UNLOCKING GROWTH IN THE ERA OF SMALLHOLDER FARMER FINANCE

Matt Shakhovskoy
Executive Director
Initiative for Smallholder Finance
Introduction to “ISF”

- ISF is a multi-donor and investor platform for the development of financial services for the smallholder farmer market

- It acts as a “design catalyst,” mobilizing additional financing for smallholders and seeding replication of innovative models in new markets

SUPPORTERS

- Citi Foundation
- The MasterCard Foundation
- Small Foundation
- FEED THE FUTURE
- Ford Foundation
- KFW
- Skoll Foundation
- Bill & Melinda Gates Foundation
Objectives for today

• Frame the global smallholder finance challenge from latest research

• Discuss the current state of play globally

• Introduce our perspective on some of the big opportunities to move the needle
Our latest state of the sector research was based on literature review, stakeholder interviews and collaborative research with key market participants.

+160 reports and other research documents on smallholder finance

+80 interviews with capital providers, financial service providers and market enablers

Collaborative Research Group with key market participants
There are an estimated 450 million smallholder farmers in the world on farms smaller than 5 hectares.

Geographic distribution of smallholder farmers

Estimated number of farms smaller than 5 hectares (millions, 2014)

Over time we have come to understand that these smallholders are a heterogeneous group that can be segmented in different ways:

<table>
<thead>
<tr>
<th>Farmer type</th>
<th>Segment size</th>
<th>Land</th>
<th>Crop</th>
<th>Market engagement</th>
<th>Access to tech</th>
<th>Access to finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large farmer</td>
<td>&gt;2ha</td>
<td>Cash, few staple</td>
<td>Little subsistence, most surplus sold to a contracted buyer</td>
<td>Good</td>
<td>Informal and formal, some provided by buyers</td>
<td></td>
</tr>
<tr>
<td>Medium farmer</td>
<td>1-2ha</td>
<td>Staple, some cash</td>
<td>Some subsistence, reliable surplus sold to offtaker or in local markets</td>
<td>Limited</td>
<td>Limited and informal</td>
<td></td>
</tr>
<tr>
<td>Noncommercial smallholder farmer</td>
<td>&lt;1ha</td>
<td>Staple</td>
<td>Most subsistence, little surplus</td>
<td>Very limited if at all</td>
<td>Limited, informal if at all</td>
<td></td>
</tr>
<tr>
<td>Commercial smallholder farmer in loose value chains</td>
<td>7% of total smallholder farmers</td>
<td>Cash, few staple</td>
<td>Little subsistence, most surplus sold to a contracted buyer</td>
<td>Good</td>
<td>Informal and formal, some provided by buyers</td>
<td></td>
</tr>
<tr>
<td>Commercial smallholder farmer in tight value chains</td>
<td>33% of total smallholder farmers</td>
<td>Staple, some cash</td>
<td>Some subsistence, reliable surplus sold to offtaker or in local markets</td>
<td>Limited</td>
<td>Limited and informal</td>
<td></td>
</tr>
</tbody>
</table>

Source: CGAP. Segmentation of Smallholder Households. 2013
By the numbers: Currently, we estimate that total smallholder lending through financial service providers is ~$55Bn

Smallholder lending in South and Southeast Asia, Sub-Saharan Africa and LATAM by source
(Annual disbursements $USD Bn)¹

**See Inflection Point report for full breakdown of lending**

1. Excludes China, Central Asia, Middle East and North Africa, and Eastern Europe. Includes financing to producer groups by state banks and commercial banks. Includes agri and non-agri lending.

