of time. Without careful analysis, the financial returns may not be obvious.

The decision to upgrade will be based in part on the incentives to do so. However, individual firms may unable to assess the value of upgrading, and may either over- or under-invest. For example, in Mali an entrepreneur sought financing to build a refrigerated warehouse for potatoes. He felt that he could then preserve potatoes for marketing during low production seasons, competing with imports. On the surface, this made sense. However, in reality, taking into account energy costs, the entrepreneur would not have been able to sell potatoes for less than the imported potatoes, even taking into account the transport costs borne by the importer. Conversely, because of a lack of information, an individual firm may be unable to recognize the benefits that upgrading will yield, and forgo investments that could increase their profits.

The same is true for donors who often lack the industry information needed to make or refrain from making investments in value chains. Supporting financing for upgrading (or worse, supporting finance for finance sake) can result in investments with little or no payoff. When finance is promoted for a sector or for one type of upgrading within a sector (e.g., improved seeds or fertilizers or export to reach new markets) without a full view of the sector or value chain or competitiveness issues, resource poor households and firms can be put at considerable financial risk. For that reason, donor support for financial services to a sector should be considered as part of a carefully developed competitiveness strategy.[4] The assessment of financial services is part of the assessment of other key supporting markets in a value chain. Addressing financial services within this broader analytical framework will result in a better understanding of the finance availability and needs specific to the value chain, and allow for the prioritization of finance along with other potential constraints.

Industry support to microfinance institutions to move into financing of value chains requires the same careful consideration. That is, supporting product development for targeted value chains must include careful assessment of end market demands and overall competitiveness.

The following section is intended to guide in part the decision to understand and support value chain finance either by donor activities or microfinance industry leaders. This is not intended to be a comprehensive guide to supporting value chain finance.

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[4] For more on this, please see Globalization and the Small Firm: A Value Chain Approach to Economic Growth and Poverty Reduction. AMAP Publication: microREPORT #42. Olaf Kula, Jeanne Downing, and Michael Field. 2006.

II. DATA COLLECTION & ANALYSIS

Financial services may be a constraint in certain value chains and not others, and/or at certain points along the value chain. However it is impossible to know without preliminary mapping and analysis of the overall value chain to understand end-market constraints and opportunities and the upgrading needed to address those constraints and opportunities..

Once a sector or value chain has been selected as a potential candidate for intervention, industry and firm level information is collected and analyzed. Information on financing is collected along with other value chain information from industry stakeholders and firms. In addition, financial providers in and outside of the value chain are consulted to determine the degree to which financing is already available, and where any finance gaps exist. Finally, any enabling environment and financial sector issues which may be impacting on finance availability will need to be identified.

INFORMATION SOURCES

The types of questions to be asked of different players include (but are not limited to):

VALUE CHAIN ACTOR / FIRM

Questions to discuss with firms within the value chain include whether financing is received and from whom, in what form. Describe the financing (terms, timing, size, timing, interest rate, collateral required, etc.). Discuss the degree to which financing matches or does not match needs, and any challenges encountered around financing. When financing is provided by a value chain actor, discuss how they came to provide or receive the financing and any challenges facing that actor. Also try to assess the opportunity costs to the actor of providing finance; that is, are there investments the value chain finance provider is forgoing in order to provide financing within the value chain. In addition, for recipients of the finance, identify any constraints they face because of receiving financing in the way they do, e.g., loss of market-based decision making power.

FINANCIAL SERVICE PROVIDER

When talking to financial institutions determine the degree to which financing is provided to the value chain of interest, where in the value chain, and the terms of the financing. If financing is not provided in this value chain, determine if financing is provided in a similar value chain. Also determine the degree to which the finance provider is familiar with this or similar value chains. Also discuss with the financial institutions how they obtain industry information and information about firms in that industry.

GOVERNMENT AND OTHER ENABLING ENVIRONMENT ACTORS

Enabling environment information and issues will likely emerge during conversations and interviews with the above actors. In addition, government officials, donors, and industry groups should be interviewed in order to further identify enabling environment conditions, constraints, and opportunities. Some, but not all, of the actors who should be contacted include

