PURCHASE ORDER FINANCE IN BOLIVIA

INNOVATIONS IN FINANCING VALUE CHAINS

microREPORT #151

APRIL 2009

This publication was produced for review by the United States Agency for International Development. It was prepared by Hannah Schiff and Janice Stallard of ACDI/VOCA with assistance from Ramiro Ortega Landa and Megan Falvey of Crimson Capital. It was funded by the Accelerated Microenterprise Advancement Project.

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ACRONYMS

ARCo	Chemonics/Crimson Capital's Rural Competitiveness Activity
FIE	Centro de Fomento de Iniciativas Económicas, a Bolivian microfinance institution
POF	Purchase Order Finance
USAID	United States Agency for International Development

I. INTRODUCTION

In an effort to capture and disseminate innovative practices in the field of value chain finance, ACDI/VOCA, under the AMAP BDS[1] Knowledge and Practice II task order, solicited submissions for a competition from practitioners implementing value chain finance programs. Value chain finance is defined as financial products and services that flow *to or through a value chain* to increase returns on investment and growth and competitiveness of that value chain. The "Innovations in Financing Value Chains" competition was held in December 2008, and two selected winners were honored at an awards ceremony in February 2009. This case study details the methodology and experience of one of the winners, Crimson Capital/Chemonics' Rural Competitiveness Activity in Bolivia.[2]

This case study comprises four main sections: Section II describes the Bolivian context and rationale for the intervention; Section III outlines Crimson Capital's methodology; Section IV describes how the approach was implemented in the coffee value chain in the Yungas region of Bolivia; and Section V provides conclusions and lessons learned.

II. BACKGROUND

During the late 1990s, Bolivia's economy was deeply affected by a decrease in export demand and climatic changes that destroyed producers' crops and assets. Although the economy has begun to climb back, it continues to suffer from the effects of a history of political transition and social unrest. Many microfinance institutions operating in Bolivia before the crises of the late 1990s shut down, and the remaining microfinance and other financial institutions alike are reluctant to provide financial services to the rural sector because of the perceived high risk and considerable transaction costs.

In addition to the costs and risks of rural lending, another obstacle to extending financial services relates to the type of crop grown in some provinces. In areas conducive to coca, farmers find it far more profitable to grow the illicit crop, and its prevalence increases perceived risk and discourages financial institutions from engaging in rural lending opportunities. In turn, the lack of access to financial services exacerbates the difficulty of developing a licit economy in those areas.

Many products offered by traditional financial institutions in Bolivia are ill-suited for small-scale producers, as they have strict collateral requirements (often urban real estate worth several times the loan value). The lack of branches of financial institutions in rural areas also creates a major obstacle for small businesses to borrow needed capital. While some informal financing within the value chain does occur, it is not always successful in terms of matching demand with supply. In addition, short-term working capital loans extended from a buyer to a supplier bind producers to specific buyers rather than allowing them competitive choices.

In this context, Chemonics and Crimson Capital are implementing the USAID-funded Rural Competitiveness Activity (ARCo) to improve licit productive activities and access to financial services in the coca-growing Yungas and Chapare regions of Bolivia. ARCo had two main components: a technical assistance component to resolve bottlenecks at the production level and facilitate sales, and a value chain finance component. Under the second component, ARCo identified twelve key constraints to providing profitable rural financial services in Bolivia that financial products must overcome/minimize to profitably serve the Bolivian rural sector (see text box).

ARCo developed a product to address key barriers (e.g., lack of collateral and the need for working capital loans) and increase access to financial services for small-scale producers in Chapare and Yungas. The result, an innovative arrangement called "purchase order finance" is being tested under the project and is described in this case study.

[1] Accelerated Microenterprise Advancement Project Business Development Services

[2]Another case study is available on the second winning project from the World Council of Credit Unions in Peru.

Purchase order finance takes into consideration all the actors in the value chain—input and equipment suppliers, producers, processors, distributors, traders, wholesalers, retailers and end consumers—rather than just the individual enterprise. The approach leverages existing relationships among those actors to guarantee loans without physical collateral requirements and provides much-needed working capital to the borrower. The increased sharing of information, collaboration and understanding of each party's constraints also has the important benefit of improved trust and cooperation among buyers, sellers and financial intermediaries and supports greater equality in negotiations and future business transactions.

