DEVELOPMENT FINANCE:

How it can enable the growth and transformation of agriculture

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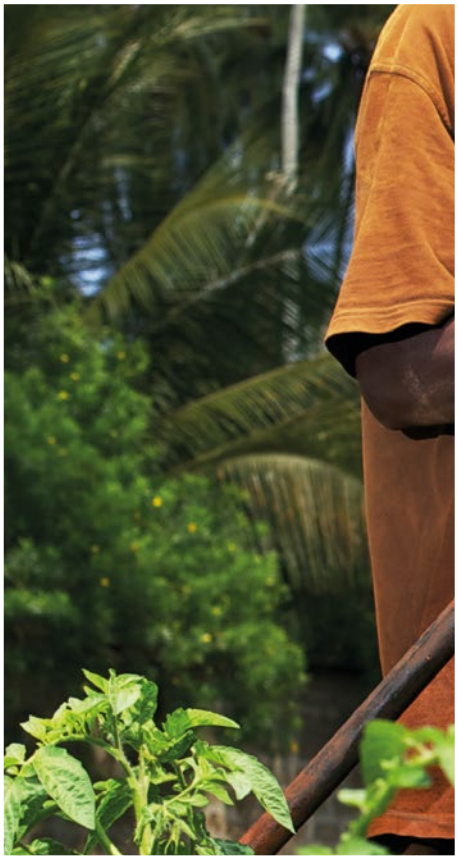

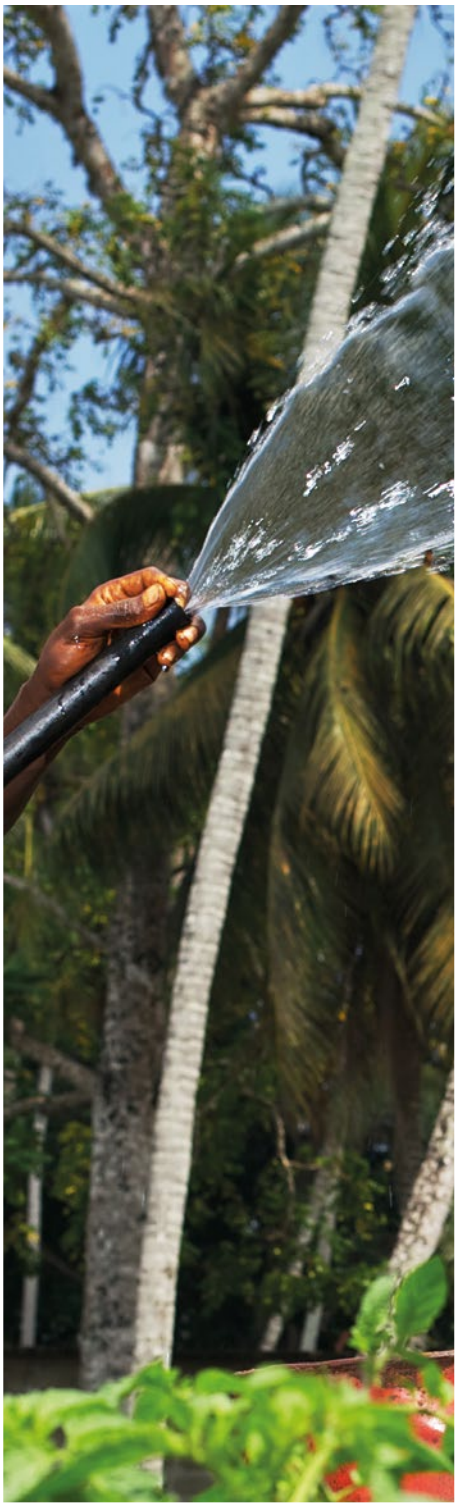

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EXECUTIVE SUMMARY

Our case studies demonstrate the potential for providing concessional finance to support sector transformation – but it is not without risks.

THE PURPOSE OF THIS STUDY WAS TO:

1. Look at sectors that have been successfully transformed – with a specific focus on agriculture – and then determine the role played by finance in supporting these transformations;

2. Consider the extent that this specific type of finance is currently available for agriculture, given its importance to the achievement of the Sustainable Development Goals (SDGs); and

3. Present some initial ideas to increase the quality and quantity of the type of finance needed to support the transformation of the agricultural sector in developing countries.

KEY FINDINGS OF THE RESEARCH:

- Case studies on five sectors that achieved sustained economic transformation highlight the role that DFIs and other financial providers played in providing 'concessional finance' (defined as finance that does not seek a market return) to pioneering sectors. Much of this investment did not achieve (nor did it seek) risk adjusted returns, and was instead concerned with building capability, demonstrating success, and crowding in other players.
- DFIs were originally set up to take on the high risks of pioneering (e.g. in start-up ventures, new sectors, newly independent countries, etc.) either directly (100% owned ventures or majority stakes), via concessional support to private investors, or by simply sharing risks and reducing the private sector's exposure. This role has changed in recent decades, with the private sector taking more of the pioneering risks and DFIs entering later with risk/return requirements similar to commercial capital.
- As a result, there is a considerable gap in the supply of concessional finance required to support the transformation of high impact sectors, particularly agriculture; although new and interesting models and initiatives are now emerging at the fringes.

Photo: Ross Johnston | Newsline Media, for The Wood Foundation Africa

More concessional finance is needed for agriculture in particular as a driver to poverty reduction.

KEY FINDINGS, CONTINUED:

- Agriculture has a central role to play in the achievement of the SDGs (particularly goals 1 & 2 on poverty reduction and zero hunger). Economic growth in the agricultural sector is believed to be up to 11 times as effective at reducing poverty as growth in other sectors. According to World Bank data for 2017, 57% of workers in Africa are employed in the agricultural sector — with the IFC estimating that over 80% of the rural population rely on agriculture for their source of income.
- There are initial signs that agricultural sectors across Africa are starting to transform, with the growth of small commercial and medium-sized farms taking up an increasing share of farm holdings. These farms have the potential to be a force for dynamism, technological change and wider commercialisation, but they need access to concessional finance to do so. This is evidenced by a recent Council on Smallholder Agricultural Finance (CSAF) study, which shows that investors require more initial subsidy if trying to target new and/or smaller borrowers in more nascent agricultural value chains.[1]
- The case studies show that sector transformation requires supportive industrial policy with additional sector level support. In many cases of early stage finance leading to transformation, the finance provider was also able to rely on technical support to key firms and close government engagement to resolve specific bottlenecks.
- Finance often needs to be linked to programmes or mechanisms that enable firms, especially MSMEs, to access appropriate and affordable technologies and skills training. When creating technical assistance (TA) funds, moral hazards need to be accounted for to ensure funds are not used to prop up investee core operations and balance sheets.
- More research is needed into what development impact targets should be in place, with a need for indicators that are credible, measurable and – critically – are aligned better with the sector strategy of the ultimate funders. In addition, there is a significant gap in the evidence base around the most effective options for providing concessional finance to agriculture.

Photo: Rob Beechey

2 CASE STUDIES OF TRANSFORMATIONAL DEVELOPMENT FINANCE

Case studies show the key role developmental finance has played in supporting sector transformation, but such finance was not seeking high risk-adjusted returns.

THE FOLLOWING PAGES PRESENT CASE STUDIES OF:

1. The growth of the Ethiopian floriculture sector;
2. The Chilean salmon sector;
3. Kenya's tea sector;
4. The recent growth of the off-grid power sector; and,
5. The emergence of Africa's mobile phone sector.

