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The U.S. Government's Global Hunger & Food Security Initiative

GLOBAL LEARNING AND EVIDENCE EXCHANGE

MARKET SYSTEMS

June 5-9, 2017 // Dakar, Senegal

Unlocking growth in the era of smallholder farmer finance

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Introduction to "ISF"

THE INITIATIVE FOR SMALLHOLDER FINANCE

- 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

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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

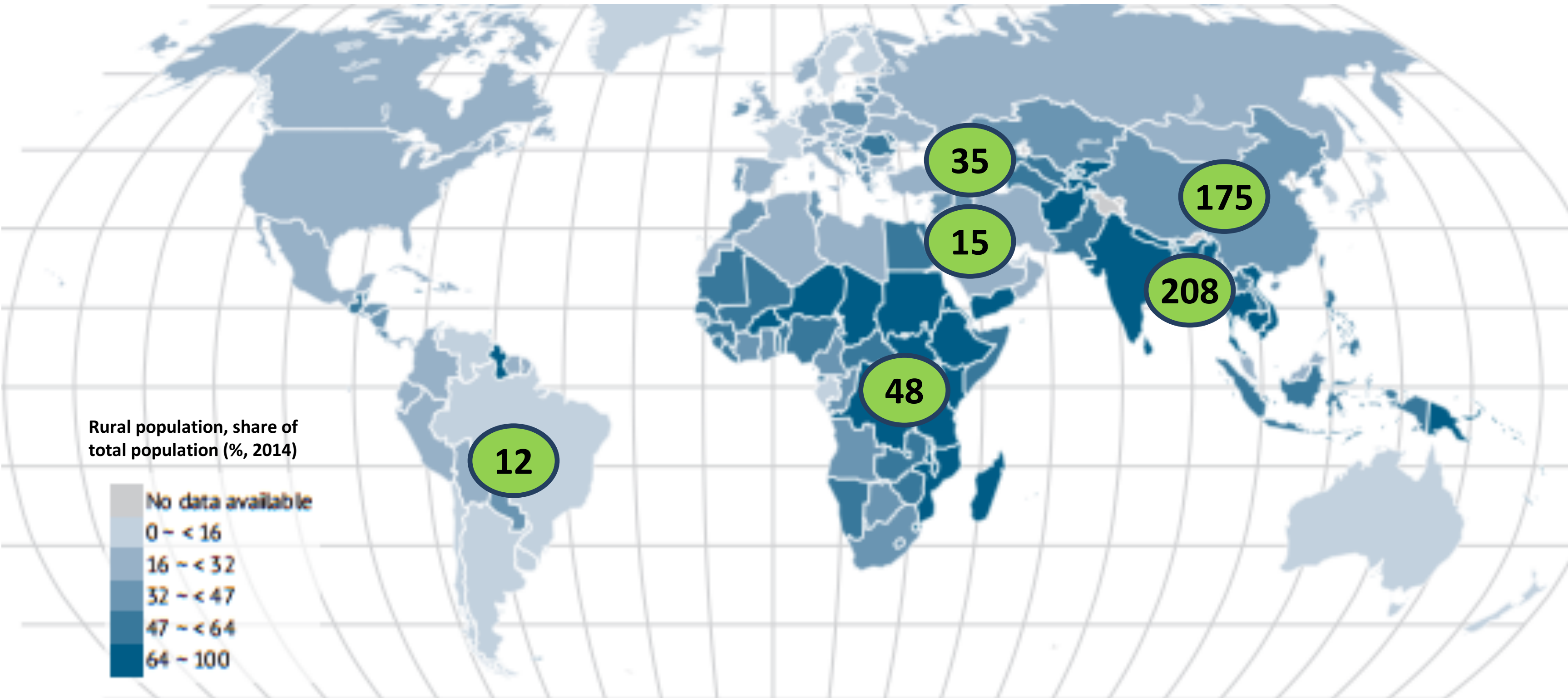
+160 reports and other research documents on smallholder finance

+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)*

Source: FAO, "Statistical Pocketbook: World food and agriculture", 2015; FAO ESA Working Paper No. 14-02, Dalberg Analysis

