ValueLinks Module 8

Value chain finance

giz

ValueLinks 2.0

Setting boundaries
1. Scope of value chain development

Chain analysis and strategy
2. Value chain analysis
3. Value chain strategies
4. Programs and projects

VC upgrading solutions
5. Business models
6. Business linkages
7. Services
8. VC Financing
9. Quality and standards
10. Policy instruments

Monitoring
11. Managing data & monitoring

Solutions for improving the value chain

Value Chain Financing Solutions

Contents

VC development and financing issues

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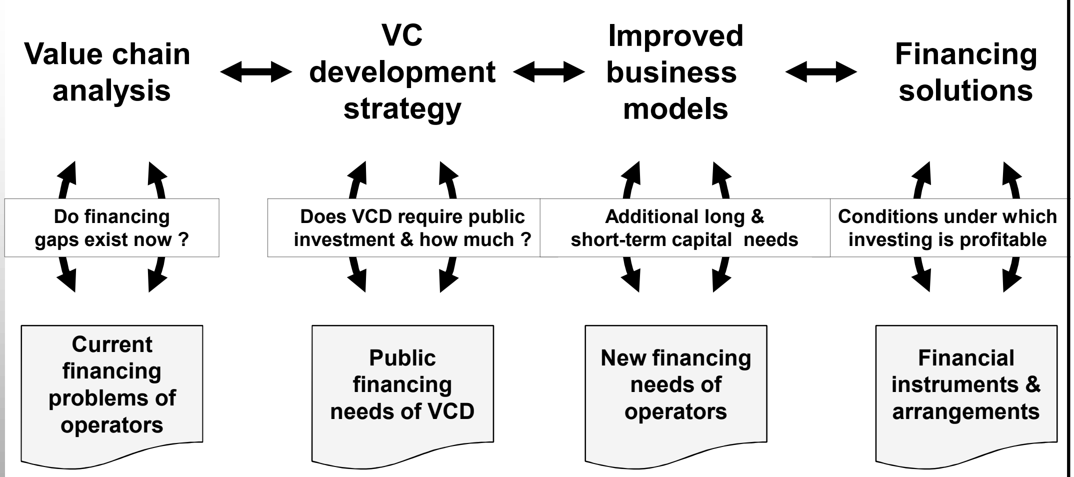

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Reasons for financing gaps along the VC

Current financing problems along the value chain

Technology suppliers → *Primary producers* → *Processors Industry* → *Traders* →

Financing gaps

Technology suppliers	Primary producers	Processors Industry	Traders
Internal financing	Internal financing	Internal financing	Internal financing
External financing	Financing gap	External financing	External financing
		Financing gap	

Reasons for gaps, e.g.

Primary producers:

- No access to credit for small size and lack of collateral;
- Little saving potential;
- Business model not attractive enough

Processors Industry:

- New entrants with no track record
- Small size
- Business model not attractive enough

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Financing needs of value chain development

Classifying the financing needs arising in VC development

...physical & financial capital	*...institutional & human capital*	
LT capital (fixed assets) ST working capital *of operators*	Funds for *building cooperatives* *vocational training*	*Primary Producers* → *Industry* → *Traders* → *Market*
LT capital (fixed assets) ST working capital *of service providers*	Funds for *associations* *staff training*	Support Service Providers
Rural infrastructure *(from resource management to communications)*	Funds for *improvement of organization and staff training*	Government (national or regional)

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Calculating capital needs

…derived from the analysis of improved business models

Key activities:

- New production technology
- Intensification / more inputs
- New sales channels

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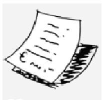
Key resources:

- Equipment
- Buildings
- Other long-term assets

Cost structure:



- Greater working capital to pay for raw material and inputs
- Ability to repay long-term credit

Financial Needs of VC Actors

Typical financing needs of operator business models

Primary producers → Processors Industry → Traders → Market

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	Primary producers	Processors Industry	Traders
Short term working capital *2-6 months*	Bridging the period between - purchase of inputs and sale of harvest - delivery of buyers	Bridging the period between - purchase of intermediate products and sale of pruduct - delivery of products and payment of buyers	Bridging the period between - purchase (in bulk) and retail (store value) - Export of product and payment of overseas buyers
Long term Fixed assets *2-5 years*	Investment into - tree plantation - greenhouse - storage space - equipment, machinery	Investment into - buildings - equipment, machinery	Investment into - buildings - vehicles

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Value Chain Financing Solutions

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1 Financing needs of value chains and VCD