Source: ISF Briefing 1, "Local bank financing for smallholder farmers," Oct. 2013; Rural and Agricultural Finance Learning Lab Smallholder Financial Solutions Database; annual reports; expert interviews; Dalberg analysis.
Compared to the different smallholder segments there are very clear gaps in provision

<table>
<thead>
<tr>
<th>Financial needs and disbursements (USD Bn)¹</th>
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</tr>
<tr>
<td>100% → 30</td>
<td>35</td>
<td>10</td>
</tr>
<tr>
<td>Formal financial institutions</td>
<td>48%</td>
<td>98%</td>
</tr>
<tr>
<td>Value chain actors</td>
<td>12%</td>
<td>2%</td>
</tr>
<tr>
<td>#farmers</td>
<td>ST agri needs²</td>
<td>LT agri needs³</td>
</tr>
<tr>
<td>~18 million</td>
<td>~15</td>
<td>~88 million</td>
</tr>
<tr>
<td>Financial needs and disbursements (USD Bn)¹</td>
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</tr>
<tr>
<td>100% → 30</td>
<td>35</td>
<td></td>
</tr>
<tr>
<td>Formal financial institutions</td>
<td>40%</td>
<td></td>
</tr>
<tr>
<td>Value chain actors</td>
<td>12%</td>
<td>Informal / community-based financial institutions</td>
</tr>
<tr>
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<td>ST agri needs²</td>
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</tr>
<tr>
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<td>Noncommercial smallholder farmers</td>
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<td></td>
</tr>
<tr>
<td>100% → 30</td>
<td>35</td>
<td></td>
</tr>
<tr>
<td>Formal financial institutions</td>
<td>41%</td>
<td></td>
</tr>
<tr>
<td>Value chain actors</td>
<td>93%</td>
<td>Informal / community-based financial institutions</td>
</tr>
<tr>
<td>#farmers</td>
<td>ST agri needs²</td>
<td>LT agri needs³</td>
</tr>
<tr>
<td>~161 million</td>
<td>~15</td>
<td></td>
</tr>
</tbody>
</table>

¹ Excludes China, Central Asia, Middle East, and North Africa and Eastern Europe. Includes financing to producer groups by state banks and commercial banks. ² ST agri needs refers to short term financing needs of less than a year (typically for inputs, harvest and export). ³ LT agri needs refers to long term financing needs of more than one year (typically for renovation or equipment). Notes: Commercial banks and social lenders disbursements counted toward SHFs in tight VCs; state bank financing distribution in proportion to farmer segment needs; MFI agri lending included in loose value chains; MFI noncommercial-agri lending distributed in proportion to farmer segment need; “high touch” NGOs included under subsistence. Informal / community-based allocated in proportion to non-agri needs.
Looking ahead the current trajectory of formal lending growth will not significantly close the gap; a new trajectory is needed.

**Growth projections for smallholder lending by source 2015-2020**
(Annual disbursements, USD billion)

- **State banks**: ~3
- **MFIs**: ~5
- **Commercial banks**: ~1
- **Social lenders**: ~0.4
- **High touch NGOs**: ~0.1
- **Value chain actors**: 2.5
- **Lending by formal fin. institutions and value chain actors today**: ~31
- **Lending by formal fin. institutions and value chain actors 2020E**: ~43
- **Demand partially served through informal and community-based financial institutions**: ~167
- **Total smallholder need for finance**: ~210

Estimated portfolio growth 2015-2020

1. Excludes China, Central Asia, Middle East and North Africa, and Eastern Europe.
2. CAGR assumptions: state bank market participant projections of ~8.5%, value chain actors in line crop production projections: 3.1% export crops, 2.3% non-export crops; MFIs market participant projections of ~13.90%; commercial banks in line with projected growth of retail banking: ~15% in Sub-Saharan Africa, ~14% in South and Southeast Asia, ~13% in Latin America; social lenders market participant projections of ~15%; high touch NGOs in line with 2010-2015 growth of ~30-35%.

Sources: expert interviews; FAO crop production projections; World Bank, McKinsey and BMI retail banking projections, annual reports.
Our vision: A doubling of annual growth in smallholder lending to serve 50% of the projected need by 2025

1. **Affordable directed agriculture credit** Supply driven, centrally planned, and managed by governments and donors

2. **Microfinance in rural areas** Demand driven and market oriented, mostly by NGO MFIs, deposit-taking MFIs, and some commercial banks

3. **Farmer finance** An emerging approach with a range of actors

The new era of farmer finance affords us more opportunities than ever before to collectively tackle this agenda.
In considering the challenge we took a holistic view of the smallholder finance “industry,” developing a model to unpack the dependencies.
What we found was that to truly “unlock financing,” action was needed to address barriers at all levels of the industry.

