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BRIEFING PAPER

FINANCE IN THE VALUE CHAIN FRAMEWORK

"Value chain finance" is defined and applied in many ways, referenced in countless articles and discussed at numerous conferences. This brief paper is designed to clarify the term for practitioners, implementers and donors by answering four questions:

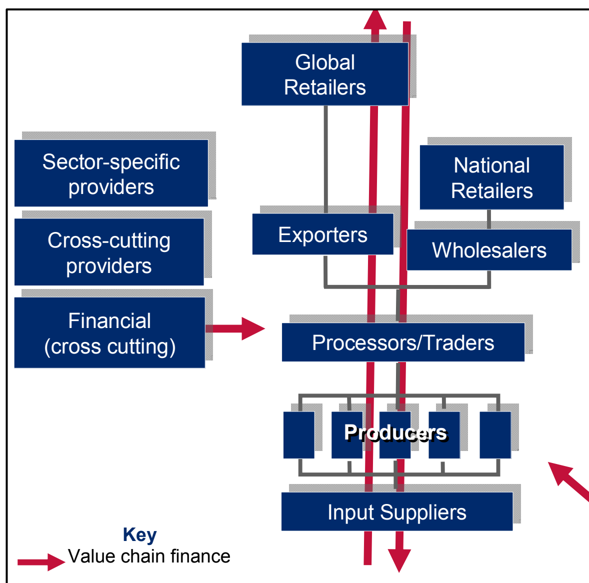
- What is value chain finance?
- Why does it matter?
- What is its relevance to value chain development?
- What are recommended good practices when designing value chain finance interventions?

WHAT IS VALUE CHAIN FINANCE?

Simply defined, value chain finance is *financing provided to or by a value chain actor in order to increase value-chain growth and competitiveness.* Whether provided by a bank, a buyer or an input supplier, value chain financing allows firms to operate, to transact with others and to upgrade. Value chain finance is neither a separate subset of finance, with unique or distinct products, nor is it a complex new field.

There are different opportunities requiring various types of financing (or none at all), and there is a range of actors that can deliver this financing. As figure 1 illustrates, value chain finance can be provided by various entities from within or outside the chain. For example, it can be provided by value chain participants themselves, by banks or microfinance institutions, or by a combination of forces through strategic alliances.

Figure 1. Financing through and to the value chain



Value chain finance includes a wide range of products. While firms may self-finance at times, producers also receive trader credit in the form of in-kind loans from input providers, and seasonal loans from buyers. Buyers use credit not only to secure future products; in out-grower schemes they ensure that products meet standards by monitoring the farmer, providing inputs and credit effectively in the process. To manage risk, value chain participants take advantage of their business relationships to screen borrowers for their ability and willingness to pay. They also use relationships as a modified form of collateral, for informal or contractual commitments to deliver future products.

Financial institutions also offer short-term or seasonal loans for working capital and longer-term investment loans, lines of credit, overdrafts, letters of credit and insurance products. Financial institutions often use more formal types of collateral to secure their loans—e.g., real estate and registered movable property. Other value chain financing arrangements include the following:

- Buyers provide screening services, guarantees or collection services for banks interested in lending to affiliated producers.
- Financial products that align disbursements and repayments with production cycles to manage credit risks with unsecured collateral (e.g., contract farming) or secured collateral (e.g., warehouse receipts).
- Financial institutions can provide partial guarantees: for example, USAID's Development Credit Authority (DCA) mitigates lenders' risks with partial guarantees.
- Insurance companies can help to manage production risk for producers and lenders.
- Commodity exchanges can link future buyers and sellers to reduce producers' price and marketing risks.

WHY DOES VALUE CHAIN FINANCING MATTER?

Value chain financing provides a critical input to the increased competitiveness of an economic sector by helping an industry expand and compete more effectively. For example, providing opportunities for upgrading assets can allow firms entry into more lucrative markets. Financing promising economic opportunities accrues benefits throughout the chain. To unleash its potential, the distinctive elements of a value chain must be recognized and exploited. The following themes further highlight the importance of value chain finance.