III. A NEW TOOL: PURCHASE ORDER FINANCE

Purchase order finance is a transaction-driven form of working capital financing. When a company gets an order for its products from a buyer, the lender advances sufficient funds for the company to process, package and ship the order. Purchase order finance can also be used for the purchase of raw materials or other production costs if production timing permits, but it is never a general loan or line of credit. Under purchase order finance arrangements, the purchase order (the contract between the seller and buyer) becomes the collateral for the loan. The accounts receivable is transferred to the lending institution and becomes the source of loan repayment. The financial institution collects payment for the loan plus interest and fees from the buyer once the product has been delivered.

Twelve challenges to value chain finance for Bolivia's farmers:

1. **Systemic risk** such as weather and crop failure
2. **Market risk** generated by cyclical and seasonal price fluctuations
3. **Credit risk** including lack of collateral and incomplete support services
4. **Investment returns** are limited and slow in Bolivia, where rural capital revolves slowly with one or two crops per year
5. **Low investment and assets** which provide limited collateral options
6. **Geographic dispersion** make economies of scale difficult to achieve
7. **Inadequate infrastructure capacity** including communications, roads, social services, all of which increase the cost of lending
8. **Technical capacity and training** is lacking, limiting adaptation to new technologies, productivity and competitiveness
9. **Social exclusion** inhibits integration into financial markets and reduces market efficiency
10. **Institutional capacity,** including management and technical capacity of organizations in rural Bolivia is lacking and results in few new products being piloted to meet farmer and small business needs
11. **Political and social interference** such as forgiving loans, withholding savings, capping interest rates, and subsidies creates a potential risk for financial intermediaries
12. **Regulatory risks** include excessive requirements and/or a lack of enforcement of regulations, hindering the viability of business and financial operations in rural areas

Successfully introducing purchase order financing through a lending institution requires: 1) a thorough understanding of the market for financial services, 2) a long-term commitment by the implementing organization, and 3) significant technical assistance to promote the financial product and training for lending institution staff on structuring deals with associations and/or companies (as the typical client base is primarily individuals or small businesses). Therefore, the ARCo project began by conducting supply and demand analysis of the Yungas and Charpare regions to assess potential market demand for the POF product. The supply analysis showed that there were nine institutions (mostly NGOs) supplying financial services, but were operating with limited products and resources. Working capital was virtually non-existent. The demand analysis showed a subsidy-dependent culture and a lack of adequate access to financing that prevented the growth of business opportunities in new and existing market chains. There was an unmet demand for credit and other types of financial services. Based on this analysis and the ARCo project focus, the project staff determined that working capital loans should be the first intervention, possibly followed by rural leasing and warehouse receipts.

Next, the ARCo project solicited expressions of interest from 13 lending institutions in the targeted provinces. The terms of the competition provided a small subsidy for start-up costs to open new branches in Yungas and Chapare, as well as technical assistance from ARCo to train financial institution staff in purchase order finance. The terms of competition required that interested lending institutions open full service banking branches in Yungas and Chapare; that they use their own funds for the purchase order finance loans; and that they meet set loan targets (in this case, the selected institution committed to distributing $2.2 million in loans in Yungas and Chapare in two years). Out of three initial expressions of interest received from financial institutions, ARCo selected the private financial fund FIE, a leading Bolivian micro-finance institution, to pilot test purchase order financing in the Yungas and Chapare regions of Bolivia.

The ARCo project then began working with FIE to develop a POF product tailored to local needs. This included developing contracts, tracking systems, and costing/pricing policies for FIE to implement POF. Finally, ARCO conducted training programs for more than 100 FIE staff members in how to:

- identify clients in the market that have a need and interest in new working capital loan arrangements;
- assess potential borrower needs;
- structure POF loans in a flexible manner to meet the needs of small farmers as well as cooperatives and associations;
- assess POF loan risk and structure deals to lower possible default; and
- market the POF product.