**FRAMEWORK FOR ACTION**

**MARKET ACTORS**
Three key groups of market participants

- **CAPITAL PROVIDERS**
  - Limited and mismatched capital availability
  - Market cannot clear

- **FINANCIAL SERVICE PROVIDERS**
  - Low business model sustainability
  - Market cannot clear

- **SMALLHOLDER FARMERS**
  - Shortfall of demand relative to need

**STATUS QUO**
Three key barriers currently limit sector growth

**ENVISIONED FUTURE STATE**
Three key areas of activity unlock progress

- Smart subsidy unlocks new and better-matched sources of capital
  - Market clears

- Progressive partnerships increase risk-adjusted business model returns
  - Market clears

- Customer centric product design drives demand and usage
  - System effects: improvements at one level of the industry model have a positive effect on other levels

See report for full breakdown of current state of the industry and major barriers.
This report also broke down the market to consider established lending models...

**Established smallholder finance models based on smallholder segments and needs**

**Smallholder segments**

1. (In-kind) inputs on credit directly by value chain actors

2a. Working capital loans directly by MFIs

3. Working capital loans directly by state banks

4. Trade finance loans for producer groups by social lenders

2b. Short-term loans, saving accounts and microinsurance directly by MFIs

5. Short-term loans and saving accounts directly by informal and community-based institutions

**Agricultural needs targeted**

1. Significant portion used for agriculture purposes even if not specifically targeted or customized to meet agricultural needs; 2. Have more recently started offering some long-term financing; 3. Not shown: national safety nets, e.g., food reserves, national health insurance, etc. 4. Refers to bank and non-bank microfinance institutions; 5. Some buyers have more recently started offering some long-term finance to increase farmer mechanization

**General needs targeted**
…as well as emerging models where innovation is taking place

**Emerging smallholder finance models based on smallholder segments and needs**

<table>
<thead>
<tr>
<th>Smallholder segments</th>
<th>Agricultural needs targeted</th>
<th>General needs targeted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial smallholder farmers in tight value chains</td>
<td>Working capital loans by commercial banks through value chain actors¹</td>
<td>Making payments</td>
</tr>
<tr>
<td>Commercial smallholder farmers in loose value chains</td>
<td>Input loans directly by high touch NGOs</td>
<td>Smoothing expenditures &amp; building assets</td>
</tr>
<tr>
<td>Noncommercial smallholder farmers</td>
<td></td>
<td>Mitigating general “life” risk</td>
</tr>
</tbody>
</table>

¹ Includes input suppliers, buyers and outgrower schemes, farmer orgs and warehouses. ² MNOs refers to Mobile Network Operators
Across all of these providers and underlying models it is important to understand that most use different types of subsidy.

**Returns for smallholder financing**

- **Negative returns**
  - High-touch NGOs
  - State Banks
  - Insurance

- **Below market returns**
  - Commercial banks
  - MFIs

- **Market rate returns**
  - Social Lenders

**Direct external subsidy to FSP**
- Required to operate the model by bridging the gap between cost to serve and ability to generate revenue
- Required to bridge the gap between effective rate of returns and availability of commercial capital
- Usually no direct subsidy required

**Indirect external subsidy**
- Reduce farmer riskiness
To achieve meaningful change we believe action is needed in three core areas:

1. **CUSTOMER CENTRICITY**
2. **PROGRESSIVE PARTNERSHIPS**
3. **SMART SUBSIDY**

**Enablers**
- **TRANSPARENCY** • Improved information gathering and sharing
- **TECHNOLOGY** • Continued digitization of data collection and service provision
- **POLICY** • Reform of policies that affect smallholder finance provision
Progressive partnerships are about sharing costs and risk