In different ways the case studies covered demonstrate how developmental finance has played a key role in stimulating sector-level transformation. Much of this investment did not achieve (nor did it seek) the risk adjusted returns that DFIs are currently looking for. For instance:

- Fundación Chile (FCh) was designed specifically to help diversify the Chilean economy by acting as a pioneer investor in emerging sectors. FCh played an important role in facilitating the growth of the salmon sector, particularly in helping to demonstrate that the Chilean salmon sector was able to apply global standard technologies;
- CDC was an early investor in the Kenyan tea sector. It provided support in the form of soft loans, equity investment and technical assistance;
- The Development Bank of Ethiopia helped to catalyse the growth of the flower sector by providing concessional long-term loans. Around 42 out of 57 investors in the flower sector took a loan from the Development Bank.[2]

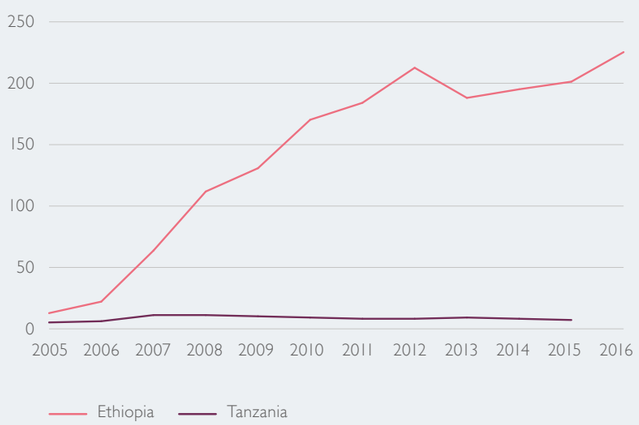
Our key question is: which institutions are able to provide this sort of investment in agriculture and other riskier/early-stage sectors at the moment?

2.1 CASE STUDY: ETHIOPIAN FLOWER SECTOR

A combination of industrial policy and long-term subsidised finance.

The Ethiopian horticultural sector has grown rapidly in the last twenty years. In the early 2000s, Ethiopia had similar level of exports to the EU as Tanzania. Since then, exports have grown to around $225 million, and the sector now employs more than 50,000 individuals and involves around 75 firms.[3]

Comparison of Ethiopian to Tanzanian Horticulture Exports to the EU
($m)



Source: Ethiopian Horticulture Producer Exporters Association (EHPEA), EuroStat

KEY TO SECTOR TRANSFORMATION WAS THE IMPLEMENTATION OF:[4,5,6]

- **Industrial strategy.** After some pioneer companies' successes, the flower sub-sector was targeted as a priority in Ethiopia's 2002 industrial strategy.
- **Supporting measures** such as providing land near the airport (floriculture is not land intensive so relatively easier in this sector); fiscal incentives; a one-stop-investment shop in the Ethiopian Investment Authority (EIA); and work to improve coordination between the industry and airports.
- **Credit provision from the Development Bank of Ethiopia** for up to 70% of any new investment in the sector (with no collateral requirements other than the project itself). Loans to expand existing products were offered for up to 60% of the new investment with an interest rate of 7.5%.

Loans were available for either up to 5 years or up to 15 years. Up until 2013, 42 of the 57 firms registered at the EIA had received loans from the Development Bank, the sum of which equated to roughly €44 million. More than half of them have, at some stage, defaulted on their loans. By the end of 2013 data from the Development Bank suggested that around $6.5 million of loans to the floriculture sector were in arrears.[7]

In response, the Development Bank has worked to support companies facing short-term difficulties by rescheduling payment requirements.

A pioneering firm – enabled by concessional financing – kickstarting sector transformation.

Photo: Morgana Wingard for ONE

One of the first rose farms in Ethiopia was called Golden Rose, which began exporting in 2000.

Golden Rose's founder, Mr. Ryaz Shamji, was not initially a flower specialist and had come to Ethiopia to explore the potential to invest in privatised state firms. Following a failed attempt to bid for a state-owned brewery, he hired a consultant to carry out a feasibility study. This suggested Ethiopia had conditions for rose farming at least as suitable as Kenya. They proceeded with the plan to establish a rose farm.

Golden Rose had to rely on importing the equipment and expertise needed to get their farm up and running. They worked with an Israeli consulting company, which constructed the farm facilities, planted the roses and provided a farm manager for the start-up phase of the company.

Despite some early set-backs, the firm grew rapidly during the 2000s, trebling in size from 7 ha to 22.5 ha and growing from 115 to around 900 employees.

Mr Shamji said they would not have been able to proceed without receiving a $1 million subsidised loan (8% interest rate) from the Ethiopian Development Bank — no other bank was willing to lend to a new venture (particularly one without a track-record in the sector).

The success of Golden Rose led to four new firms entering the market between 2001 and 2003, three of whom were domestically owned. From 2003, the sector began to attract more international investors — one of the most important being Sher-Ethiopia (a subsidiary of Sher-Holland, the biggest flower producer in the world). In 2007 it sold its farm in Kenya and moved to Ethiopia to become the biggest investor in the sector.

2.2 CASE STUDY: SALMON IN CHILE

A globally competitive industry developed almost from scratch.

Photo: Sam Beebe for Ecotrust

Chile has grown to become the world's second largest salmon exporter. In 1989, the country earned just $50m from its exports. This increased to just over $2bn in 2007 and since then has doubled again to over $4.5bn. By 2006, the sector was estimated to have created over 50,000 jobs (direct and indirect).

The salmon sector has evolved over the years through three distinct phases:[8,9,10]

1. **Industrial initiation phase (1974 – 1984)**
   This phase was characterised by the growth of a small number of public-private salmon and trout farming companies. For instance, Domsea Farms Chile (owned by Unión Carbide) which, in 1974, started producing salmon using imported genetic material. In 1981 Fundación Chile bought Domsea Farms and created Salmones Antartica, which remains one of the industry's largest firms. The performance of the few local pioneers and foreign firms stimulated interest amongst more local entrepreneurs.
2. **Industrial expansion phase (1985 – 1995)**
   During this period the sector began to experience rapid growth. The number of firms producing salmon increased from 36 in 1985 to a total of 994 by 1991. The Fishery and Aquaculture law was enacted in 1991, which created the three main regulatory bodies: The environmental regulator (RAMA); the sanitary regulatory for aquaculture (RESA); and the regulator for aquaculture licences. Another key development during this phase was the establishment of the Association of Salmon and Trout Producers (APSTC), which created a forum through which the Chilean companies could coordinate their activities more effectively and created a quality certification system.
3. **Market expansion phase (1995 – present)**
   The market matured as producers reached industrial scale. Due to a fall in world prices in the 1990s and a more demanding technological and competitive regime, several mergers and acquisitions occurred within the industry, leaving the average firm larger, more capital intensive and technologically more sophisticated. A number of the remaining larger firms adopted a vertically integrated model to reduce production costs and become more internationally competitive. The increased sophistication of the companies operating in the market was complemented by an increase in the depth and breadth of regulations governing the sector.

Two parastatals' roles in driving sector transformation.

Fundación Chile (FCh) is an institution that was created by the government in 1976. Positioned between government and the private sector, FCh can bring policy and government support alongside investment in lead firms — mostly through joint ventures that bring in capability. It has worked across a number of sectors in Chile, including salmon.[11,12]

Overall, FCh's approach to sector transformation involves three main avenues:

- **Identifying new opportunities** where it can add value.
- **Forming partnerships** with international institutions to obtain the technologies that the sector/company needs to grow.
- **Supporting local businesses** to scale-up and facilitate the spread of the innovation/technology across the industry in order to increase the competitiveness of the sector in Chile.

FCh established its salmon project in 1980. One of the important features of this project was the acquisition and improvement of technologies and standards. For instance, the project established a knowledge centre for salmon farming, which drew on the techniques applied in Norway.