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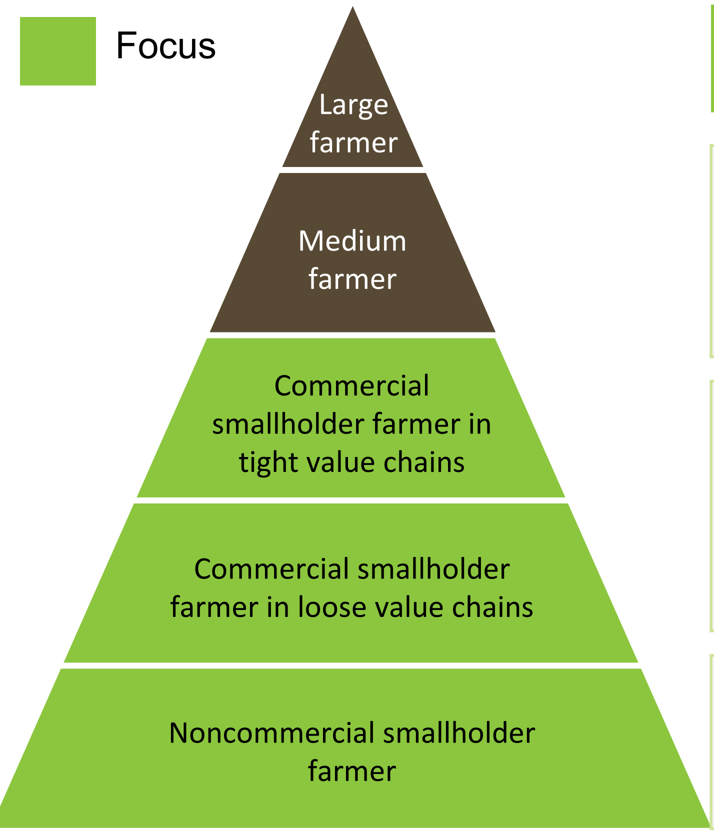
Over time we have come to understand that these smallholders are a heterogeneous group that can be segmented in different ways

Farmer type



Scope and key characteristics

Segment size	Land	Crop	Market engagement	Access to tech	Access to finance
7% of total smallholder farmers	>2ha	Cash, few staple	Little subsistence, most surplus sold to a contracted buyer	Good	Informal and formal, some provided by buyers
33% of total smallholder farmers	1-2ha	Staple, some cash	Some subsistence, reliable surplus sold to offtaker or in local markets	Limited	Limited and informal
60% of total smallholder farmers	<1ha	Staple	Most subsistence, little surplus	Very limited if at all	Limited, informal if at all

