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WORKING WITH LEAD FIRMS WITHIN THE VALUE CHAIN APPROACH

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I. INTRODUCTION

In the field of private sector and value chain development, practitioners frequently come across dynamic firms that play a critical role in moving their industry and other value chain participants forward. The objective of this paper is to explore the topic of working with such lead firms in a value chain context.

The paper begins by defining a lead firm. This is followed by a discussion on the rationale and importance of working with lead firms to achieve sustainability and scale of impact with micro, small and medium-scale enterprises (MSMEs) as well as greater industry competiveness. The incentives and challenges of lead firms are then presented, followed by a discussion on how broad-based impact can be achieved. The final section explores the role of development organizations in developing and managing collaboration with lead firms.

II. DEFINITION OF LEAD FIRMS

For the purpose of this paper, lead firms can be defined as small, medium, or large firms that have forward or backward commercial linkages with a significant number of MSMEs. Examples of lead firms include buyers, traders, input suppliers, veterinarians, exporters and processors. Lead firms often provide important products or support to the MSMEs they buy from or sell to, as part of their commercial relationships with them. Examples include training, technical assistance and inputs. They are often engaged in aggregating the production of MSMEs, adding value to raw materials, and selling finished products in domestic and international markets. Lead firms can vary significantly in size and may operate as part of either the formal or informal economy. They are often key innovators and respected thought leaders in their industries.

III. RATIONALE/ IMPORTANCE OF COLLABORATING WITH LEAD FIRMS

There are a number of reasons that private-sector development programs might choose to work with lead firms. These include the possibility of achieving sustainability of impact, scale of impact, development of embedded support among market actors and greater industry competitiveness.[1] These are described in more detail below.

SUSTAINABILITY OF IMPACT

Working with lead firms can help ensure the sustainability of a development program's impact. This is because the lead firm is a commercial enterprise that does not depend on donor subsidy for its existence (as a development program or donor subsidized-organization does). If a lead firm has a commercial interest in buying from, or selling to, a large number of MSMEs (and can do this in a commercially viable manner) then it will continue to do so after a development program ends. It will therefore be able to sustain the relationship it has with MSMEs, along with the different kinds of support it provides.

A common problem with development organizations is that they are established or establish other entities as active participants in value chains (buying from or selling to producers, distributing heavily subsidized or free products to producers, providing support market functions, etc.). This is often done based on a rationale that existing market actors are unable to perform these functions or are acting unfairly to MSMEs. The problem of sustainability arises once the funding of the development organization (or the entity they were subsidizing) ends, and the functions they had been performing also end, leaving MSMEs in a difficult and sometimes worse position. Working with lead firms

[1] For the purpose of this paper it is assumed that the development project has an objective of impacting a large number of MSMEs and their employees (and that the term MSMEs includes farmers). The importance of large companies that have few forward or backward linkages with MSMEs is not discounted (as they help increase employment, create foreign exchange, etc) but the rationale for working with such companies is different.

can help address this problem—as they can support themselves and their ongoing relationships with MSMEs in a sustainable manner through their commercial activities.

SCALE OF IMPACT

By working with several lead firms in a value chain, each having commercial relationships with a large number of MSMEs, a development organization can multiply the scale of its impact. For example, if a development organization is working with four lead firms, each with linkages to 250 MSMEs, then the potential impact of working with those four firms is 1000 MSMEs. This concept is also referred to as "leveraged impact." Lead firms can be considered "points of leverage" in a value chain because by working with a few lead firms, many MSMEs can be impacted.

Leveraged impact through lead firms can be achieved in different ways. If an implementer can facilitate greater market access for lead firms (that are purchasing from MSMEs), then those firms can source from more producers or source greater quantities from existing producers. Leveraged impact can take place when lead firms (with capacity building from a development organization) provide the MSMEs they source from with improved production methodologies, designs and technical support. It can also occur when a development organization works with an input supply company to improve the quality, price or availability of products sold to MSMEs.

PROVISION OF "EMBEDDED" SUPPORT

As seen above, lead firms often provide products, services, and solutions to the MSMEs they buy from or sell to, as part of their commercial relationships with them. Examples include:

- lead firm buyers who offer pre-financing, technical advice and/or inputs to their MSME producers in order to ensure a quality product that meets market standards; and
- lead firm input suppliers who provide training, information, and/or technical advice to the MSMEs they sell to in order to ensure successful usage of their product.