Thus, the ARCo project provided incentives for FIE to commit time and resources to the design, marketing and implementation of the POF product. The first incentive was offering to expand their client base through a new product that could compete in Bolivia's saturated microcredit markets. The training ARCo offered allowed FIE to develop staff knowledge and skills for designing, testing and introducing a new product. Technical assistance to FIE also deepened staff members' overall capacity with respect to credit evaluation, risk assessment, loan management and international trade. Finally, the performance-based subsidy incentives tied to four specific lending targets lowered the financial risks for FIE to launch a new product with a new client group. ARCo's approach to creating incentives and reducing risks resulted in a sustainable set of conditions that enabled FIE to launch the POF and grasp the potential profitability of this product. FIE will now continue expanding its POF product throughout Bolivia based on its recognized profitability as a lending product.

New Savings Services

While working with producer associations in Yungas and Chapare, the ARCo project recognized that supporting producer associations to register their businesses would help the associations begin to operate in the formal economy, moving away from informal transactions, utilizing legal contracts and conducting transactions via the bank instead of in cash. The project worked with the government to develop a new form of business registration for associations and producer groups. ARCo assisted the local government to simplify the registration process, decrease registration fees and reduce the registration timeframe from several months to several days. ARCo then worked with FIE to develop a new type of savings account specifically designed for 'registered' associations; savings account products have no maintenance fees or minimum deposit requirements. ARCo then assisted FIE to market and promote the benefits of registration to the associations, leading to 66 associations and producer groups opening savings accounts with FIE in Yungas and Chapare.

IV. IMPLEMENTING POF IN THE COFFEE VALUE CHAIN

This section will illustrate the use of purchase order finance by describing how the model worked in the organic coffee value chain in the Yungas region of Bolivia. One of the first POF loans financed a transaction between

Cooperativa Agropecuaria Integral Noreste, a 260-member association of small coffee producers, and A. Van Weelly, a well-known Dutch trading company specializing in organic goods. Integral Noreste had received a purchase order from A. Van Weelly for a full container (nearly 20,000 kg) of washed Arabica organic Bolivian coffee, but lacked the financing necessary to process, ship and fill the order.

In October of 2007, FIE issued a purchase order finance loan to Integral Noreste of $30,000 for 90 days at a 12 percent annual rate. This financing was used by Integral Noreste for post-harvest processing and packaging and payments to coffee growers. As collateral for the purchase order, Integral Noreste officially transferred its accounts receivable from A. Van Weelly to FIE and deposited $10,000 in savings in a FIE account. No other fees or collateral were used. As a price of $2.84 per kilo was agreed upon, the total value of the transaction $55,664.

Previously, Integral Noreste was able to pay its members (coffee suppliers) only *after* payment was received from the buyer, usually three to four months after delivery. As a result, producers often sold their better-quality coffee to other intermediaries for immediate payment at lower prices. The POF loan from FIE allowed Integral Noreste to pay suppliers upon delivery of coffee, thus providing an incentive for members to sell higher-quality coffee to the cooperative. In the future, this will allow the cooperative to negotiate higher purchase prices for its premium coffee.

ARCo's POF pilot has proven to be a profitable mechanism for financial intermediaries to lower the risk of lending in rural areas. As a result, ARCO has drawn on this success and replicated the POF model through 38 transactions in the coffee value chain totaling over $1 million in the Yungas region over the period of a year and a half.

FIE is exploring opening additional branches on its own in other rural areas and expanding the use of purchase order finance throughout Bolivia on a permanent basis. It also plans to introduce purchase order finance in larger urban markets in Bolivia to finance small and medium-sized enterprise operations.

The Integral Noreste example is providing a demonstration effect to other financial institutions, such as Prodem, a non-bank financial institution that now offers products in competition with purchase order finance. Prodem's trade financing products are very similar to purchase order finance, though the interest rates are currently higher in Prodem's product. Prodem provides a more comprehensive financial product line for producers' and farmers' groups to choose from and creates a more competitive operating environment for Bolivia's small and medium-sized enterprises.

The pilot project also continues to grow, with FIE disbursing over 262 POFs totaling $2.1 million over two years. In addition, through the new savings product developed, 66 new association savings accounts have been opened with an average of $8,500 per account for a total of $561,000. These savings provide financial intermediaries with additional onlending capital as well as serve as an emergency financial cushion for the cooperatives in the Yungas province.