Source: CGAP. Segmentation of Smallholder Households. 2013

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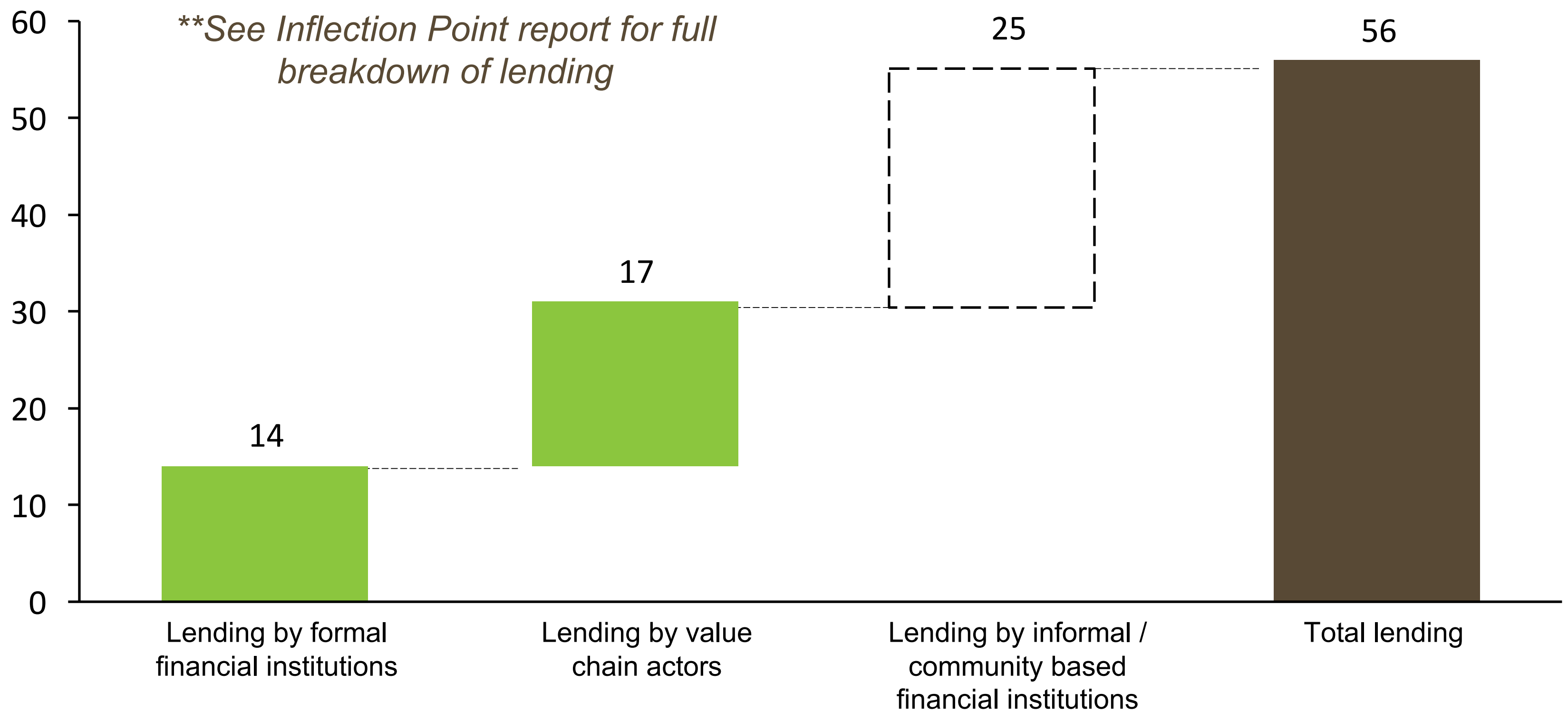