In many cases these products and services are provided by the lead firm on a non-fee basis to the MSME (the cost being absorbed in their operating margins). This can be advantageous to MSMEs who lack the scale or financial stature to pay cash to independent providers. By working with lead firms to improve or expand their capacity to provide these kinds of embedded support, development organizations can have a positive and leveraged impact on MSMEs.

GREATER INDUSTRY COMPETITIVENESS

Lead firms are often major market actors, innovators and first adopters in their industries. Their abilities to produce quality products and services and compete in national or international markets have a direct bearing on the competitiveness of their industries. They can also be the drivers of growth for the MSMEs they transact with and play a key role in promoting change or improvements in their value chains. Development organizations can assist lead firms to overcome constraints and take advantage of opportunities that in turn create benefit for the MSMEs they buy from or sell to, and strengthen the overall competitiveness of their industry.

IV. INCENTIVES AND CHALLENGES OF LEAD FIRMS

This section will explore the incentives and challenges that lead firms have in making investments in the value chains they operate in. These investments often include developing or improving training, information, inputs, and technical support for the MSMEs they transact with. By supporting lead firms to pursue incentives and address challenges, development organizations can have a positive impact on both the competitiveness of the value chain and participating MSMEs.

INCENTIVES

Lead firms that source from MSMEs frequently have incentives to upgrade these producers in order to obtain quality product that they can then sell, finish or use in their production processes. Vegetable exporters, for example, need high-quality products that meet import specifications. Snack food producers need raw materials that meet their consumers' preferences. Milk producers need milk that is not adulterated or spoiled. Craft product exporters/buyers need to introduce new designs and production techniques to the craftspeople they source from in order to stay competitive in their end markets. In all of these cases there can be incentives for lead firms to invest in the upgrading of their producers so that their own finished product will be of high quality and acceptable to their end markets.

Managers of outgrowing operations (lead firms that source directly from farmers and provide them with a variety of support) frequently point out the need to increase the productivity of their farmers by at least 20-30 percent in order to make their outgrowing operations viable. This is because if farmers are more productive (producing more on the same amount of land), then the company that is buying from them can get the quality production they need from a smaller number of producers, thereby keeping their operational costs in check (the more farmers they buy from the higher their transaction costs). This is a good example of the kind of incentives that lead firms often have for upgrading the producers from whom they purchase.

Lead firms that sell inputs or services to producers also have incentives for upgrading the producers they transact with. A provider of crop inputs has an incentive to train producers in the advantages of using those inputs and also of how to use them successfully (sometimes a good input will not work if it is not used or applied correctly). A veterinarian has an interest in promoting the development and expansion of producers' herds as this can translate into more business as well as a greater ability of the producer to pay service fees. A provider of animal feed has an incentive to train producers in the optimal formulation of feed for their animals. These investments by suppliers often make good business sense as they create loyalty with the MSMEs who purchase the goods or services and encourage them to continue buying from the supplier. It can also help ensure the success of the supplier's product and result in increased sales.

Lead firms in other types of value chains also have incentives for investing in the MSMEs with which they collaborate. In the tourism sector, for example, tour guides often have an incentive to help village-based tourism entrepreneurs to develop interesting attractions for their clients. In the construction sector, larger firms often have an interest in developing the capacity of their smaller subcontractors, especially when they are under pressure to include these contractors in their bids. Building the capacity of their subcontractors can help ensure that the entire project is cost effective and successful.

CHALLENGES

Lead firms often face challenges, however, in supporting or upgrading the MSMEs in their value chains. Lead firms that have only sourced their products from intermediaries or in open markets often lack the understanding or capacity to work directly with producers. In other cases, buyers and their staff lack the technical skills needed to train or advise producers in new production techniques, designs, and more cost effective operations. Sometimes the lead firm's constraints are due to low margins on their sales (leaving only a small margin that can be used for investing in producers) or to low sales in general. In other cases the lead firms may be too busy with the daily operations of their business to focus effectively on developing support services for producers or subcontractors. Lead firms may also lack understanding of the benefits, risks, economic feasibility and long-term advantages of investing in their MSME suppliers and buyers. They might also hesitate to invest in producer upgrading fearing that producers might then sell or buy from their competitors. Many of these challenges can be addressed with the support of a well-designed and executed development program.