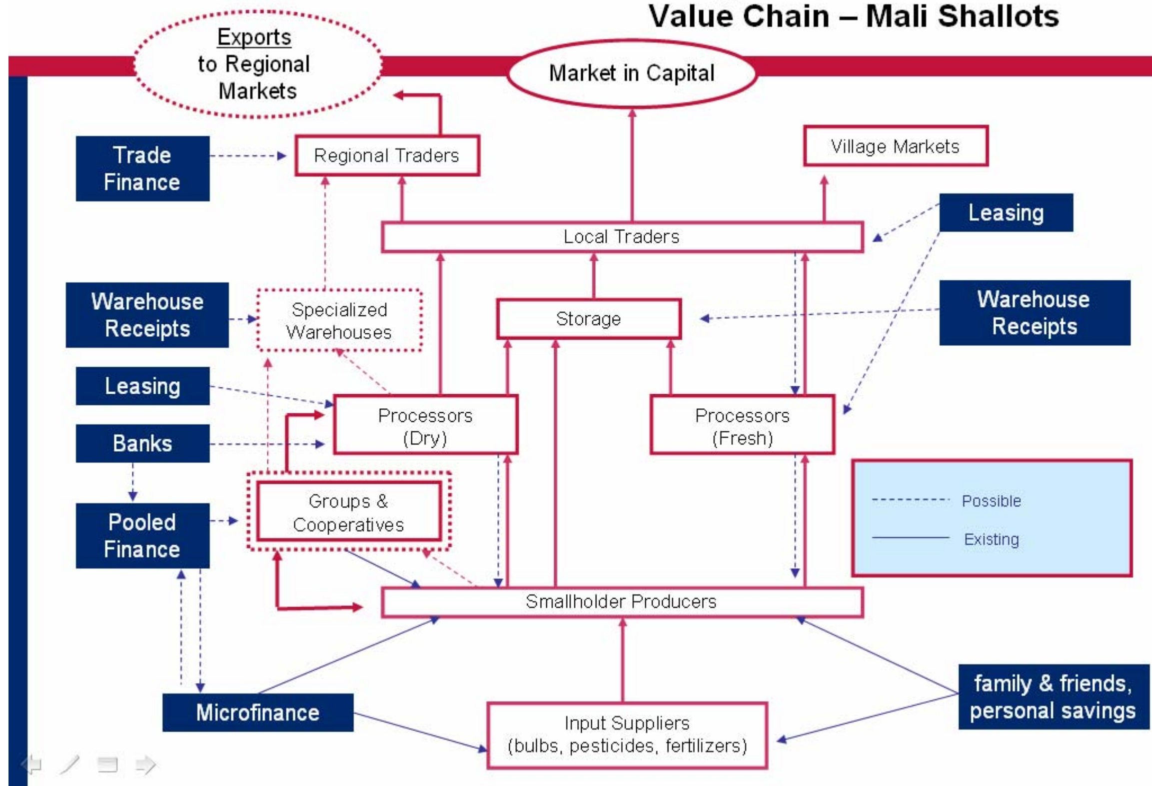
representatives from pertinent ministries, such as Trade, Commerce, Agriculture, Labor; the Central Bank; as well as key donors and industry players or associations.

INFORMATION ANALYSIS USING THE "4-A FRAMEWORK"

Once information is collected it needs to be put into a meaningful framework for analysis. A schematic of the value chain showing product and financial flows is a useful first step. This schematic helps identify overall finance gaps, which can result in the underperformance of a value chain. In particular, gaps in financing preclude upgrading investments that can increase the performance of the value chain, as well as income to individual firms. One of the benefits of value chain analysis is that it helps us identify these gaps. So instead of just looking at what exists within a value chain, it is possible to look at what is missing or what else could exist that would help to develop and/or strengthen a value chain.

Below is a schematic which presents a summary of product and financial flows, current and possible in the Mali shallot value chain. The schematic shows the current finance that is available (the solid blue lines) to the various value chain actors, from within (i.e., from other value chain actors) and from outside the value chain (from financial institutions), as well as a summary of the remaining needs (i.e., the dotted blue lines showing gaps in access to finance). As is common in many developing countries, Mali's agricultural sector, represented here with shallots, especially suffers from a lack of access to medium and longer-term finance needed to upgrade processing, production, and storage systems especially, but also to expand wholesalers' import and export capacity.

A diagram of the value chain provides an overall snapshot, but does not help to explain why the value chain is not fully developed, and why financial flows are lacking. Factors which may affect the availability of financing include, but are not limited to, misperceptions around the value chain (over-estimation of risk or under-estimation of market potential); a poorly developed market; power relationships which distort the free flow of information, finance and other goods and services; and/or weak supporting markets or enabling environment, e.g., transport, business services, quality standards, trade barriers, etc.