They also made stage investments in the sector by injecting equity as well as acquiring and developing local salmon companies. For example, it purchased Salmones Antartica for $1m in 1981, redeveloped its operations and then sold it for $22m in 1988.[13]

Alongside FCh's role as an early-stage developer, the Corporacion de Fomento or Economic Development Agency (CORFO) was important in providing public sector investment to support the growth of the salmon sector. Working with the InterAmerican Development Bank (IDB), CORFO provided $231m worth of subsidised loans to investors in Chile in 1983 and another $310m in 1986 – a significant proportion of which were targeted at the salmon sector.

Over half of the salmon producers in Chile received at least one loan from CORFO during their development; the availability of the soft loans was a critically important factor for their decision to invest in salmon.[14]

OVER HALF OF THE SALMON PRODUCERS IN CHILE RECEIVED AT LEAST ONE LOAN FROM CORFO DURING THEIR DEVELOPMENT

2.3 CASE STUDY: KENYA TEA SECTOR

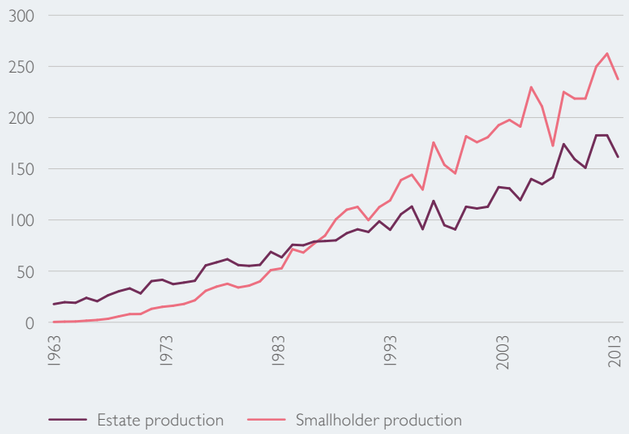
The success of the Kenya Tea Development Agency, supported by government policy and DFIs.

Kenya has grown to become the largest African tea exporter — ranking as one of the largest tea exporters in the world and accounting for 16% of global exports.[15] The tea sector is currently a source of income for over 560,000 tea growers supplying 66 factories.[16]

A driving force in the rapid increase of exports was the Kenya Tea Development Authority (KTDA), which developed Kenya's successful out-grower tea model (e.g. by providing input credit and technical assistance to smallholders) that maintains the quality of production. KTDA also acted as the off-taker for smallholders' green leaf production.[17,18]

Alongside KTDA, the Kenyan government provided supportive fiscal policy and regulatory conditions to enable the sector to flourish. For instance, the creation of the Tea Research Institute of East Africa (TRIEA), which developed nurseries and high-yielding tea varieties. The government also built roads to transport tea between farms and markets.

Growth of Kenyan tea production
(Tea production kg million)



Source: East African Tea Trade Association: Tea Production statistics

CDC was the first DFI to support the KTDA. By 1981 it had lent £15.5m, with loans being guaranteed by the Kenyan government. The initial loan had a lifetime of 20 years and all loans have since been serviced and repaid. These soft loans were accompanied by two IDA credits from the World Bank. The World Bank also issued a loan of $10.4m for the construction of 17 tea factories and associated services between 1974 and 1981.[18,19]

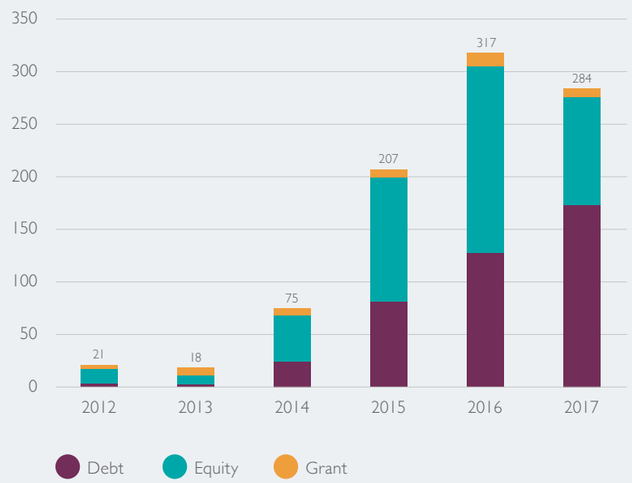
Apart from financial support, CDC also assisted KTDA with technical assistance and the development of its business plans. It seconded experts to KTDA and provided assistance in recruiting staff.[20]

2.4 CASE STUDY: SOLAR HOUSEHOLD SYSTEMS

Provision of an attractive product at an affordable price for consumers.

A report by Catalyst prepared for the Shell Foundation estimates that by 2016 over 12 million Solar Household Systems (SHS) products have been sold across SSA, growing from less than 1 million in 2012.[21]

Sources of funding for off-grid solar market 2012–2017
($m)



Source: World Bank Group (2018). Off-grid trends solar market report 2018

The growth of the sector is a very recent phenomenon, but it is an interesting contrast with the mobile phone sector (noting obvious differences in the sector context and financing opportunities/requirements).

The early-stage seed capital required to support the development of the sector in SSA has come from a range of sources such as self-finance, crowd-funding and family offices. As the sector began to grow it has been able to garner investment from early-stage impact investors and foundations.

It is only in the last few years that the largest companies operating in the sector have been able to move towards profitability and attract DFI investment to support their further expansion. This approach is different to earlier pioneering roles DFIs have taken.

For instance, M-KOPA is one of the biggest companies operating in the sector and has had some success in raising finance from DFIs and local banks — particularly using the consumer receivables model (leveraging the value of the loans on its books to free-up working capital). In 2017, it agreed a pioneering $55m equivalent in Kenyan and Ugandan shillings local currency facility using the value of its consumer receivables from CDC, FMO and Stanbic Bank.[22]

Mobisol raised $25m of new investment from Investec and others such as IFC and FMO in 2017 to support its expansion, having been in operation since 2011.[23]

2.5 CASE STUDY: MOBILE PHONES

A mix of government privatisation, development finance and consumer appetite.

As shown in the figure below, the mobile phone sector grew rapidly in sub-Saharan Africa (SSA) since the beginning of this century. Between 1998 and 2008, the SSA telecommunications sector has on average received investments amounting to $5bn per year.[24]

A key distinction of the transformation in the mobile phone sector was that growth was largely driven by private sector investment — which was possible because governments across Africa were willing to liberalise the sector.

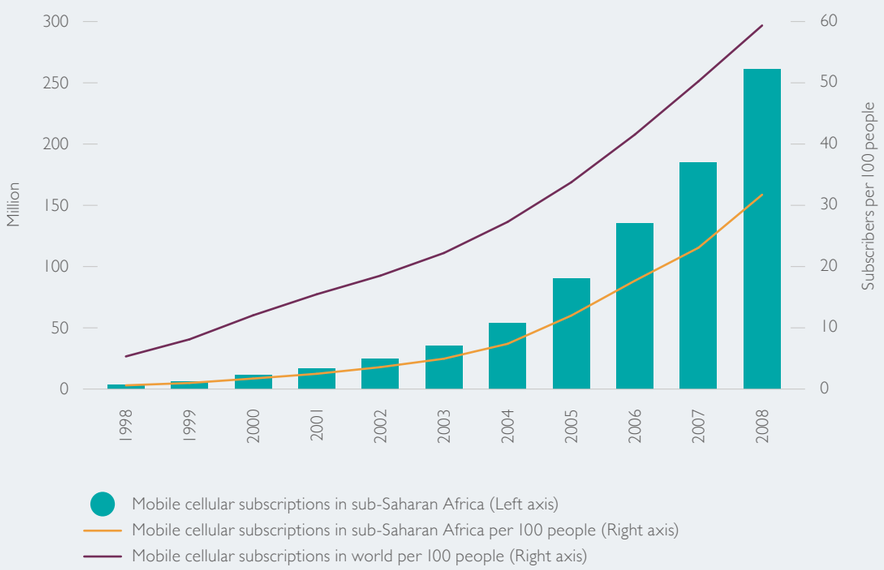
Private sector investment took two main forms. Most was on greenfield mobile projects needed to develop the infrastructure required to provide mobile phone services; this totaled $37bn between 1998 and 2008.[25] In addition, investment came in the form of equity purchased to acquire privatised, formerly state-owned operators.