DIRECTED GOVERNANCE STRUCTURES AND BENEFITS FOR MSMES

Lead firm investment in upgrading the MSMEs that they buy from or sell to often implies a more "directed" governance structure between the market actors. In a directed governance structure, lead firm buyers play an instrumental role in determining the products that their suppliers will produce as well as the product specifications. In return, they often provide technical support, inputs and an assured market for their producers. These relationships can provide advantages to both parties if the terms of agreements are respected. However, there are potential risks if one or both parties fail to respect the agreements.

There are a variety of ways that development organizations working with lead firms can help ensure benefits for MSMEs. Conducting due diligence of the lead firms and understanding their incentives can help development organizations identify lead firms that are most likely to enter into mutually beneficial relationships with MSMEs (see section on the respecting knowledge of lead firms below). The development of memoranda of understanding between the development organization and lead firm is another opportunity to help clarify the firm's work plan, planned investments and initiatives for upgrading MSMEs in their value chain. Once memoranda are established, the development organization can monitor the commitment of lead firms in carrying out agreed-upon activities and cost-share agreements.

It is important that development organizations see the risks involved from both the lead firm and the MSME perspective and not take a biased position in favor of MSMEs. In many cases it is the lead firm that is taking most of the investment risk in terms of upgrading MSMEs or developing more directed business models—especially when producers have a ready alternative market for their products. Development organizations must recognize that both parties in the relationship (lead firms and MSMEs) must benefit for it to be successful. It is also interesting to note that mutual dependency among market actors helps to ensure that both parties respect agreements and work fairly together.

V. ACHIEVING BROAD-BASED IMPACT BY WORKING WITH LEAD FIRMS

This section will look at how working with lead firms can lead to broad-based and systemic impact in a value chain. To do this it will explore the role that lead firms play in value chains and how support to lead firms can increase benefits for MSMEs and improve industry competitiveness.

ESTABLISHING A MODEL

Changes in value chain or industry competitiveness are often driven by the innovations and dynamic strategies of lead firms within those value chains. When one or more companies develops new products, creates operational efficiencies and succeeds in entering new markets, then other companies often follow their lead. When these companies have commercial linkages to MSMEs then their initiatives and success can lead to broad impact with a large number of participants in the value chain.

Dynamic lead firms often set a model for other firms to follow. For example, over the past few years in India a few lead firms have begun to source directly from vegetable farmers and set up dedicated retail outlets for fresh vegetables. Now that these firms have demonstrated this business model other firms are beginning to do the same thing. In Bosnia, a few exporters of natural herbs and tea recently gained ISO certifications that opened up new international markets. This encouraged other lead firms to follow suit. In both these examples development organizations were involved in supporting the lead firms to develop their new and improved operations.

CRITICAL MASS FOR IMPACT

In some cases there are only a limited number of lead firms performing certain functions in a value chain. Working with most or all of these firms increases the likelihood of a systemic impact on the industry. Even working with a smaller number of lead firms can create a critical mass of firms that are demonstrating improved operations, products, access to markets and support services to the MSMEs they buy from or sell to. If development organizations can facilitate improvements in a number of individual lead firms they can not only create leveraged impact on the MSMEs that transact with those firms but can also promote even broader impact on the industry as a whole.

PROMOTING INDIVIDUAL LF INITIATIVES

Professional associations or collective initiatives on the part of lead firms in an industry are useful for promoting industry-wide initiatives that cannot be undertaken by individual firms alone. These include promoting policy reforms, establishing or enforcing industry norms, managing government rebate programs, or providing information to members. They are not effective, however, in changing or improving the internal operations of individual firms. Initiatives such as developing new products, establishing relations with new buyers, introducing new equipment and technologies, or developing improved relationships with their MSME suppliers must be done by individual firms on their own. Each firm will have a somewhat different culture, risk tolerance, management capacity, and entrepreneurial flair that will influence the decisions they make and the strategy they employ. Development organizations must therefore work with these firms on an individual basis if they are going to have significant impact in these areas.

VI. ROLE OF THE FACILITATOR

This section looks at the role of development organization "facilitators" in developing and managing collaboration with lead firms. It is assumed, for the purposes of this discussion, that prior to initiating activities with lead firms the development organization has conducted a value chain analysis and program design. It is also assumed that this program design determined that working with lead firms in the value chain could result in sustainable benefits for MSMEs and greater value chain competitiveness.