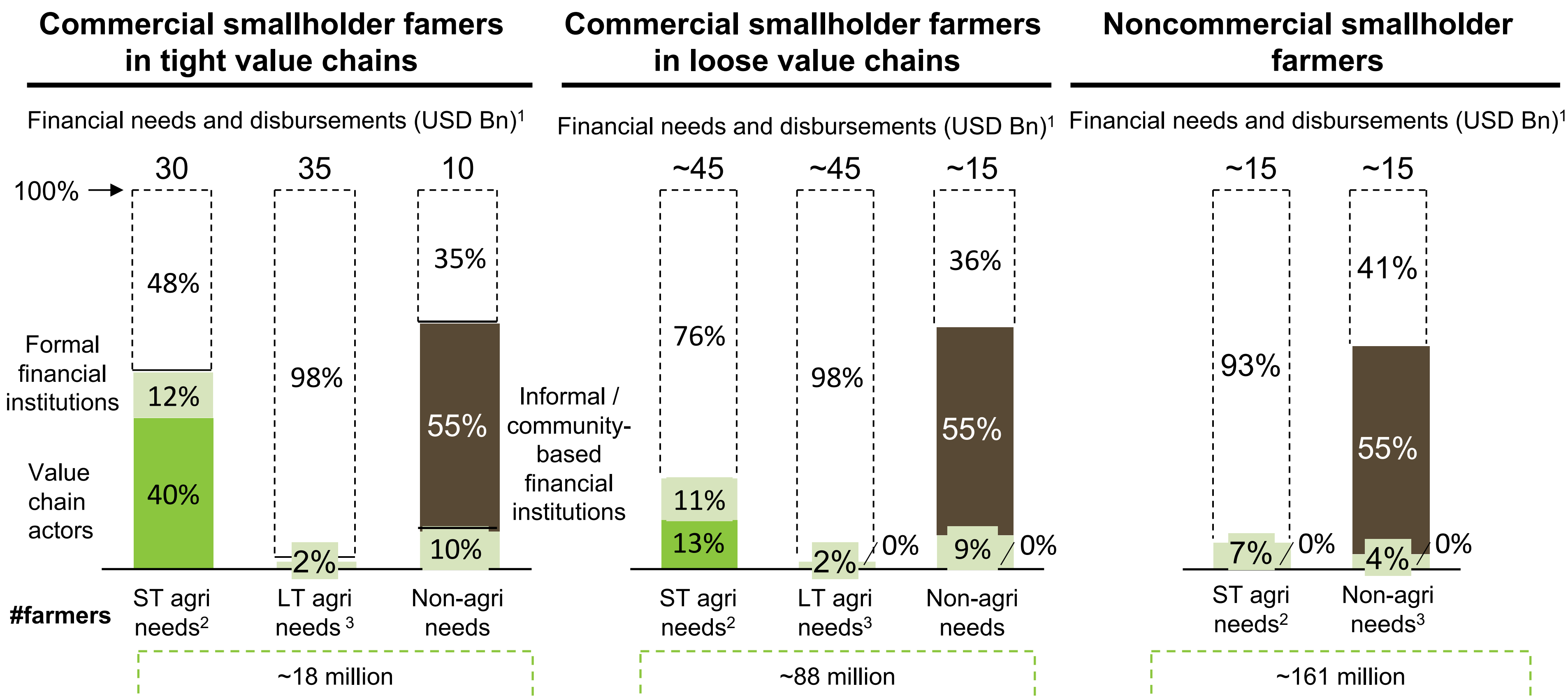
By the numbers: Currently, we estimate that total smallholder lending through financial service providers is ~$55Bn