Theme 1: Reaching More through Less. Because of different incentive structures, value chain actors can provide loans to smaller-scale producers more readily than financial institutions. Firms within a value chain have preexisting business relationships and therefore a better sense of how risky a borrower or client is; credit becomes an extension of their business dealings. Knowledge of the markets in which borrowers operate also lowers the firms' perceived risk of default and leads to speedier transactions.

Theme 2: Reaching Critical, 'Risky' Client Groups. Value chain financing reaches 'risky' businesses that can play an important role within a value chain. Many rural businesses, often with important supporting roles in agri-processing, are considered very risky by banks and other financial institutions. However, without access to finance these businesses are stifled and the sector can lose opportunities to compete and grow.

Theme 3: Replication and Expansion. Value chain financing or lending arrangements that evolve from business relationships can have a demonstrative effect for financial institutions. Financial institutions, often seeking new ways to safely diversify their product range, may consider value chain financing if profit margins can be maintained. Bringing new financing to a value chain offers options for longer-term and larger loans to growing businesses.

WHAT IS ITS RELEVANCE TO VALUE CHAIN DEVELOPMENT?

The value chain approach is a market systems approach requiring an in-depth understanding of end markets, the role of value chain governance, the importance of relationships, the need to facilitate changes in firm behavior, and a focus on empowering the private sector. Value chain finance brings another important element to this mix of features with an examination of credit access and other financial services as critical to competitiveness.

The value chain approach seeks to facilitate changes in firm behavior that increase the competitiveness of the chain and generate wealth for all participating firms, thereby contributing to economic growth with poverty reduction. For project implementers, this requires identifying incentives that exist within the chain and that can be built upon in order to make sustainable changes in firm behavior.

The three themes above play a catalytic role in creating incentives that lead to a more competitive value chain. By reaching more through less, serving 'risky' businesses and offering examples for replication and expansion, value chain finance is critical for donors, designers and implementers of value chain projects to bring about sustainable growth and change.

RECOMMENDED GOOD PRACTICE FOR DESIGNING VALUE CHAIN FINANCE INTERVENTIONS

Reflecting lessons from the field, the following are recommendations for designing value chain financing programs:

1. Design interventions based on value chain analysis. Effective interventions require an appreciation of the dynamics of the value chain. Recommended steps to gain this appreciation include the following:

- Conduct a value chain analysis that identifies the driving opportunities for growth and increased competitiveness
- Specify those opportunities that are constrained by a lack of appropriate financial services
- Identify a) firms that will benefit from these services, and b) firms with an incentive to introduce or expand these services; and analyze the relationships between these two groups
- Bring together players who possess ***incentives, knowledge, skills*** and ***resources*** to ***deliver*** appropriate financial products and services

2. Select partners carefully. Effective design entails bringing together the right players. In situations where formal financial institutions have demonstrated little or no interest in a value chain, information about the industry is critical in order to engage the right partners. Compared with conventional financial institutions, value chain firms possess cheaper access to information about other value chain participants, particularly with regards to the willingness and ability of potential clients to honor contracts. Through their business relationships, these firms have advantages in delivering timely products, with lower transaction costs, and with cost-effective mechanisms for enforcing contracts. Conversely, because financial institutions have access to capital and less personalized, more efficient systems of monitoring and controlling large numbers of customers, they offer advantages in increasing scale and rapidly expanding outreach. As mentioned above, this access helps firms demonstrate the feasibility of lending to borrowers in competitive value chains, which in turn provides a solid business case for financial institutions to begin serving new markets and thereby scale up the services.

3. Recognize both the limits and the benefits of financing by value chain actors. While the advantages of a value chain financing approach are significant, financing by value chain participants is not a panacea. Financing is mostly in the form of short-term loans. Input providers are generally constrained by the fact that they are financed by their providers through 30- or 60-day sales arrangements, and they have no means by which to extend credit for a longer period without gaining new forms or sources of financing themselves.

Relationship building can be difficult. Value chain participants tend to have opaque pricing mechanisms for their services, compared to formal financial institutions. This can limit their understanding of whether they are making or losing money, and can create unrealistic price expectations for borrowers—expectations that are impossible for financial institutions to meet. For example, when a financial institution enters a market dominated by trader credit, producers may be unaware of the effective price they pay for their financing, and view rates offered by the institution as high; but a transparent comparison may show the rates to be reasonable.