CHOOSING LEAD FIRMS

It is important that development organizations establish clear criteria for selecting lead firms to work with. In general, it is preferable to work with lead firms that have: 1) commercial linkages with large number of MSMEs; 2) sufficient financial strength and long-term perspective; 3) strong demand for their products and ability to compete in end markets; 4) potential to influence their industry; and 5) an acceptable reputation. Lead firms with existing commercial linkages with large number of MSMEs allow development organizations to facilitate larger-scale impact. Their resources can be used more cost-effectively and with greater leverage. Lead firms with sufficient financial strength and a long-term perspective are in a position to make needed investments and will exercise the patience needed for benefits to materialize. Strong demand for lead firm products and the ability to compete in end markets improves the firm's position to influence the MSMEs they buy from or sell to (helping them to produce to specifications, training them how to use new products and services, etc). It also increases the likelihood that that they will be able to raise or at least maintain purchases from the MSMEs into the future. If lead firms are in a position to influence other lead firms and actors in the value chain, then the new strategies and approaches they develop can serve as a model for others firms to learn from and emulate. Finally an acceptable lead firm reputation minimizes the risk of problems due to inappropriate behavior.

Development organizations can employ a variety of methods in assessing lead firms against these criteria. These include conducting due diligence during value chain analysis, organizing stakeholder meetings and requesting "applications" from lead firms to propose cost share activities that respect parameters and guidelines established by the organization.

In general, working with a larger number of lead firms can lead to greater impact on the industry and the MSMEs that sell to or buy from the lead firms. Working with a larger number of lead firms can: 1) increase the scale and number of MSMEs impacted; 2) foster competitiveness among the lead firms; 3) ensure that the program will continue if one of them drops out; and 4) promote broader industry impact. There can be exceptions, especially if one lead firm had a very large network of MSMEs with which it transacts or if one lead firm is exceptionally placed to set an example for the industry, but in general, development organizations can achieve broader and more systemic impact by working with as many lead firms as possible.

RESPECT THE EXPERIENCE AND KNOWLEDGE OF LEAD FIRMS

The owners and managers of lead firms usually have significant experience in their industry. Many have made, or have attempted to make, inroads into new markets or have experimented with different operational methods. They often know what is needed to advance their business and their industry but have not been able to do it for different reasons. They also understand the business environment they are working in. Project implementers must respect this experience and knowledge and be careful to avoid harboring paternalistic attitudes where they feel that they know better than the lead firms or that their research will show the lead firms what to do. They must resist the temptation toward extensive conceptual discussion on how lead firms could introduce new products and brands, take advantage of new market opportunities, change business practices, etc. in the absence of the lead firms. This kind of discussion should take place with the lead firms themselves in order to determine what they know, what they have tried, and how such ideas might or might not work in the local context. Development organizations should therefore make a concerted effort to engage lead firms in the design of program interventions. They need to listen to the lead firms and then help them to generate the information or develop the systems and skills that they feel that they need.

STAY OUT OF COMMERCIAL, INTERMEDIARY, OR NEGOTIATION ROLES IN THE VALUE CHAIN

Development organizations need to be careful not get between market actors, trying to negotiate with lead firms on behalf of producers (or vice versa). This usually leads to market distortions and unsustainable impact. Development organizations also need to allow lead firms and producers to work out the most appropriate structures for buying and selling without imposing preconceived organizational structures (such as groups or cooperatives). Aggregation and economies of scale can be achieved in different ways, including the use of “lead farmers” that help lead firms to manage relationships with other farmers. Offering to “organize groups” on behalf of lead firms is a risky endeavor as the lead firm does not need to demonstrate commitment (as they would if they were responsible for organizing producers themselves). It can also lead to problems for the implementer if the commercial linkages between the lead firm and the groups do not materialize as expected. In addition, heavy involvement by the implementer in structuring relationships and defining responsibilities between lead firms and producers can create confusion on both sides and delay the establishment of sustainable relationships.

BUILD LEAD FIRM CAPACITY TO PROVIDE PRODUCTS/SERVICES TO MSMES

One of the most valuable roles that a development organization can play is to improve or expand the capacity of lead firms to provide needed products/services to the MSMEs they buy from or sell to. These products and services include technical support, training, inputs, finance and access to markets. Development organization activities in this regard might include: 1) introducing or improving models where lead firms engage in direct procurement with producers; 2) building the capacity of lead firm staff to train MSME producers; 3) assisting lead firms to identify or develop new sources of raw materials that they can provide to producers; and 3) assisting lead firms to access finance or enter into tripartite agreements with financial institutions to finance MSMEs, etc. Building the capacity of lead firms to provide these products and services to MSMEs can be facilitated through cost-share mechanisms whereby each party (the implementing organization or project and the lead firm) pay a percentage of the costs for pilot activities (training for MSMEs, development of raw materials, etc). Over time the percentage paid by the project is reduced to zero, thereby ensuring the sustainability of the activity.