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



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



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.

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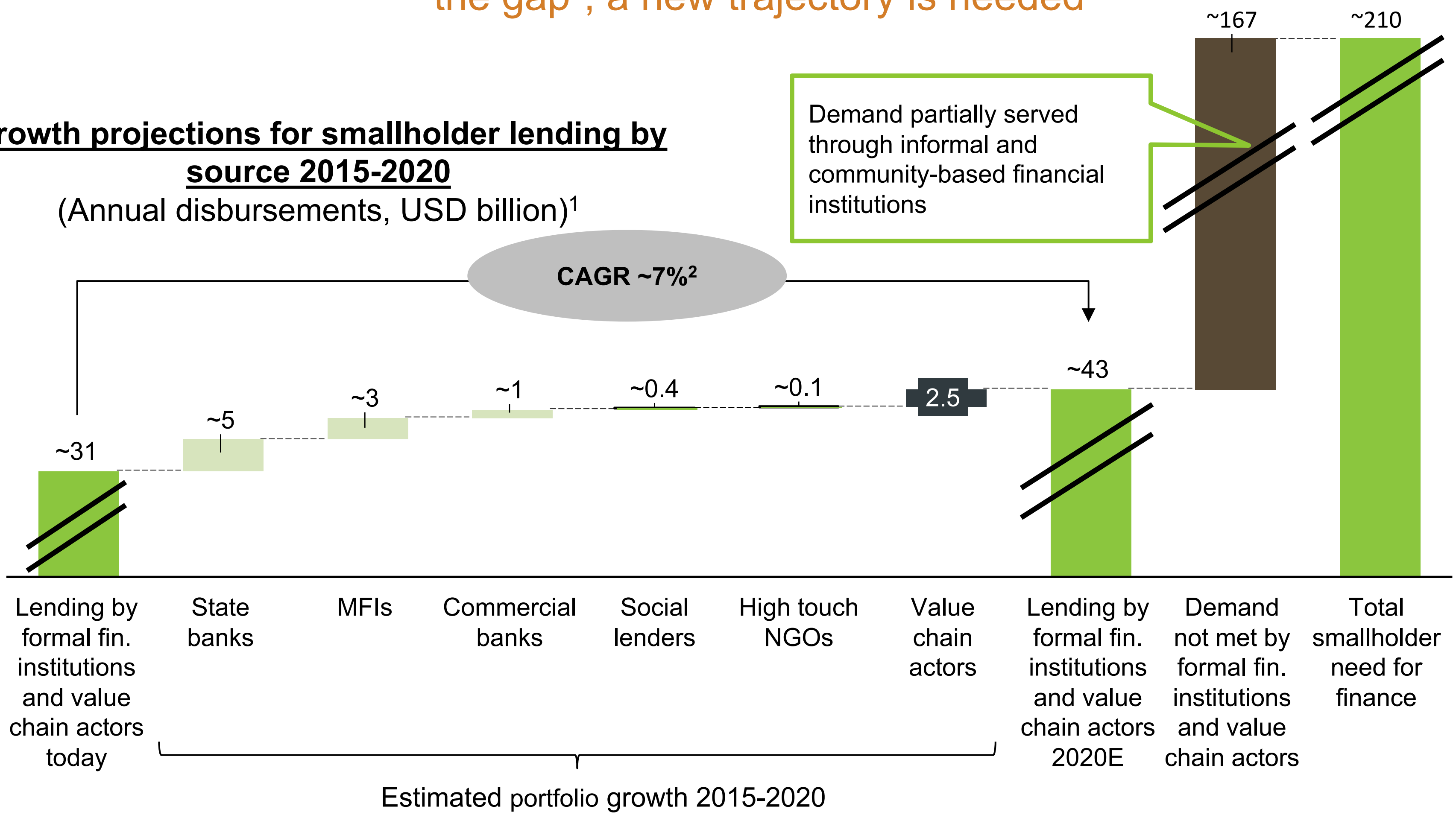
Looking ahead the current trajectory of formal lending growth will not significantly "close the gap"; a new trajectory is needed