2 Financing solutions

3 Risk management

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Financing solutions

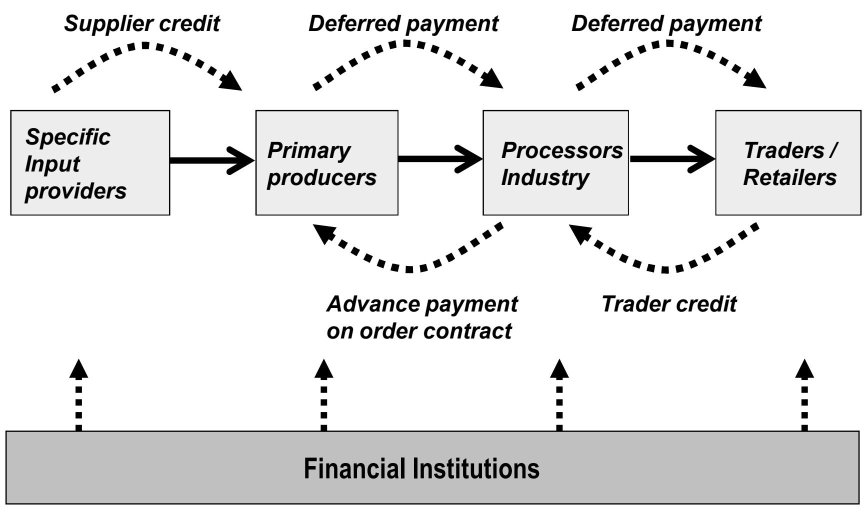
Overview of financial instruments / arrangements

Period	*Value chain finance*		*Individual lending*
	VC-internal finance	***VC-external finance using VC linkages as hard / soft collateral***	***VC-external finance using hard collateral***
Short-term *(up to 12 months)*	***Based on contracts*** Supplier credit; Buyer credit; Finance interlinked with production contracts	***Based on hard collateral (assets):*** Warehouse receipt finance; Trade finance, such as factoring, purchase-order finance, repo finance; Export trade finance (export receivables financing), especially letter of credit, bill of lading financing; ***Triangular arrangements with buyers, based on soft collateral:*** Short-term bank loans based on guarantees or contracts + onlending; Credit based on production contracts	***Based on hard collateral / cash flow*** Bank overdraft; Individual short-term credit; Microfinance loans
Medium and long-term *(1-7 years and longer)*	***Based on hard collateral:*** Equity capital of buyers / lead firms	***Triangular integrated arrangements based on hard and soft collateral:*** Medium-term bank loans based on contracts of buyers and on long-term support by NGOs and/or producer associations – using a combination of different financial instruments	***Based on hard collateral and/ or balance sheet:*** Financial Leasing; Operating Leasing; Individual term loans; Equity venture capital

Source: own compilation based on Coon et al., 2010; KIT and IIRR, 2010; Meyer, 2007; USAID, 2008

VC-Internal Financing Arrangements

Internal / external value chain financing



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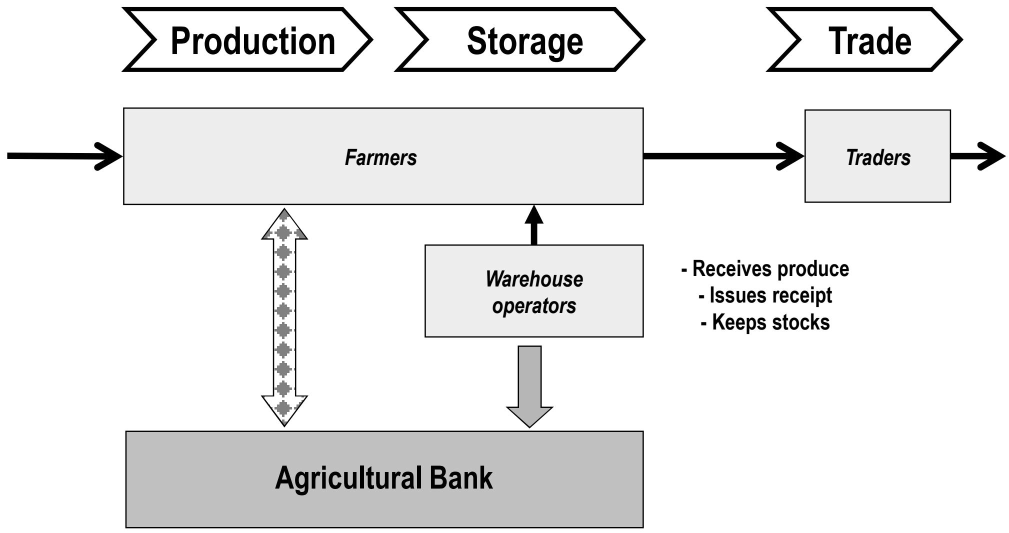
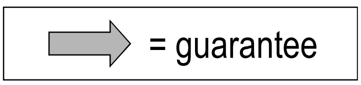
Warehouse receipt finance