The private sector investment in mobile phones came from large corporates, which crucially were able to attract finance from a range of sources with DFIs playing an important catalysing role, alongside commercial banks and other investors.

MTN, which is the largest provider in SSA, used finance from DFIs to support initial investments in the sector. In 2003, MTN benefited from a $395m financing package ($110m from the IFC and $20m from both FMO and DEG).[26]

Similarly, the initial investment in Celtel to begin operations in Zambia came from IFC, which provided both a $4.5million senior loan and an equity investment of $600,000. The project received additional debt financing of $4.5 million from the Development Bank of Southern Africa (DBSA).[27]

Mobile cellular subscriptions in SSA, 1998–2008



Source: World Bank Development Indicators

The role of DFIs in accelerating the market in Nigeria.

Particularly during its first few years of operation in Nigeria, DFIs played a considerable role in the financing of MTN's investment alongside both international and local banks. In 2003 MTN benefited from a US$395m financing package which included a US$75m senior loan and US$25m equity investment by IFC and US$20m senior loan financed by both FMO and DEG.

This investment was one of IFC's largest investments in telecommunications and its second largest investment in sub-Saharan Africa at the time and was awarded the "Africa Telecoms Deal of the Year" award by Project Finance Magazine for the catalytic role it played in mobilising private financing from international banks such as Standard Chartered, alongside a range of local banks.

MTN Nigeria also benefited from a US$200m financing package led by Standard Chartered the following year, which included a US$10m senior loan from the Emerging Africa Infrastructure Fund (EAIF).

Despite the DFI involvement in earlier MTN Nigeria financing deals, recent transactions have been on a much larger scale and tended to be dominated by commercial bank investment, suggesting that the company's risk profile has developed to such an extent that DFI involvement is no longer required. For example, in 2013 the company secured a US$3bn loan facility from a consortium led by Zenith Bank and stated that it was looking to invest this amount in its network expansion over the coming three years.

Photo: Sunshine Seeds

2.6 SUMMARY

> OUR CASE STUDIES HIGHLIGHT THAT CONCESSIONAL FINANCE HAS BEEN CATALYTIC TO THE GROWTH OF SECTORS OF HIGH DEVELOPMENTAL IMPORTANCE

- DFIs and other finance providers have played a role in the past in providing 'concessional finance' (i.e. investment that does not seek to achieve a market return) to pioneering sectors. Much of this investment was instead concerned with building capability, demonstrating success, and crowding in other players.
- Our case studies highlight that this type of finance has been catalytic to the growth of sectors of high developmental importance — such as floriculture in Ethiopia, tea in Kenya, and aquaculture in Chile. The case studies on mobile phones and the solar home system (SHS) markets are contrasting, as they show that DFIs were more willing/able to support the early-stage investment needed to catalyse the mobile phone sector but have primarily engaged with SHS companies only once they have achieved a certain size/scale and track record.
- The case studies show that sector transformation requires a supportive industrial policy with additional sector level support. In many cases of early stage finance leading to transformation, the finance provider was also able to rely on technical support to key firms and close government engagement to resolve specific bottlenecks. Or, at minimum, government was neutral and there were no significant policy barriers or political economy constraints to sectoral expansion and investment.
- The next section explains why agriculture is critical to the achievement of the SDGs and the important need to provide it with more concessional finance to facilitate transformation in the future. We then provide an overall review of the current sources of finance available to developmental sectors such as agriculture.

3 IMPORTANCE OF AGRICULTURE FOR THE ACHIEVEMENT OF THE SUSTAINABLE DEVELOPMENT GOALS

Photo: Neil Thomas

AGRICULTURAL TRANSFORMATION

What is agricultural transformation?

While there is no specific definition of what is meant by agricultural transformation, the concept is understood widely.

Photo: Neil Thomas

FOR INSTANCE:

- The African Center for Economic Transformation (ACET) defines it as a process that leads to higher productivity on farms, commercially orients farming, and strengthens the link between farming and other sectors of the economy.[28]
- McKinsey's Center for Agricultural Transformation suggests that the dynamics of an agricultural transformation start with increasing the income of rural households, higher productivity on farms, and greater demand in local markets. As the sector becomes more productive, larger markets are served, agro-processing expands, and some farmers decide to spend less time farming and take other jobs that offer better economic opportunities.[29]

For the purpose of this analysis, we will link these to the widely accepted definition of economic transformation as…

"the ongoing process of (i) increasing aggregate productivity by moving labour and other productive resources from lower- to higher-productivity sectors and activities (structural change) and (ii) raising within-sector productivity by sector-wide improvements, for example skills training or clustering of firms, as well as firm-level innovations."[30]

AGRICULTURE'S ROLE IN DEVELOPMENT

What role can agricultural transformation play in achieving the Sustainable Development Goals?

Source: un.org/sustainabledevelopment

It is recognised that transformation of the agricultural sector in Africa has a central role to play in the achievement of the Sustainable Development Goals (SDGs):

- Economic growth in the agricultural sector is believed to be up to 11 times as effective at reducing poverty as growth in other sectors.[31]
- According to World Bank Group Development Indicators Data for 2017, 57% of workers are employed in the agricultural sector and approximately 80% of rural people rely on agriculture as their main source of income.[32]
- Therefore there is an important need to better understand which interventions are able to catalyse transformation in the agricultural sector. Our review of case studies from the agricultural (and other sectors) highlights the critical role of finance, and in particular of concessional finance, alongside other interventions.

Our review of the current financing landscape for agriculture suggests that there is a gap in the provision of finance of the kind needed to facilitate agricultural transformation.

IS AGRICULTURAL TRANSFORMATION UNDERWAY?

The emergence of more farms ready to 'step-up'.

Photo: Neil Thomas

Research on farm sizes in Africa is suggesting that small commercial and medium-sized farms (5 hectares–100 hectares) are taking up an increasing share of farm holdings.[33]

The rapid rise of medium-scale holdings in most cases reflects increased interest in land by urban-based professionals or influential rural people. These farms have the potential to be a force for dynamism, technological change and the wider commercialisation of agriculture in Africa, but they need access to concessional finance to do so.

These changes are not just happening on farms. The Africa Agriculture Status Report notes the crucial role played by midstream (e.g. traders and processors) actors in driving this transformation as this is the closest the market gets to the farmer, making up about 40% of the total gross value of value chains — and about 80% of this midstream is made up of SMEs. These firms also create significant rural off-farm employment.[34]

The demand for agricultural products in Africa is growing significantly, driven by population growth, increase in the consumption of processed foods, and urbanisation.