Growth projections for smalllholder lending by source 2015-2020
(Annual disbursements, USD billion)[1]



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

1950 — **1970** — **2000**

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

- Asia
- Latin America
- Africa

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

- Asia
- Latin America
- Africa

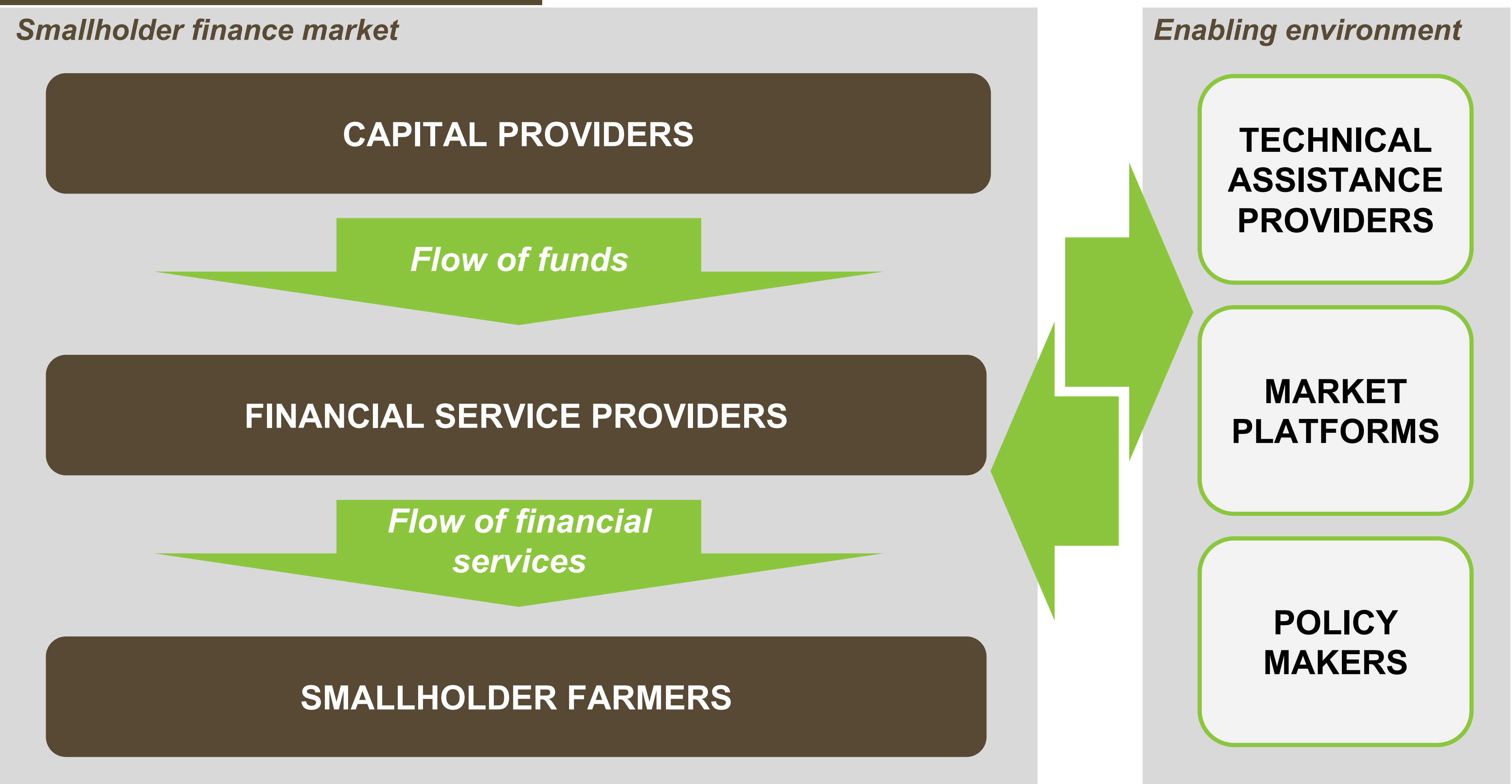
3. Farmer finance *An emerging approach with a range of actors*