**ILLUSTRATIVE**

<table>
<thead>
<tr>
<th>NGO / Public agency</th>
<th>Value chain actor</th>
<th>Financial institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farmer aggregation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technical assistance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market access</td>
<td></td>
<td></td>
</tr>
<tr>
<td>R&amp;D and other back office</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan origination and collection</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of capital</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **NGO / public agency supports value chain actor with farmer aggregation**
- **Buyer has incentive to train farmers to increase production quality and volume**
- **Guaranteed through buyer participation**
- **NGO/ public agency supports financial institutions and agri-product development and system building**
- **Close relationship also lowers risk for the fin. institution**
- **Leverages existing value chain actor-farmer interactions**
- **Financing moves off value chain actor balance sheet**

Change in cost bearing responsibility

Source: Dalberg Analysis
In this context we need a capital market that uses “smart subsidy” and blended finance to unlock innovation and scale in lending.

### Subsidy purpose

#### Reduce risk

**One-off subsidies to overcome perceived risk**
- Temporary, customized market entry guarantees to offset investor risk to enter new market
- Grants to set up well managed producer organizations that aggregate farmers, giving them access to inputs and markets and thus reducing the risk of serving them

**Ongoing subsidies to mitigate intrinsic risk**
- Long run guarantees to share the risk of serving more vulnerable customers
- Grants and sidecar technical assistance facilities to fund extension services that lower inherently high sector risk
- Subsidies to offset the cost of foreign currency hedging

#### Reduce cost

**One-off subsidies to overcome entry costs**
- TA grants to develop FSP capabilities to serve smallholder farmers
- Grants and high risk equity to set up new business models that benefit smallholders and can gradually attain self-sufficiency
- TA grants to develop aggregators’ ability to serve as the front office for FSPs

**Ongoing subsidies to bridge the gap between cost to serve and ability to generate revenue**
- Interest rate / insurance premium subsidy to increase financial service provider revenue
- Concessionary debt to fund operations of FSPs who experience high cost to serve due to provision of supporting services

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**ILLUSTRATIVE EXAMPLES**

<table>
<thead>
<tr>
<th>Subsidy type</th>
<th>Ongoing</th>
<th>Catalytic</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reduce risk</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>One-off subsidies to overcome perceived risk</td>
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<td></td>
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<td>One-off subsidies to overcome entry costs</td>
<td>Ongoing subsidies to bridge the gap between cost to serve and ability to generate revenue</td>
<td></td>
</tr>
</tbody>
</table>
To change the growth trajectory of smallholder financing over the next 5-10 years stakeholders will need to take on ambitious roles

<table>
<thead>
<tr>
<th>Financial service providers</th>
<th>Funders</th>
<th>Market and research platforms</th>
<th>Technical assistance providers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pioneers of product and service design</strong></td>
<td><strong>Champions of smart subsidy</strong></td>
<td><strong>Connected savants</strong></td>
<td><strong>Constructive educators</strong></td>
</tr>
<tr>
<td>• Use customer knowledge to make product offering more relevant to farmers</td>
<td>• Carefully assess financial models to support and design the investment mechanisms</td>
<td>• Fill-in key knowledge gaps e.g. value of customer centricity or business models performance</td>
<td>• Become advisors to financial service providers to serve smallholder more efficiently</td>
</tr>
<tr>
<td>• Explore partnerships to alleviate high cost to serve and information asymmetries</td>
<td>• Provide support for research, cover upfront costs of new partnerships and facilitate connections between investees</td>
<td>• Go beyond research designing common reporting standards, aggregating data and creating opportunities for actors to connect</td>
<td>• Extend beyond the educator by contributing data from their experience into industry research effort</td>
</tr>
</tbody>
</table>
Thank You

Matthew Shakhovskoy
Executive Director
Matthew.shakhovskoy@globaldevincubator.org
http://www.initiativeforsmallholderfinance.org/