DEVELOP LEAD FIRM COMPETITIVENESS

Development organizations can also play an important role in building the competitiveness of targeted lead firms. This in turn has a positive impact on the producers that the firm buys from or sells to. Examples of development organization activities in this regard include assisting lead firms to: 1) develop or improve finished products that meet end market needs and specifications; 2) identify new buyers for their products (allowing greater purchases from the MSMEs that supply them); 3) develop or improve production and packaging processes; 4) identify new types of machinery or equipment; 5) access finance for expansion of operations, etc. In many cases the development organization can carry out these activities through the development or improvement of sustainable "support markets" in the value chain. In this case the development organization identifies third-party firms or consultants who can offer commercial services to lead firms and assist them with certification, advertising, strategic planning, information technology applications, financial management, access to inputs and machinery, etc. One method of doing this is to identify private providers of these services, help them to adapt their services to the needs of the targeted lead firms, and then help them to link with lead firms. The development organization can then provide incentives for the lead firms to try these commercial services in such a way that the firms begin to pay the full cost of the services after the initial trial.

ESTABLISH CREDIBILITY

To succeed, development organizations need to establish credibility with the lead firms they want to work with. Without this credibility lead firms may be reluctant to enter into agreements that have implications on their time, resources and business. Establishing credibility can begin during initial meetings. During these meetings the development organization should demonstrate a respect for the role that the company plays in the value chain and the contributions they make to the economy. The development organization's rationale for working with lead firm should be made clear, i.e. they wish to collaborate with them to improve their competitiveness, the competitiveness of the industry, and create added benefits for the MSMEs that they buy from or sell to. The goal of sustainable impact, and the importance of working with all market actors in the value chain in order to achieve this, can also be stressed (along with past experiences that show that the impact of programs that ignore or try to replace certain market actors typically is short-lived). All of this can help clarify the role and objectives of the organization in the eyes of the lead firm.

One of the first activities frequently conducted by a development organization with a lead firm is to assess the feasibility of a proposed lead firm investment in their supply chain. These investments might include capacity building of producers they buy from or sell to, establishing direct procurement operations, producing or sourcing raw materials that can be provided to producers, etc. A development organization can demonstrate responsiveness and professionalism in supporting the firm with this activity. Credibility can also be established during the development and discussion of memoranda of understanding, and by demonstrating a capacity to provide useful technical support once agreed upon activities begin. Finally, the organization must respect principles of confidentiality regarding the operations of lead firms.

CREATE APPROPRIATE INCENTIVES

The development organization can play a key role in mitigating the risks that lead firms face in taking on value chain investments that will benefit both them and the producers they transact with. However, the organization must be careful to strike the right balance when it come to providing incentives or subsidies. While there are no hard and fast rules about this, there are certain principles that should be followed to help insure that lead firms take responsibility for new activities and that sustainability is achieved. Subsidies are generally acceptable to build the capacity of lead firms to undertake new initiatives, to offset the cost of pilot activities, to link lead firms to new buyers and input suppliers, for feasibility assessments, and for research and development. However, subsidies are more difficult to justify when they cover all or part of a lead firm's recurring operational costs, personnel or physical assets. These types of subsidies greatly increase the risk of creating dependency, distorting markets and slowing ownership of the process.

MONITOR AGREEMENTS

It is important that the development organizations monitor work plans and cost-share agreements with lead firms to ensure that they are making agreed-upon investments and that they are conducting activities appropriately. There should also be specific "exit strategies" for each cost share activity with lead firms to ensure sustainability.

COMMUNICATE WITH DONORS

It is important that development organizations communicate the rationale of their value chain strategy to the donors that are supporting them. Some might take issue with working with lead firms, as these firms are not the ultimate "target group." The importance of sustainable, long-term impact needs to be stressed, as well as how this impact can be achieved through improved relationships and collaboration between all market actors. The downside of unsustainable and short-term "results" (produced by development organizations who might take a commercial position in value chains, distort markets with direct subsidy of products and services to MSMEs, set up unsustainable firms or organizations, etc.) also merits discussion with donors.