- Asia
- Latin America
- Africa

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

INDUSTRY MODEL



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What we found was that to truly "unlock financing", action was needed to address barriers at all levels of the industry

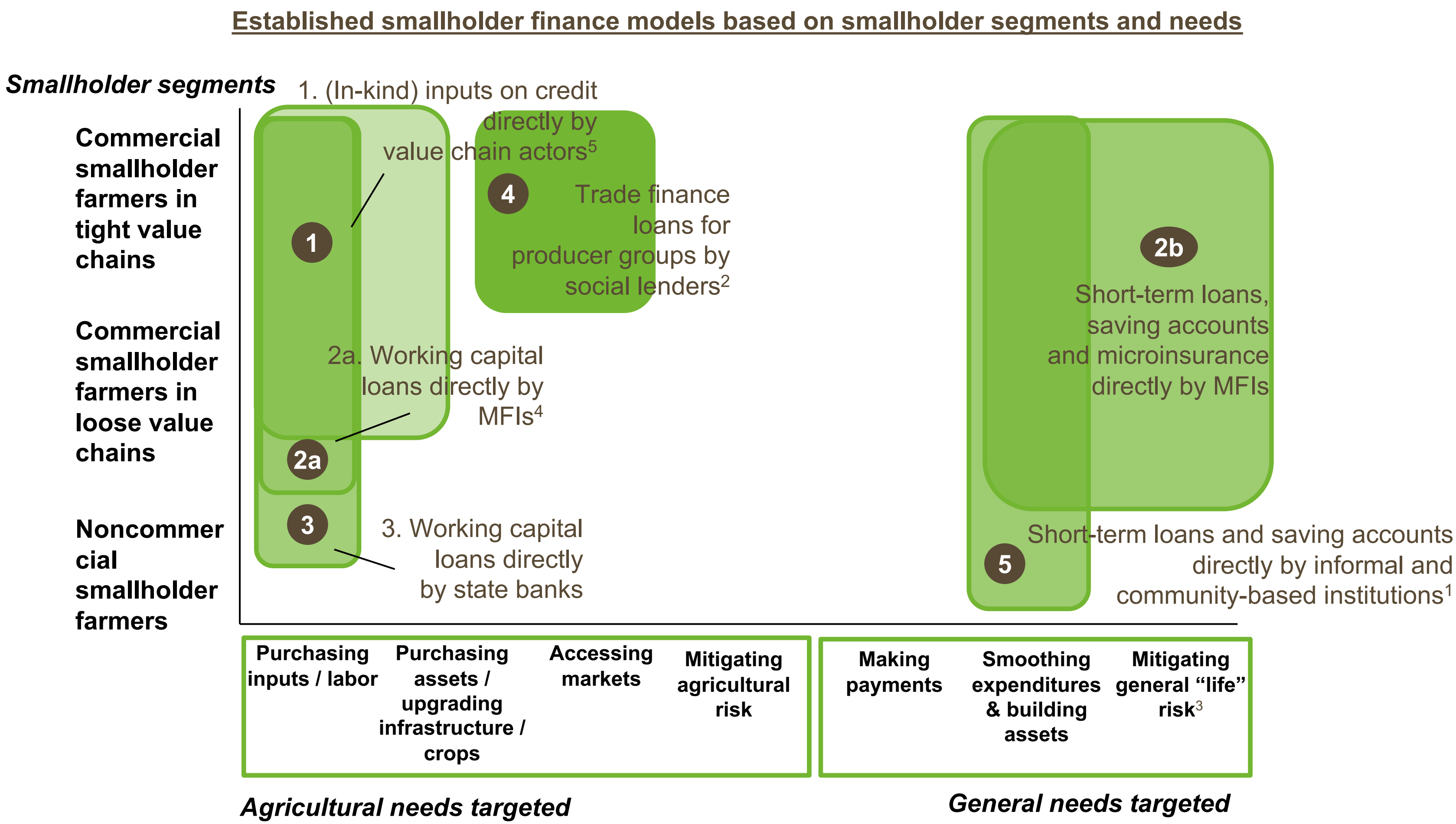
FRAMEWORK FOR ACTION

MARKET ACTORS Three key groups of market participants	**STATUS QUO** Three key barriers currently limit sector growth	**ENVISIONED FUTURE STATE** Three key areas of activity unlock progress
CAPITAL PROVIDERS	**Limited and mismatched capital availability**	**Smart subsidy unlocks new and better-matched sources of capital**
	Market cannot clear	*Market clears*
FINANCIAL SERVICE PROVIDERS	**Low business model sustainability**	**Progressive partnerships increase risk-adjusted business model returns**
	Market cannot clear	*Market clears*
SMALLHOLDER FARMERS	**Shortfall of demand relative to need**	**Customer centric product design drives demand and usage**

See report for full breakdown of current state of the industry and major barriers

System effects: improvements at one level of the industry model have a positive effect on other levels