The rural economy is shifting and pathways for growth and income improvements for farmers are – in line with DFID's approach to agriculture and economic development – to:

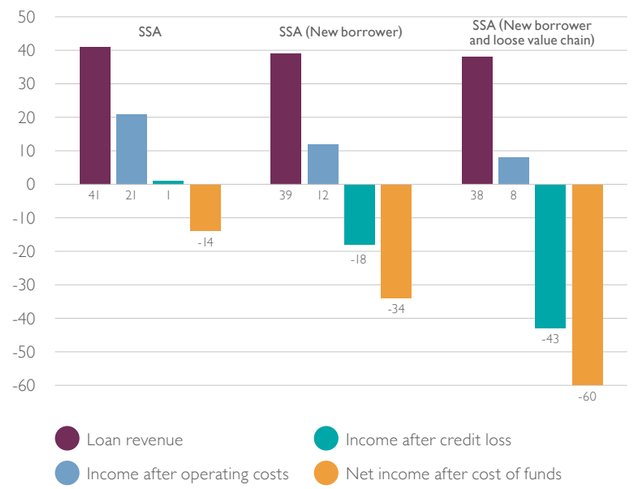
- **Step out:** i.e. find employment, which will enable their smaller land parcel to be consolidated into bigger and more efficient farms, or converted for other use;
- **Hang in:** Accept that agriculture will provide a low and variable income while additional investment in the land remains out of reach, but choosing to wait for such opportunities to arise;
- **Step up:** This refers to emerging farmers (5–100 hectares), which are a major growth area driving positive change. These are currently not well serviced by DFIs, impact investors, banks, other commercial financial service providers or development programmes.

MSME AGRICULTURE NEEDS CONCESSIONAL FINANCE

Smallholder and MSME agriculture in Africa does not yet offer market returns.

These emerging farmers in SSA will be particularly challenging to service. For example, a 2018 Council on Smallholder Agricultural Finance (CSAF) study presents some analysis on the loan-level economics of supporting agricultural projects based on data provided by nine of their members.[35]

Average net income after cost of funds for 3,600 investments in SME agriculture across SSA ($k)



Source: USAID (2018). CSAF financial benchmarking. Summary presentation

THE ANALYSIS FOUND THAT:

- Loans in sub-Saharan Africa were twice as likely to end up in recovery than loans in Latin America. Loans in SSA also had operating costs that were 22% higher.
- Larger loans performed better than smaller ones. The operating costs were similar, but interest and fee income was proportional to the loan size. Furthermore, loans below $500k had an approximately 80% higher risk of default than the larger loans.
- First time borrowers were twice as likely to default than existing clients and new borrowers had 50% higher origination costs.
- Loans in formal export value chains: (e.g. cocoa, coffee) performed much better than loans in other sectors (e.g. staple grains) which were 2.5 times more likely to default.
- Short-term loans (less than 12 months) performed better than long-term loans — which were four times more likely to default.
- This chart shows that given standard costs for CSAF members, loans are loss-making in SSA and require more subsidy if trying to target new borrowers and/or borrowers in less commercial value chains.

4 EXISTING SOURCES OF FINANCE FOR AGRICULTURAL TRANSFORMATION

Photo: Rob Beechey

SUPPLY OF CONCESSIONAL FINANCE FOR TRANSFORMATION

A lack of access to finance remains a constraint for the agricultural sector.

Despite evidence of the role that agricultural transformation needs to play in meeting the SDGs, the sector continues to suffer from limited availability of finance, even for large agribusinesses. For instance, it is estimated that there is a financing gap of $11bn annually for the expansion of agricultural output.[36]

In practice, it is not clear that there is an effective financing gap; the main issue is the mismatch between the available supply of commercial finance seeking a risk-adjusted return and the nature of investment opportunities in agriculture and other developmentally important sectors, which really need concessional finance.

This section reviews the main existing sources of finance for the agricultural sector:

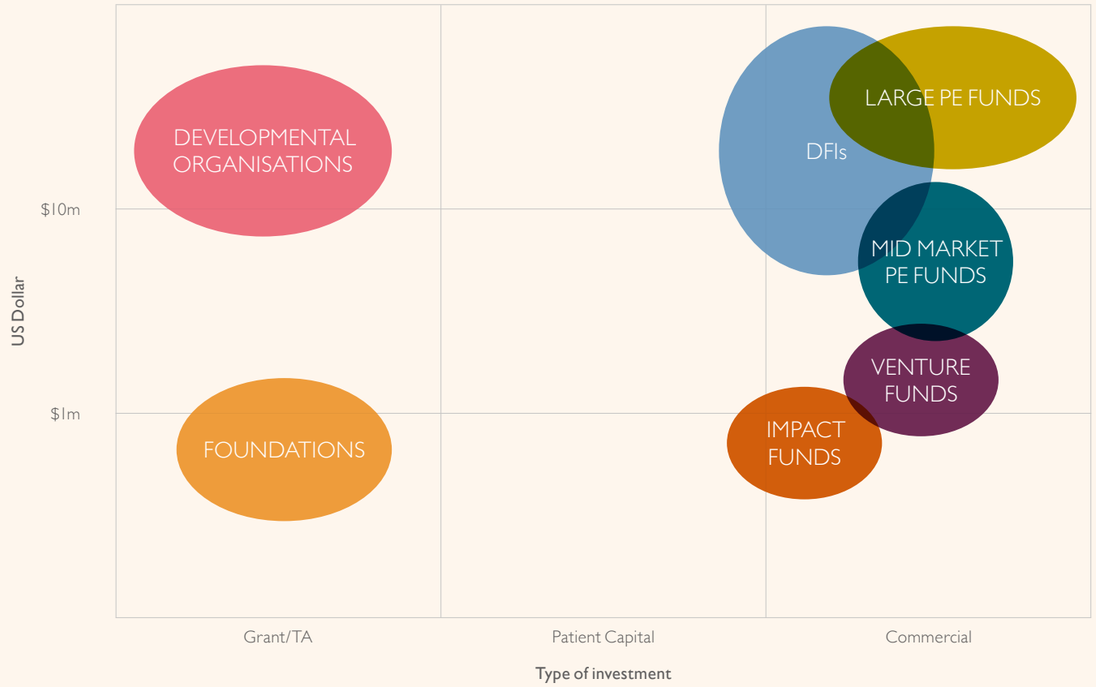
- We present the context for the development finance landscape, illustrating the different types of financial instruments required by the agricultural sector, how they are used, and an overview of different sources of available finance.
- We then look at commercial banks, DFIs, impact investors, sovereign wealth funds, private equity and investment funds in turn to explore the role that each are playing in providing finance to agriculture.

Photo: Neil Thomas

CURRENT FINANCE LANDSCAPE IN AFRICA

Entrepreneurs looking for opportunities in the agricultural sector are typically caught in the middle of grants available from donors/ foundations and financiers seeking commercial returns.

The development finance landscape in sub-Saharan Africa



Source: Robert Jenkins (2019): The Need for Private Equity, Patient/ Concessional and Donor Capital coupled with Integrated Sector Strategies in Sub Saharan Africa to support the development of Sustainable Businesses and Industry Sectors

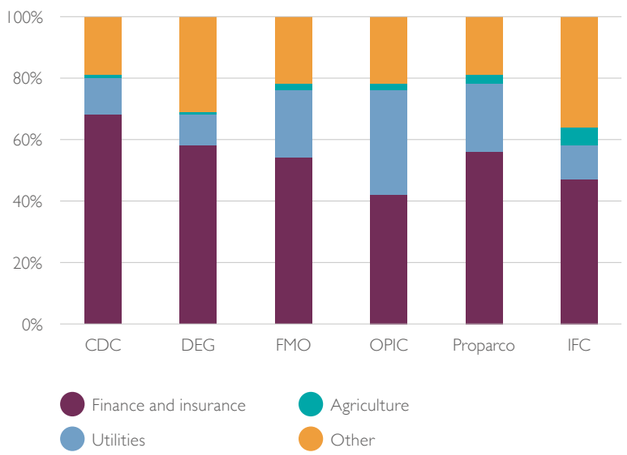
Photo: Neil Thomas

SUPPLY OF FINANCE FOR AGRICULTURE: DFIS

Agriculture is a marginal area for DFIs, in practice most only engage using blended finance.