This paper presents a conceptual guide for looking at financial flows, informally known as the "4-A Framework." The 4-A Framework is intended to provide a logical sequence for looking at financing at each point in the value chain from four distinctive vantage points:

1. The enterprise or upgrading activity
2. The entrepreneur
3. The financial product
4. The financial provider.

The purpose is to get a better understanding of why financing is lacking and what can or should be done to address financing needs.

The issues to be considered when looking at finance for operating or upgrading value chains can be grouped under four key questions, which correspond to these four vantage points. The key questions are:

1. **Is the activity "bankAble"?** Simply, will the upgrading pay for itself in a reasonable period of time? I.e., are there incentives to upgrade? What are they? What kind of upgrading makes sense?

2. **Does the value chain actor have the needed know-how or "Acumen" to get optimal return from this financing?** That is, can the value chain actor obtain and apply the financing in a profitable way?

3. **Is the financing needed "Accessible" to the user?** That is, is the financing in the form needed (product, size, and term) and is it geographically accessible?

4. **And, finally, is the financing "Available"?** Does the finance provider have the industry information they need to make an informed decision? Can the financial provider effectively and accurately assess and mitigate risks and cover costs in order to make the financing available?

Depending on the analysts vantage point, the questions may be addressed in a different order. E.g., those with an entrepreneur or farmer focus, may begin by looking at the capacity or "acumen" at that level, and proceed next to accessibility, availability, and bankability. The main point is that all levels need to be considered before developing an approach.

There are also other more intangible issues to consider. For example, how factors such as horizontal and vertical linkages, cooperation, and governance structure affect or could affect the demand, supply, and use of finance.[5]

Below are examples of more detailed questions that can be used to assess factors affecting financial flows and to make sense of the data collected from the value chain actors. Information collected from value chain actors, finance providers, and enabling environment actors is used to address these questions.

BANKABILITY

Based on existing markets, market trends, market share (local, regional, global), is there growth potential for this value chain? (i.e., is there strong end market potential?)

Can firms more profitably & productively reach these end markets by upgrading? Which type(s) of upgrading make the most sense, i.e., which will have the highest returns. How long will it take to achieve return? What will cash flow realistically look like?

Do firms have knowledge of and access to the best, most appropriate equipment/technologies available in order to achieve the highest level of productivity (output per inputs) as possible?

What other factors affect or might affect returns on investment in upgrading, e.g., enabling environment issues, linkages, cooperation, supporting markets (business development services, transport & logistics), etc.

ACUMEN

Do firms have the know-how they need to make informed and rational *upgrading* investments? For example, do they know what to produce, how to produce it? Do they have information needed to know, for example, whether to purchase or use saved seeds? Do firms have the information they need to make informed and rational *financing* decisions, i.e., where and how to

[5] See for example, "The Governance of Global Value Chains" by Gary Geriffi, John Humphrey, and Timothy Sturgean. Review of International Political Economy. 12:1. February 2005: 78-104.

get finance, and what financing options are available. And, do they have the motivation / incentives to make and carry out these decisions?

Do firms have the power they need to make upgrading investment of their choice? Do firms have the power they need to make financing choices, or are they finance "takers", having to take what ever finance is offered them?

How are information flows and power relationships affecting or being affected by horizontal and vertical linkages? Is any absence of information and power resulting from or causing weak horizontal or vertical linkages and a general lack of trust?

ACCESSIBILITY

To what extent are financial products accessible and usable to the firms? Are financial products well designed to meet the needs of clients (size, term, time/season available, etc.)? Does loan delivery and repayment match borrower cash flow needs and availability?

Are savings, credit, insurance, and transfer services readily available?

Are technologies available & used to bring financial services close to the client i.e., are products physically and geographically accessible?

AVAILABILITY

Analyze the financial institution capacity to make the right kind of financing available. Do financial institutions have an accurate understanding of the value chain in question? Do they have access to client, commodity, sector, and industry information and expertise in order to accurately asses opportunities and risk? Do they have the liquidity to make any longer term financing available? Does the finance provider have the portfolio diversity to offer financing to this value chain? And, are there incentives for the finance provider to engage in this value chain, i.e., do benefits outweigh risks?

Analyze the enabling environment issues that might be affecting the financial sectors. E.g., Does the legal & regulatory environment support open financial markets? Is the government effectively controlling interest rate and foreign exchange risk? Is there competition from government bonds or finance institutions? Are contracts (implicit or actual) respected and enforced? Do collateral laws exist and are they enforceable? Do policies effectively reduce financial sector risk?

Again, financing should be addressed as part of an analysis of the entire value chain.[6] The analysis will help determine, what if anything, needs to be done to make financing available, accessible, and better used. Financing should be considered both from the financial sector (indirect) and from value chain actors (direct).