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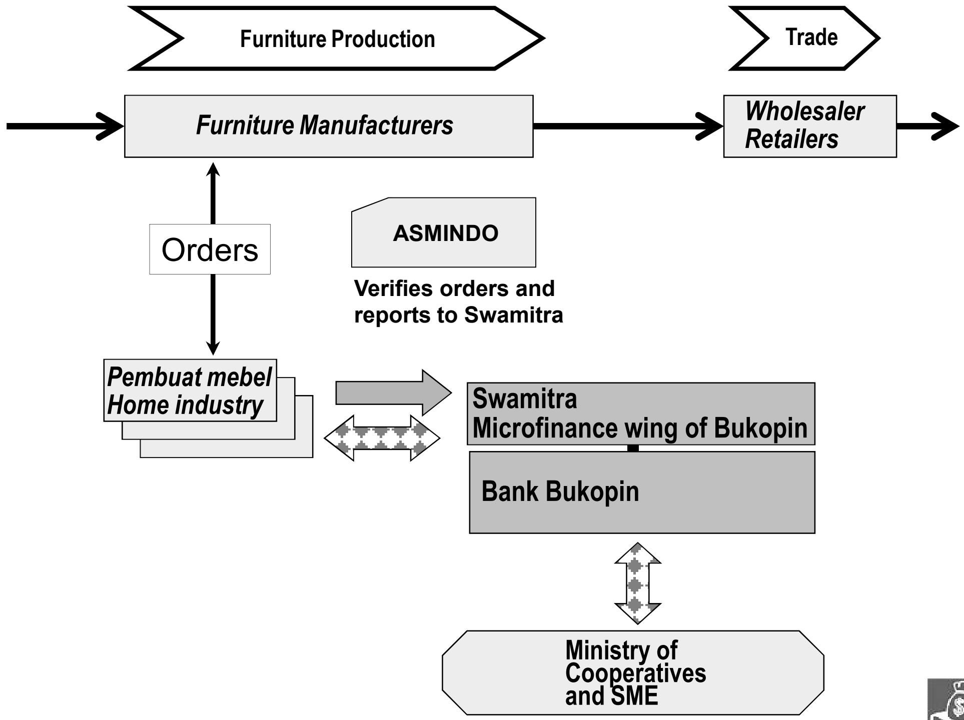
Tripartite Finance



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Value Chain Financing Solutions

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Risks And Costs of Financing…

…individual enterprises

…commercial transactions & export business

…value chain upgrading

Increasing risk / coordination needs / information needs

…companies with sufficient equity

…(informal) SME lacking equity

Increasing risk

- Technical / weather risk
- Perfomance risk (failure to realize biz model and generate cash flow
- Market risk (price, cost demand volume)

PLUS:
- Contract default risk (due to informality)
- high transaction cost for small loan size and heterogeneity of lenders

PLUS
- Coordination cost
- contract risk / moral hazard

PLUS
- uncertainty & intrans-parency of VC
- supply chain risk
- (= high information and monitoring cost along the VC)
- contract risk

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Risk Management Instruments

- ***Technology development and adoption*** (R&D, postharvest technology, software development, IT, education programs)
- ***Enterprise management practices*** (e.g. farm diversification, certification, Just-in-time management, inventory control, food safety practices, logistics planning, early warning systems)
- ***Financial instruments*** (e.g. credit, insurance, warehouse financing)
- ***Investment in infrastructure*** (e.g. transport / communication, energy, informatics and knowledge transfer, storage and handling, processing facilities, weather stations)
- ***Policy and public programs*** (regulatory measures, agricultural policies, property rights, labor laws, disaster management, safety nets)
- ***Private collective action*** (action by cooperatives, industry associations)

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Summary: Main lessons to remember

- Value chain development requires that operators invest into fixed assets and use greater amounts of working capital. Often, VCD also implies that governments have to invest into physical infrastructure and public service capacity.
- Mobilizing the necessary funds is a challenge. Financing gaps have to do with the size and amount of collaterals of enterprises, financial literacy, the attractiveness of business models and with constraints in the financial system.
- Financing solutions include complementing existing business linkages by advance or deferred payments, and/or using business linkages and contracts as a means to secure external loans. VC finance integrates financing solutions and the improvement of business models, linkages and services to address the constraints that prevent financial institutions from lending.
- Important accompanying solutions include risk management and instruments to enhance financial literacy and make the financial aspects of VCD more transparent.