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# **Alternative finance in commodity chains**

**How small entrepreneurs and farmers can  
benefit from novel ways of financing**

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Photo: FAO Olivier Asselin

## Summary

Access to affordable and reliable financing in agri-food commodity chains is of key importance for all actors along the chain, to use as working capital, and to invest in capital assets. There are a wide range of financing instruments available but these do not always meet the demands of these businesses. Smallholder farmers, small and medium-sized enterprises (SMEs) and other vulnerable groups in developing countries are at a particular disadvantage with regard to access to necessary financing services. There are many options that are being promoted for smallholder farmers and SMEs, such as microloans, village saving and lending associations, and contract farming (e.g. Magaja & Agai, no date) however, this article focusses on some alternative options for businesses in commodity chains, including (reverse) factoring, leasing, warehouse receipt and blended finance. As well as looking into the reasons why smallholder farmers and SMEs are not reached by traditional finance, this article provides some inspiring examples where such alternative finance mechanisms have been introduced to secure access to finance where none existed. With more innovation and new ways of tackling existing problems, vulnerable groups can improve their access to finance and enhance their businesses.

## Introduction to business financing options

Financing for businesses in commodity chains can be obtained in many different forms. For companies involved in commodity chains two forms of finance are of particular relevance; trade finance and supply chain finance. Trade finance represents the financial instruments and products that are used by companies to facilitate domestic and international trade transactions. Such transactions require a seller and a buyer of goods and services. Various intermediaries such as banks and financial institutions can facilitate these trade transactions by financing or securing the trade. Traditional trade finance instruments include trade credit, letters of credit, guarantees and standby letters of credit.

For banks in Africa traditional trade finance comprises 88% of their trade finance portfolios, with 72% of banks indicating letters of credit as their preferred instrument (Mwaba, 2020). However, large gaps in access to trade finance exist; the current gap between supply and demand of trade finance has been estimated at US\$1.5 trillion globally (Azevêdo, 2019). About 40% of this unmet demand is in developing countries in Asia, and 10% is in Africa. SMEs face the greatest hurdles in accessing affordable financing. The poorer the country in which

they are based, the greater the challenges SMEs face in accessing trade finance (IFC & WTO, 2019).

Supply Chain Finance (SCF) is a collective name for all kinds of financing between companies in the supply chain. The aim of SCF is to improve the financial position of all parties in the chain and to spread financial risk. For instance, SCF allows companies to improve their working capital and, as a result, less funding is needed. Moreover, because of this improved 'financial housekeeping', banks may be more willing to provide a loan or to provide the loan with a lower interest rate. SCF products include factoring, receivables finance and payables finance. The differences between trade finance and SCF is mainly in the degree to which trading partners know and trust each other (ICC Academy, no date).

The world market of SCF is a large and growing industry. In 2015, a McKinsey report suggested that SCF had a potential global revenue pool of US\$20 billion (Herath, 2015). Asian markets in particular, were found to be extending increasing amounts of credit in supply chains (of any goods), growing the total market rapidly (Moody, 2019). However, in Africa SCF volumes are small (Mwaba, 2020), although there have been encouraging developments. For example, between 2015 and 2018, factoring volumes have grown from €18 billion to €22 billion, a growth of 18%. Significantly, while factoring activity has thus far been concentrated in only five of Africa's 55 countries, a number of factoring companies are now emerging across the continent and volumes have been projected to exceed US\$50 billion by 2025 (Mwaba 2020) (although COVID-19 may have an impact on this number).

## **Reaching Vulnerable Groups in Commodity Chains with Financing**

Globally, 450 million people, or 70% of the rural poor in developing countries, rely on agriculture as a main source of income (IDH, no date). Many of these are smallholder farmers, stuck in a vicious circle of underfinancing, face low productivity and low incomes. Companies and non-governmental organisations (NGOs) have models to provide services and inputs to these farmers, and banks and donors are keen to take these models to scale, however, there still remains a lack of access to finance for small farmers and SMEs. According to

the World Bank and IFC, 40% of formal micro, small and medium enterprises (MSMEs) in developing countries together have an unmet financing need of \$5.2 trillion every year. This financing gap is most pronounced in Latin America and the Caribbean, and the Middle East and North Africa regions, where the gap compared to potential demand has been measured at 87% and 88%, respectively. While about half of formal enterprises lack access to formal credit, an even larger proportion of micro and informal enterprises face these challenges (World Bank, no date). Two main reasons why vulnerable groups are unable to access traditional financial services are: 1) a lack of recognisable collateral; and 2) the (perceived) high risk of lending to these customers by financial institutions.