Furthermore, outreach by value chain actors is limited. Because credit from traders and buyers draws mostly on business relationships, it is rarely possible to achieve the same volume of business as a specialized financial institution. Lastly, there is potential for exploitative relationships, such as buyers who control the market and price their services unfairly; or producers who sell to competing buyers, breaking contracts they have signed with the firms providing them with financing.

4. Focus on economic opportunities. Programs that incorporate a value chain orientation to expanding financial services have, primarily, an economic objective, rather than a purely financial objective. They target specific opportunities for value chains to upgrade and expand. Consequently, a value chain program is, by definition, opportunistic, and project implementers can adopt opportunistic tactics, including the following:

- ***Consider investment capital.*** One challenge to the growth and increased competitiveness of a value chain is the effectiveness of using chain participants for financing investment. These actors, with limited financial resources, face a trade-off between increasing volume of product for which they provide financing and increasing competitiveness. As mentioned above, it is often easier for value chain actors to provide working capital than to provide longer-term investment financing. Certain upgrading opportunities require investment capital, and therefore a significant and long-term relationship among those operating within the value chain is needed. A unique example comes from Costa Rica's dairy value chain. Dos Piños, a cooperative, provided five-year financing to its members to upgrade their on-farm cooling facilities. This financing allowed the cooperative to expand its market and increase both the quantity and the price of its product.

- ***Work to change perception or behavior.*** There are cases when financial institutions are wary of a new value chain because of limited information or concerns about risk or lack of collateral. It is expensive to assess risks in a new market, or to meet collateral requirements with small farmers or other borrowers who lack clear title to property. Guarantees can be used to reduce the risk for banks to enter the market. In one case in Ethiopia, financial institutions were unwilling to work with cooperatives until a bank tapped a DCA mechanism, which shared the risk on loans to cooperatives that

provided advances against product deposited by their members. After a successful collaboration, the bank obtained a second guarantee, but continued to lend without it since the costs of tapping the guarantee exceeded the benefit; the initial experience allowed the bank to change its assessment of cooperatives' willingness and ability to repay loans.

While there may be a place in programs for traditional training activities, it is better to design value chain interventions that lead to behavior change, not simple information transfer. For example, a USAID-funded project in Malawi worked to overcome information asymmetries in several value chains (via wide distribution of value chain analyses and bringing stakeholders together in workshops and meetings) and reduced perceived risk by harnessing DCA guarantees and encouraging strategic alliances among stakeholders. Consequently perceptions among value chain actors changed and several local commercial banks began aggressively pursuing rural borrowers. These interventions did not simply provide information or training to small enterprises but encouraged the system to change the way information is shared.

- ***Look for aggregators or leverage points.*** It is often unrealistic to expect banks to work with large numbers of small players: transaction and screening costs can be prohibitive. However, viability can be enhanced by seeking out entities that can reach and serve larger numbers of people. Credit unions can make promising partners in value chain finance initiatives due to their community ties, strong rural presence and lending experience with low-income or small firms. In some cases, relationships have been built between small rural financial institutions with larger institutions, blending the rural institutions' track records of reaching small, remote players with the larger institutions' access to capital.

- Value chain actors can likewise serve as effective aggregators, using extensive networks to lower a financial institution's costs for screening and serving new clients. Information and communication technology can also help to lower costs, expand outreach and blend financial and non-financial services. For example, the *e-Choupal* model in India provides computer access to market information in rural areas, which increases transparency and facilitates sales. A more sophisticated, complete aggregation of a chain or several chains is a commodity exchange, which allows for highly efficient financial and commodity transactions, and has the capacity to introduce futures (if the enabling environment permits). These services allow producers and buyers to reduce transactions costs and manage price risk.

In summary, the spectrum of value chain financing runs from small input loans to increasingly complex loan products—all serve as engines for increased value chain competitiveness and growth. These value chain financing structures can help reduce costs, manage risks and build trust—themes that are critical not only to the value chain but also to bankers and financial institutions as they assess types of profitable future investments. The most suitable partners are those with the right incentives to develop and deliver the financial services needed to pursue these economic opportunities. Given the dynamics of value chains, these partners are likely to change not only from place to place, but over time in the same place.

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