And, it should be determined whether financing should be directly supported and/or whether non-financial interventions are needed to making financing more available and effective.

[6] See for example, *Making Value Chains Work Better for the Poor: A Toolbook for Practioners of Value Chain Analysis*, as one possible guide.

III. ADDRESSING FINANCIAL CONSTRAINTS

Once it has been determined that a value chain will benefit from upgrading, the next step in addressing finance constraints is to identify what financing is already available, and to determine whether this financing is appropriately designed in terms of risk mitigation (for both the lender and the borrower), product design and delivery, and optimal functioning of the value chain.

A challenge for donors and governments is determine ways to support a value chain without undermining private sector solutions. Interventions should be geared toward facilitating private sector solutions, addressing market failures, and ensuring a functioning enabling environment.

Donors, governments, and socially responsible finance providers may wish to address the market failures or political economy of inancing, i.e., does existing or proposed financing result in the uneven distribution of power, benefits, and risk within the value chain? Other considerations include, if, and to what extent, enabling environment issues will need to be addressed in order to increase access to finance and the competitiveness of the value chain. Donors may wish to facilitate product development process including market research, pilot testing, product refinement, marketing and roll-out.

Financial providers also need to understand the entire value chain before proceeding. In addition, they will need to understand the borrower/lender cash flow cycles in their entirety, not simply within the given value chain. This is particularly true at the micro level where households may be engaged in more than one value chain or economic activity at the same time or sequentially. Simple data collection methods, such as seasonal calendars, can help finance providers better understand household / firm / farm cash flows, and incorporate this understanding into risk assessment and product development.

Financial service providers may find that they need to form strategic alliances, i.e., working with industry experts or financial service providers at other points in the value chain.

Examples of donor or government value chain finance interventions which might emerge from value chain analysis, grouped by the 4-As include, but are not limited to:

bankABILITY: Any interventions in the value chain which increase the returns to investment in upgrading.

ACUMEN: Interventions which increase information flows to value chain actors so that they can make informed choices. Interventions which increase and equalize the power among value chain actors. Interventions which increase trust among value chain actors.

ACCESSIBILITY: Interventions which make finance more accessible, e.g., support to finance providers to develop new financial products, Support the financial flows within the value chain, from higher value chain actors to those at lower levels. Interventions which support technology use to make financing more available to rural actors.

AVAILABILITY: Interventions which increase financiers knowledge of the value chain and willingness to lend. Interventions in the enabling environment which reduce risk or the perception of risk, e.g., warehouse receipts financing, inflation control, foreign, exchange risk, credit bureaus.

IV. SUMMARY

To summarize, value chains are a concern to the microenterprise and microfinance industry because poor households do and can contribute to and benefit from engagement in dynamic value chains.

While the comfort level of the microfinance / microenterprise community may be in working with producers and enterprises at the lower end of the value chain, the entire chain must be taken into consideration.

Donors and governments may be in a better position to address the entire value chain and constraints in their programs and activities than MFIs and NGOs who focus on the lower end of the value chain. However, they will need to guard against undermining private sector market solutions.

Financial providers and NGOs can make significant contributions to value chain development, particularly if they are willing to partner with other actors involved in the value chain.

An analysis of the entire value chain needs to be conducted in order to better understand the extent to which financing is a constraint, where in the chain it may be a constraint, and whether there are other pre-disposing conditions impeding the access and best use of capital.

The first step to addressing a value chain is to understand end market demand. Too often, this end market demand is not taken into account. This can result in under-investment in the value chain, when potential is not realized, or over-investment, when potential is not understood or over-estimated.

Financing is needed for both on-going operations as well as for financing improvements (upgrading) that take advantage of new market opportunities. Upgrading can be in the form of new products, processes, functions, or market channels. Operating or Upgrading financing can be either direct (from within the value chain) or indirect (from finance providers outside of the value chain). In either case, the financing provided will have advantages and disadvantages for various actors in the chain, and may have varying impacts on value chain productivity.

Reviewing the actual and potential financial flows at all levels of the value chain, and understanding factors affecting the bankability of enterprise activities, the acumen of the entrepreneur, the accessibility of finance, and the availability of finance will help to ensure a better understanding of any market failures within a value chain.

Donors and governments must carefully assess what their role is with respect to supporting value chain development. Their role may be one of facilitation, ensuring that the enabling environment supports the optimal flow of resources and goods and services. On the other hand, donors and governments may wish to directly tackle market failures within a value chain which result in poor information flows, imbalances of power, and exploitation.

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