Financial innovation – which goes beyond traditional banking services and relationships – is rising rapidly in developing countries because it can respond to the financing needs of many people who, due to poverty and vulnerability, have no access to banks. Below we review how some of these financial innovations work in real life to overcome financial challenges.

## **Access to Finance Challenge 1: Lack of Collateral**

Access to finance challenge 1: lack of collateral

A lack of collateral will normally make a bank less willing to lend to a customer: a collateral safeguards the bank for a loss, because in case of non-repayment of the loan the bank can take and sell the collateral instead. Therefore, not owning a valuable asset to serve as a collateral makes it hard for certain businesses to get a loan. Fortunately, a number of models have been found to overcome this issue which include factoring, leasing and warehouse receipt financing models.

### **(Reverse) Factoring**

Factoring is a financial transaction in which a business sells its accounts receivable (i.e. invoices sent out to customers to be paid to the company) to a third party (called a factor) at a discount. Technically factoring is not a loan, it is the purchase of future receivables. There are two types of factoring: recourse and non-recourse. Recourse factoring is the most common and means that the company must buy back any invoices that the factoring company is unable to collect payment on. Non-recourse factoring

means the factoring company assumes most of the risk of non-payment by customers. Factoring receivables can be ideal for (small) businesses that have to wait for their bills to be paid by their customers but in the meantime have to spend money themselves on ongoing operational expenses and/or have new expenses to help propel growth. Factoring can solve these cash flow shortages.

Reverse factoring works in the opposite direction. Instead of a company factoring customer invoices, it factors supplier invoices which means that, with the cooperation of the buyer, the supplier(s) get their bills paid now rather than waiting out the payment terms of 30, 60, or 90 days. Reverse factoring is an accounts payable solution.

Factoring is an effective instrument to raise cash for current operations; if factoring was available to vulnerable people it would go a long way to solving their immediate liquidity problems. As small farmers and SMEs often do not have collateral even for a short-term bank loan, factoring is a way to get access quickly to cash which is needed for ongoing activities, such as planting new crop or repairing equipment. Factoring essentially uses invoices as a collateral instead of fixed assets. However, there

are some potential disadvantages: the total costs of factoring might be higher than the interest rate on credit from a bank (Commercial Capital LCC, no date a); it can be labour intensive for the business; finance companies will contact businesses' customers; and finance companies normally do not handle bad debt so the risks may fall back onto the business (Commercial Capital LCC, no date b). The challenge is therefore to develop factoring models that would be sustainable while providing funding for farmers and SMEs without extraordinary costs. The Common Fund for Commodities is supporting Financial Access Commerce & Trade Services (FACTS), a finance company, to expand the factoring business in Eastern Africa, with a loan of up to US\$1.2 million (Box 1).

## Leasing

A lease is known as an 'off-balance sheet financing' instrument whereby a leasing company (the lessor or owner) buys an asset (e.g. processing equipment or a tractor) for a user (usually called the hirer or lessee) and rents it to them for an agreed period. The two most common types of leases are operating leases and financing leases, with a difference in how fully

### Box 1: Financial Access Commerce & Trade Services (FACTS)

*FACTS is finance company with operations in Kenya and Uganda, and a head office in The Netherlands, that specialises in providing short-term working capital to SMEs, agribusinesses and emerging entrepreneurs that have limited access to finance from mainstream financial institutions and operate on a sustainable commercial footing. Their motto is: "working capital made easy". FACTS is convinced that economic impact is best achieved through developing a vibrant and resilient SME sector. They specialise in SCF and help SMEs balance their payables and receivables to overcome their liquidity problems. They offer the following products:*

- *Early payments to suppliers (reverse factoring): FACTS provides early payment to suppliers. The supplier pays interest and fees.*
- *Late(r) payment for buyers: on behalf of the buyer, FACTS will pay the supplier cash-on-delivery and collects this amount from the buyer later. The buyer pays interest and fees.*
- *Factoring: FACTS and the seller (SME) agree on a*

*receivables finance programme for a number of pre-approved off-takers. SMEs' sales invoices are uploaded onto the FACTS platform and form the 'Borrowing Base' against which FACTS finances 80% by means of advances. FACTS does not get involved in the collection process, and the SME remains fully responsible for buyer relationships.*

- *Invoice discounting: this is a (customised) product that is appropriate for more complex project-management situations, where a series of milestones or deliverables need to be met over time. There is one (pre-approved) client. In this case, the seller gets pre-paid and pays the financing costs. It works like this: seller uploads the invoice onto the FACTS platform and requests an invoice discount transaction from FACTS. Within the agreed credit limit, FACTS will discount the invoice on behalf of the seller. On invoice due date, the project owner pays the nominal value of the invoice directly to a FACTS collection account.*

*Source: <http://factsafrica.com/>*



the risks and rewards associated with ownership of the asset will be transferred to the lessee from the lessor. Normally, in a finance lease agreement, the lessee rents the equipment for most of its productive life, and ownership is transferred to the lessee at the end of the lease term. In operating lease agreements, the ownership of the property is retained during and after the lease term by the lessor. A professional leasing company normally has much greater purchasing power and can get better property and equipment, on better terms, than an individual SME or a farmer. For this reason, it is preferable for SMEs not to own certain types of property and equipment, but to lease them from professional companies, leaving some of the risks of ownership with the lessor.