This report also broke down the market to consider established lending models…



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

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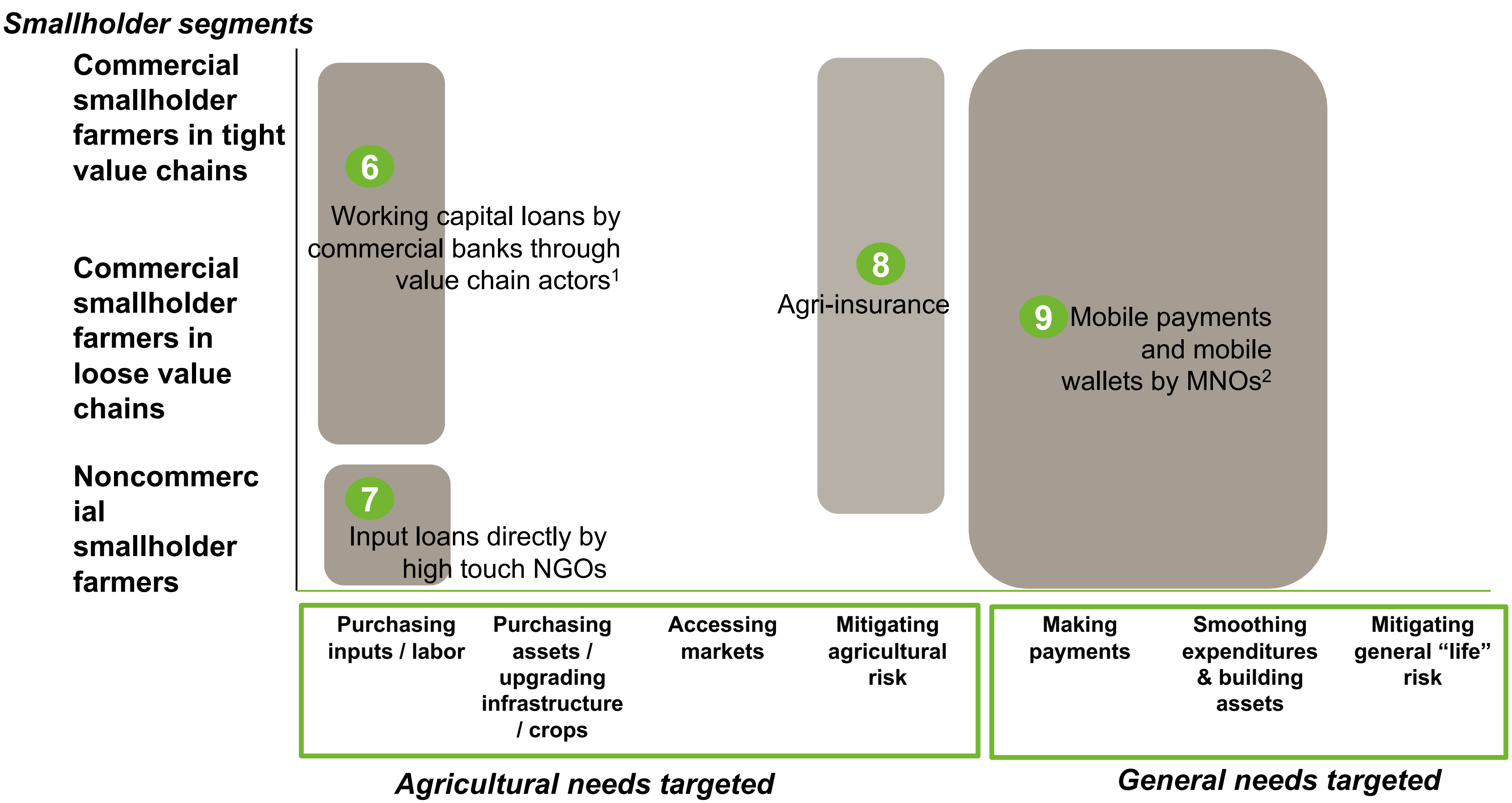
…as well as emerging models where innovation is taking place

Emerging smallholder finance models based on smallholder segments and needs



1. Includes input suppliers, buyers and outgrower schemes, farmer orgs and warehouses. 2. MNOs refers to Mobile Network Operators

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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 | Below market returns | Market rate returns

High-touch NGOs

Commercial banks

MFIs

State Banks

Insurance

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

NGO / Public agency | **Value chain actor** | **Financial institution**

Farmer support

Farmer aggregation — *NGO / public agency supports value chain actor with farmer aggregation*

Technical assistance — *Buyer has incentive to train farmers to increase production quality and volume*

Market access — *Guaranteed through buyer participation*

Financing

R&D and other back office — *NGO/ public agency supports financial institutions and agri-product development and system building*

Loan origination and collection — *Leverages existing value chain actor-farmer interactions*

Close relationship also lowers risk for the fin. institution

Cost of capital — *Financing moves off value chain actor balance sheet*

Change in cost bearing responsibility

In this context we need a capital market that uses "smart subsidy" and blended finance to unlock innovation and scale in lending

ILLUSTRATIVE EXAMPLES

Subsidy purpose	Catalytic	Ongoing
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

Subsidy type

To change the growth trajectory of smallholder financing over the next 5-10 years stakeholders will need to take on ambitious roles

Financial service providers

Pioneers of product and service design

- Use customer knowledge to make product offering more relevant to farmers
- Explore partnerships to alleviate high cost to serve and information asymmetries

Funders

Champions of smart subsidy

- Carefully assess financial models to support and design the investment mechanisms
- Provide support for research, cover upfront costs of new partnerships and facilitate connections between investees

Market and research platforms

Connected savants

- Fill-in key knowledge gaps e.g. value of customer centricity or business models performance
- Go beyond research designing common reporting standards, aggregating data and creating opportunities for actors to connect

Technical assistance providers

Constructive educators

- Become advisors to financial service providers to serve smallholder more efficiently
- Extend beyond the educator by contributing data from their experience into industry research effort

Thank-you

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