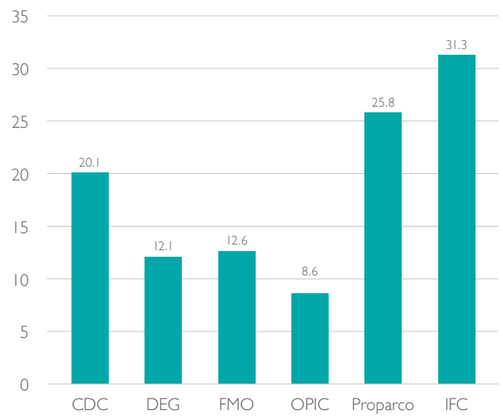
Data from six of the largest DFIs (across global portfolios) shows that typically only 1–2% of portfolios focus on agriculture. IFC was largest with just 6% going to agriculture.[37]

DFI commitments by sector % of portfolio



Source: Charles Kenny et al (2018)

Median size of DFI investment in agriculture ($m 2012–2016)



Source: Charles Kenny et al (2018)

The chart above highlights that DFIs have generally focused on big ticket investments in agriculture, because it is difficult for them to do profitable projects for smaller investments given transaction costs.

The main issue continues to be the lack of large commercial investment opportunities available that justify DFI involvement.

DFIs typically engage with the sector using a blended finance approach [e.g. IFC and the Global Agriculture and Food Security Programme (GAFSP); CDC's new Impact Fund/Accelerator and CDC Plus TA facility; KfW and the Africa Agricultural Trade and Investment Fund (AATIF)].

Photo: Neil Thomas

In the past DFIs were able to play a catalytic role in agriculture. More recently, they have been pushed towards a focus on commercial opportunities.

The role of DFIs has changed significantly over recent decades. CDC and most in-country development banks and finance corporations were set up in the immediate post-colonial era to take on early risks (even 100% shareholdings in the case of CDC) and then sold on or refinanced projects to the private sector once de-risked.

More recently, when DFIs are being seen as a key part of international development policy, available evidence suggests that they are no longer playing this type of role. DFIs are avoiding agriculture as a whole because of perceived risks (climate, disease, commodity prices etc.) and modest return potential, even though agriculture contributes most to jobs and livelihoods for the poor.

This aversion to risk is not limited to agriculture. DFIs (and the PE Funds they invest in) are also avoiding start-ups and early stage (pre-EBITDA positive) ventures in most sectors because of the risks relative to their own Return on Capital Employed (ROCE) targets. They require the private sector to pioneer, then they invest once the venture is de-risked.

Increasingly, DFIs or the PE funds they invest through are competing with commercial finance by using their grant and soft-financing windows to, in practice if not in theory, subsidise their commercial investment offers (e.g. compensating ESG requirements that come with their investment when compared with private commercial sources, or at times using TA facilities to fund temporary senior executive roles). This opens up governance and moral hazard questions regarding how these facilities are structured.

Some DFIs mention their "demonstration effect", i.e. proving they can make healthy returns and therefore attract private sector investors to the LDC countries. However, private capital often cannot take DFI investment as a model since they have privileges (for example the IFC used to have priority for debt servicing in Zambia because it invoked cross default clauses with the World Bank and IMF) that commercial investors do not. The counter factual also does not prove true in practice: every time a DFI loses money there is no evidence that private sector investment retreats.

A recent study by the Overseas Development Institute (ODI) on DFIs concluded that they need to have a greater emphasis on financial additionality and broaden their key role in early-stage projects.[38]

There are some outliers. IFC is the largest individual DFI and has committed the biggest proportion of its portfolio to agriculture.

Photo: Neil Thomas

Type of financial products provided: A review of their portfolio shows a focus on providing debt and equity, where they provide guarantees in the form of risk sharing facilities. For example, they provided a 3-year Risk Sharing Facility (RSF) to an Ethiopian company for a portfolio of up to USD $15.2m in working capital loans to coffee farmer cooperatives, originated and serviced by the Nib International Bank (NIB) in cooperation with Technoserve.[39]

They also have two programmes that support agriculture:

1. **The Global Warehouse Finance Programme (GWFP).** This seeks to increase working capital finance available to agricultural producers/traders. IFC either offers a short-term loan to a bank, which the bank then lends to farmers using a warehouse receipt as collateral, or provides the bank with a risk sharing facility.
2. **The Global Trade Liquidity Programme (GTLP).** IFC enters into funding arrangements with selected banks in which IFC invests in a selected portfolio of trade transactions originated by the bank. IFC can participate in up to 50% of the portfolio.

IFC HAS THREE MAIN FOCUS AREAS RELATED TO AGRICULTURE:

1. Building capacity of financial institutions in agri-finance through diagnostics, improving risk management systems/processes and designing new products;
2. Linking financial institutions to sustainable supply chains; and,
3. Linking insurance to agri-finance.

IFC is also managing the Global Food Security Programme – Private Sector Window (GAFSP PrSW). It uses the grant funds available through GAFSP PrSW to blend with its own commercial capital to, in theory, enable it to reach projects that it would not otherwise be able to support (such as greenfield investments or those in riskier countries). According to its website, IFC has invested over $300m across a number of sectors and has been able to invest in smaller ticket projects (avg. size is around $9.2m).

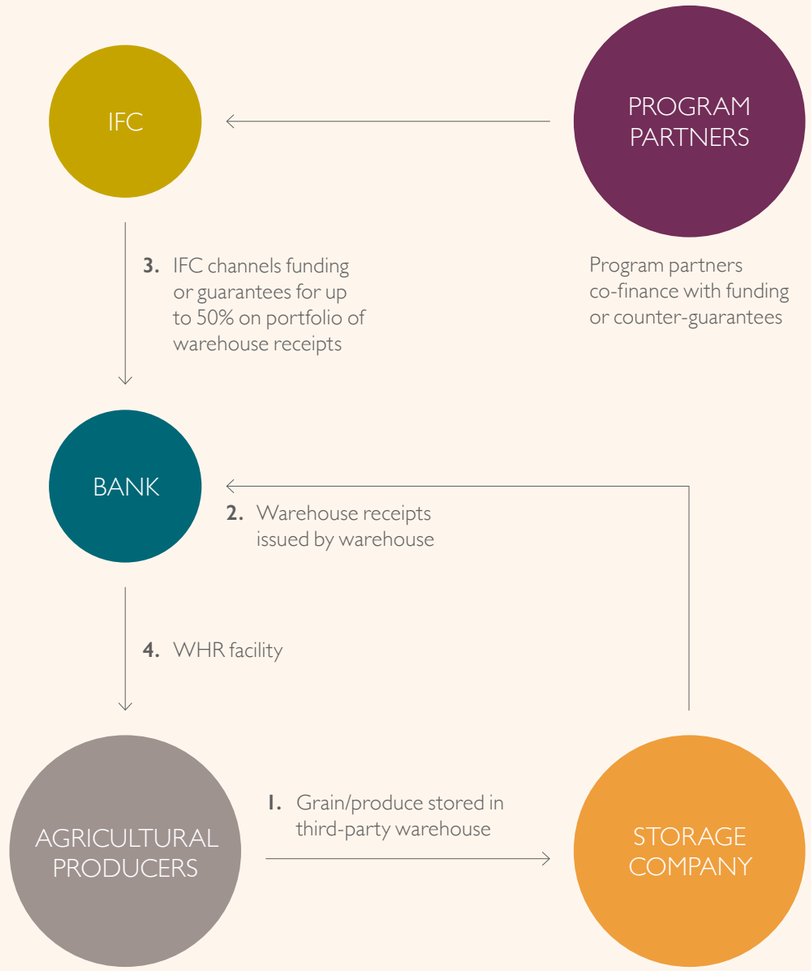


Diagram adapted from IFC

> FINANCIAL ACTORS ARE AVOIDING AGRICULTURE AS A WHOLE BECAUSE OF RISKS AND MODEST RETURN POTENTIAL EVEN THOUGH AGRICULTURE CONTRIBUTES MOST TO JOBS AND LIVELIHOODS FOR THE POOR

Photo: Neil Thomas

SUPPLY OF FINANCE FOR AGRICULTURE: COMMERCIAL BANKS

Commercial banks continue to underserve the agricultural sector.