V. CONCLUSIONS

Key challenges for any successful value chain finance project include reducing risks and creating sustainable incentives. Addressing these issues in a manner that does not replace private sector dynamics, but rather catalyzes increased competition, is critical. Several important lessons emerged from the ARCo model with respect to reducing risk and building trust and sustainable incentives throughout the coffee industry:

- Risks were reduced for financial institutions to lend by creating an accounts-receivable mechanism based on buyer demand.
- Targeted subsidies were introduced to lower costs of entering the market and to encourage long-term sustainable interventions by financial institutions. The subsidies covered the start-up costs of opening four new branches in Yungas and Chapare.

- Links of trust and cooperation were established among buyers, sellers and financial intermediaries through increased collaboration, sharing of information and understanding the constraints of involved parties.

In addition, several lessons for implementing similar projects can be concluded from ARCo's experience:

- Take time to analyze bottlenecks and determine the demand for financial services and the type of product required. The three-month analysis conducted by ARCo suggested that the first intervention should be working capital loans and that future interventions could include warehouse receipts and rural leasing.
- Initiate interventions based on well-functioning relationships within the value chain. An analysis of the value chain will reveal existing relationships with some degree of trust and/or a history of successful transactions. These relationships make good starting points for launching value chain finance interventions.
- Due diligence is necessary on both ends of the transaction because there is risk attached to both the seller and the buyer. The financial institution should obtain character references about both the seller and the buyer (how serious the person is about the business, payment record, length of time in the business, etc.).
- Training the financial institution's staff in marketing skills plays an important role in project success, as they will need to make customers aware of how the new product would fit into their business. In contrast to microfinance, which is demand driven (usually by fairly knowledgeable clients seeking out loans) and requires little marketing on the part of the loan officers, purchase order finance loans are granted in larger amounts and driven by supply to a greater extent. Thus, purchase order finance require a greater marketing effort in the field.
- Devise a specific product or products tailored to the results of the demand survey. There is no "one-size fits all" product for all contexts or needs.
- Carefully choose the best institutional delivery mechanism (credit union with strong local links, commercial bank, non-banking financial institution, SME financing institution, or micro lending institution). Start by working with existing institutions and avoid creating new ones. In ARCo's case, holding a competition and requiring the institution to use its own funds for the purchase order finance let institutions self-select and ensured that the chosen institution would be committed to the product and to working with ARCo.
- Adjust the product to the institutional culture, procedures, rules and regulations to minimize resistance to change. Crimson Capital brought FIE's risk analysts, marketing managers, product managers, loan officers and top leadership into the process of developing the purchase order finance product. This ensured a smooth adoption of the product and buy-in from all members of the staff.
- Work through the process step-by-step with the financial institution toward a successful first operation. This early success is essential for demonstrating the benefits of the arrangement.
- Technical assistance is key to improving the producer's situation by improving product quality, increasing prices and ensuring repayment. ARCo's firm-level technical assistance component fulfilled this role in this case.
- Build in incentives to make the intervention sustainable.
- Design an exist strategy from project inception to avoid creating dependency. Empower the institution to continue the operation after the project's exit.

In addition to Bolivia, Crimson Capital has successfully introduced purchase order finance and other types of pre-export finance products in Moldova, Armenia, Kosovo and Macedonia and is currently working with Chemonics to introduce these products in Azerbaijan and Peru. Purchase order finance is a powerful tool that can be used to unlock the value chain's potential in nearly every sector and geographic location. It works and is sustainable because it is a market-based tool that allows the lending institution to make a profit while providing borrowers with much-needed working capital to fill orders without prohibitive collateral requirements. In many cases, the introduction of purchase order finance will have auxiliary benefits that improve the financial services market overall, as the Bolivia example illustrates.

Purchase order finance can be applied at any point in the value chain: suppliers, producers, processers, distributor traders or wholesalers. However, it should be applied in tandem with other types of support as it is generally a better fit for small and medium-sized borrowers and not suitable at the microcredit level. Furthermore, purchase order finance provides short-term working capital and therefore will not address longer-term lending needs for infrastructure and capital equipment, which remains as an outstanding challenge for donors and practitioners.