Commercial banks are looking for the opportunity to achieve commercial returns on the loan products that they can provide.

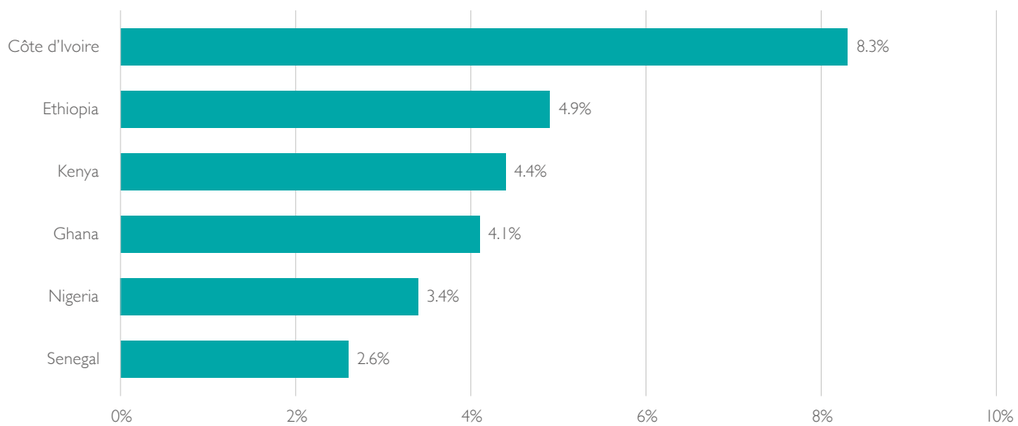
They are limited by stringent regulations regarding the length of tenor that they can offer and the types of risk that they can take on.

Commercial banks continue to shy away from lending to the agricultural sector. Agricultural loans made by banks tend to account for around just 3 to 10% of their total portfolio.

Banks typically cite factors such as the high costs involved in trying to service the agricultural sector as being a key limiting factor. The recent focus is on the use of digital finance solutions to reduce the cost of reaching rural farmers.

From the point of view of prospective borrowers in the agricultural sector – particularly SMEs – commercial banks are seen as charging interest rates that are too high and having collateral requirements that are simply not possible for them to meet. Products are also not typically tailored to the cash flow patterns associated with agricultural production cycles.

Percentage of lending to agricultural sector



Source: Central bank data from selected countries

There are examples of banks focusing on developing products for agriculture.

NMB Bank Tanzania is the second largest bank in Tanzania with a network of 189 branches across the country and over 1.6m customers. It has a stated target to increase its investment in agriculture by 500%. NMB's largest shareholder is Rabobank, which provides them with technical support for agricultural loans.

NMB has announced recently a partnership with the Mastercard Foundation to introduce a new platform to enable farmers to complete the process of receiving payments digitally instead of having to physically access markets.

Photo: Sebastian Noethlichs

NMB has a specialist agribusiness department and has the following products specific to agriculture which are being deployed with varying degrees of success:

- **Warehouse receipts financing.** Loans are given to registered farmer cooperatives/groups based on the commodity stocked in NMB approved warehouses after submission of a warehouse receipt. The minimum crop value to qualify for the scheme is 50 metric tons. NMB's programme has received a loan of up to $35m from IFC, together with a trade finance guarantee of up to $10m.
- **Out-grower loan scheme.** Targeted at contract farmers, it provides working capital finance to meet costs of farming, inputs purchase, crop maintenance, harvesting and other related crop development costs. NMB finances crop inputs which are either delivered by the off-taker or agri-input dealers. The harvest is contracted to the off-taker who pays the crop proceeds through the bank, whereby the loan is re-paid and the remainder is available for the farmer/producer group.
- **Investment and working capital loans.** These have term loans for up to 10 years to support investment in agricultural production/productivity (e.g. through the purchase of on-farm equipment, irrigation systems, etc.)
- **Emerging and commercial farmers finance.** NMB provides loans to farmers with between around 5 to 20 hectares that are within specified distances of milling/processing facilities and have some form of arrangement with an off-taker, land title and the ability to secure the loan with collateral.

SUPPLY OF FINANCE FOR AGRICULTURE: IMPACT INVESTORS

A growing source of finance for agriculture, but can investors break even?

There is no formal definition of what an impact investor is, but they are commonly understood to be investors that actively target the achievement of a social and/or environmental impact alongside a financial return.

In addition, impact investors are meant to demonstrate a commitment to measure and report on the impact of their investments.

Impact investors comprise a highly diverse group of institutions, including investors seeking risk-adjusted commercial returns through to those that just seek to preserve capital after overhead costs.

The Global Impact Investing Network 2018 Survey shows that 6% of impact investors' Assets Under Management were devoted to the food and agricultural sector, though 57% of respondents were targeting the sector (based on information provided by 229 respondents). Furthermore, 49% of respondents stated that they want to increase their investments in agriculture.[40]

Existing impact funds with an exclusive agriculture mandate have so far failed in most cases to preserve capital or meet return objectives for investors, especially when structured under a conventional LP/GP 5-year private equity model. In many cases, the first wave of funds have restructured to hold their investments on balance sheet under a longer-term holding company (patient capital) model.

Photo: Neil Thomas

SUPPLY OF FINANCE FOR AGRICULTURE: SOVEREIGN WEALTH FUNDS

SWFs have a limited presence in the agricultural sector.

Sovereign Wealth Funds (SWFs) are pools of capital that are built up from a country's reserves – typically savings accrued from earnings gained exporting commodities such as oil.

The savings are accumulated into a fund, which are then invested for the long-term benefit of the economy. The public policy rationale for establishing a SWF is to enable the government to help improve inter-generational equity, i.e. so that future generations of citizens benefit from a country's depleted natural resources.

Country	SWF Assets $ billions
Nigeria	1.5
Botswana	6.9
Angola	5
Ghana	0.1
Senegal	1
Ethiopia	1

Source: Diallo et al. (2016) on sovereign wealth funds

There are only a handful of operational SWFs in Africa. The table below lists the largest examples.[41] SWFs typically do not invest in developmental sectors such as agriculture as they usually are required to invest only in sectors that meet certain credit rating requirements. A few examples of SWFs with at least some activity in agriculture are discussed below:

- **The Nigerian Sovereign Investment Authority (NSIA).** This is a $1.5bn fund (gained from savings from oil exports) mandated to invest across all sectors, including agriculture. To date, they have invested $10m in the Fund for Agricultural Finance in Nigeria (FAFIN). FAFIN is an agriculture-focused investment fund that provides tailored capital and technical assistance. It also received investment from KfW, CDC and the Dutch Good Growth Fund.
- **The Botswana Pula Fund.** The $6.9bn Pula Fund was created to provide a long-term savings vehicle that will preserve the wealth from Botswana's diamond reserves. The Fund is managed by the Bank of Botswana, which invests the assets exclusively in foreign currency denominated assets, i.e. it is not supporting domestic agricultural projects. The strategic asset allocation includes public equity and fixed income instruments in industrialised economies.
- **Fondo Soberano de Angola.** The $5bn fund invests more than one third of its investment portfolio in securities such as treasury bonds, corporate bonds and listed securities. The remaining two-thirds are allocated to private equity activities in other countries (including developed economies) — $250m has been allocated for investment in agriculture, but it has been a marginal area of focus to date.

A few have invested through specialised funds.

FAFIN: This is a USD $66m fund that is currently managed by Sahel Capital with a target size of $100m. It provides long-term finance and technical assistance (through its $4m technical facility fund) to commercially attractive agricultural MSMEs (companies with less than 250 employees and a turnover of between $2m to $20m) across all states in Nigeria. It is a close-ended fund, due to finish in 2024, but can be extended for three additional one-year periods. FAFIN targets investments in the $3m to $6.5m approx. range (in Naira equivalent). It does not provide details of the financing for each investment, but it seems that they have primarily made equity investments into their investee companies.

Photo: Neil Thomas

Examples of its investments in the Nigerian agricultural sector are set out below:

- FAFIN made an investment in Coscharis Farms, which is an integrated rice processor that commenced business operations in 2014. Based in Ayamelum, Anambra state, the company currently has 2,500ha of land for rice cultivation. The investment was planned to enable Coscharis to invest in an integrated rice platform which can be scaled up to meet the staple food requirements of Nigerians. FAFIN's investment also provided the company with the resources it needed to invest in critical infrastructure for both its farming and milling operations needed to expand.
- Crest Agro was established in 2013 and it focuses on the cassava starch sub-sector. The company aims to become the leading producer of food grade cassava starch for industrial users in Nigeria and the broader West Africa sub-region. It has a 13,000-hectare mechanised cassava farm and an already functional and growing out-grower network of 400 smallholder farmers.

SUMMARY

1.

Despite evidence of the role that agricultural transformation needs to play in meeting the SDGs, the sector continues to suffer from limited availability of finance.

FOR EXAMPLE:

- **Commercial banks in Africa** are generally unwilling/unable to provide loans for agriculture beyond low risk secured seasonal input loans (e.g. for fertiliser). They typically account for just 3–10% of portfolios in SSA.
- Data from six of the largest **DFIs** show that typically only 1 to 2% of portfolios go to agriculture. Where they do invest in the sector, DFIs are typically looking for larger investments (generally over $10m) that have a track-record of profitability. This is where commercial finance is operating, which leads to questions around the additionality of DFIs in agriculture.
- The Global Impact Investing Network 2018 Survey shows that 6% of **Impact Investors'** Assets Under Management were devoted to the food and agriculture sector.
- There are few **Sovereign Wealth Funds** in Africa, and their exposure to agriculture is low, in part because wealth funds are typically required to invest in assets that have an investment grade credit rating.

2.

Financial actors are avoiding agriculture as a whole because of risks and modest return potential even though agriculture contributes most to jobs and livelihoods for the poor.

3.

Thus, there is a continued need for further concessional finance for agriculture, particularly for new, early and SME ventures in SSA, but this remains far from the current capabilities and incentives of the larger pots of finance.

5 CONCLUSIONS AND RECOMMENDATIONS

Photo: Neil Thomas

CONCLUSIONS

1.
The case studies highlight the role that DFIs and other finance providers have played in the past in providing 'concessional finance' (i.e. investment that does not fully price for risk) to pioneering sectors such as agriculture to facilitate sector transformation. The point is that much of this investment did not achieve (nor did it seek) risk adjusted returns, and was instead concerned with building capability, demonstrating success, and crowding in other players.

2.
DFIs in particular were set up to take on the high risks of pioneering. This role has changed in recent decades, with private sector taking more of the pioneering risks and DFIs entering later with more commercial risk/return requirements.

3.
Sectors such as agriculture have a central role to play in the achievement of the Sustainable Development Goals. However, despite the promise of 'triple bottom lines' espoused within the impact investing literature, agriculture will always remain risky to finance, with marginal (or even negative) returns commonplace for MSMEs (especially those outside cash crops like cocoa, coffee).

4.
There are initial signs that the agriculture sector in SSA is starting to transform, with the growth of small commercial and medium-sized farms (5 hectares – 100 hectares) and SMEs acting as the main engines of growth. These farms and SMEs have the potential to be a bigger force for dynamism, technological change and the wider commercialisation of agriculture in Africa, but they need access to smart concessional finance to do so. Our review of the current sources of finance available for sectors such as agriculture show that there is a considerable gap in the supply of this type of finance.

5.
This study suggests that DFIs and concessional finance investments have a much higher chance of achieving wider sector transformation and impact where there is clear government policy support for the sector.

6.
It should be noted that there are signals of a movement back towards more flexible risk capital such as CDC's Accelerator and Catalyst Funds, which can take higher risks, are not constrained by a sector-specific mandate, enabling them to "explore new pathways for market-shaping impact". This could provide scope for extending more innovative risk capital back into agriculture.

7.
There is a need for additional research to consider how best to provide agriculture with the support that it needs and we present some initial recommendations/issues on the following slide.

DIFFERENT OPTIONS FOR PROVIDING CONCESSIONAL FINANCE

Additional research is needed on the most effective approaches to allocating concessional finance.

1.
A 2017 paper by Enclude shows that there are a range of models that can be employed to combine the provision of technical assistance alongside concessional and/or blended finance structures.[42] For instance:

- Impact funds or facilities that are allowed to make sub-commercial returns such as AgDevCo or AECF;
- Blended finance: the use of catalytic concessional capital from public or philanthropic sources to increase private sector investment in sustainable development. This can include DFI concessional funds alongside commercial funds, the use of technical assistance, first loss capital structures, or guarantees and design grants that are put alongside commercial debt or equity. A prominent example is the introduction of the IDA 18 Blended Finance Facility;
- Increasingly there are also facilities being used alongside concessional funders. These include technical assistance and grant facilities alongside DFIs and impact funds (e.g. IFC and the Global Food Security Programme Private Sector Window; or CDC and the CDC Plus TA/grant facility);
- Grant facilities for technical assistance and business development services managed by investors (or separately) alongside funds to reduce risks and transaction costs.

2.
Concessional finance is effectively just another form of subsidy, which like any other subsidy can be misused if not well managed. For example, it could be used by investors to prop up the wrong projects for too long or simply provide excuse for bad deal making or lack of investment rigour. Investments still need to target opportunities that have the potential to achieve long-term commercial sustainability and impact whilst operating in a competitive market.

3.
These type of projects will on occasion fail, even when sensible investment processes have been followed and the investee company has good business fundamentals. A simple rule of thumb is that the use of concessional finance needs to be linked to clear and measurable development impact targets that are consistent with underlying sector development strategies, whilst demonstrating value for money.

4.
Despite multiple approaches and models emerging, research is still hard to find in terms of which offer best value for money and how to overcome inherent risks and governance challenges. Donors and philanthropists could develop or study a portfolio of approaches and more clearly monitor which are more successful and how best to handle the governance and management incentive challenges inherent in all of them.

5.
More fundamentally, there is a question about the extent to which donors have a coherent strategy in place to govern the way in which they facilitate the provision of concessional finance in agriculture. For instance, while DFID has a clear agriculture and growth strategy, the link to its approach and evidence for supporting various partners to disburse concessional finance is less clear. Further evidence and research in this area would be valuable and will require funders to develop and agree smarter impact and VFM evidence from the investors and programmes they support.

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