The advantages of leasing are that the holder does not need to put up a large amount of money for a purchase, so it greatly improves liquidity. For vulnerable groups, leasing is of interest because they often don't have the money to buy the items (like a machine), but would benefit from using good equipment at the right time because their income depends on it. Disadvantages include: the commitment to contract for the entire validity period, higher fixed costs per month and that it is more expensive than purchase.

To support the expansion of the leasing business in Africa, CFC is negotiating a loan agreement with Equity for Tanzania, a leasing company operating in Tanzania (Box 2).

## Warehouse Receipt Financing – Community Inventory Credit

Warehouse receipt financing is a system where the value of commodities stored in a closed space or 'warehouse' is used by the owner of the commodity to secure financing from a financial institution. The value is calculated based on the statement or 'receipt' that is issued by the authority managing the warehouse, which specifies the value i.e., quality and quantity of the commodities available. By this action, there is therefore an implied legal liability on the warehouse manager for any loss of quantity or quality of the commodity. This practice allows farmers to bridge their needs for income as they identify buyers for their produce or wait out a period of high supply (during harvest season) to fetch higher prices later in the season. Despite its usefulness in providing access to finance

### Box 2. Equity for Tanzania Ltd. (EFTA)

*EFTA is a financial leasing company operating in the United Republic of Tanzania that provides loans to farmers and SMEs for machinery, vehicles and equipment through financial leasing. EFTA invests exclusively in capital assets for local businesses, with the aim of fuelling inclusive growth and promoting job creation. It was the first African entity to address SMEs with lease-to-own finance and won the G-20 SME Financing Challenge for innovative financial products. After proving the viability of the model in Tanzania, EFTA now seeks to expand it to neighbouring countries Kenya and Uganda.*

*Through their asset-backed lending or lease arrangements, EFTA retains ownership of the leased equipment, which reduces EFTA's risk, while providing much-needed financing without collateral for its customers (SMEs or farmers). Currently, the agriculture sector represents 37% of the company's total portfolio. Their typical client in the agricultural sector operates on about 100 hectares and normally rents equipment (mainly tractors) from other smallholder farmers.*

*EFTAs lease-to-own business model is innovative because of:*

- *The substitution of collateral with the acquired equipment;*
- *Repayment terms that accommodate the uncertainties of agribusinesses through longer tenors;*
- *Formal rescheduling opportunities;*
- *Local presence through a branch network.*

*Source: <https://www.efta.co.tz/>*

for farmers, a number of challenges remain, to make traditional warehouse receipt financing accessible to vulnerable farmers. These include lack of knowledge by farmers about warehouse receipt finance, and an inadequate number of warehouses. Additionally, the cost of warehousing may prove to be too expensive for more vulnerable populations. Lastly, there is little to no grading and standardisation of crops by market actors in many developing countries, which is required for this system to function efficiently and effectively.

However, innovations in warehouse receipt financing are challenging some of these barriers. One is community inventory credit, which solves the 'cost'

problem in two ways; the storage costs can be shared by a group of farmers and, consequentially, because of crop aggregation a selling deal may be easier and more profitable. This practice has been successful in Madagascar, where the practice is called Greniers Communautaires Villageois, and in a few countries in Francophone West Africa where it is referred to as warrantage communautaire.

Three basic models exist in warrantage:

- The first is a decentralised model, where a financial institution finances an individual producer organisation (PO) which stores the commodity in a warehouse owned and operated by a separate entity. The money received by the PO is shared as a loan, across the members who have stored their commodity together. However, each farmer has the individual responsibility of identifying a buyer for their own portion of the commodities and selling them. They then pay back the 'loan' received from the PO; which in turn is responsible to pay back the loan to the financial institution.
- The second model is centralised, where a second or higher tier organisation (a union or a federation) coordinates several grassroots POs and represents

them vis-à-vis financial institutions. The advantage here is scale; they are able to obtain substantive loan sizes due to a higher volume of commodity they are able to aggregate. The commodity is still sold individually, however, with either individual POs or farmers, having the responsibility of selling their own crop and paying back the union/federation.

- The third model is a more commercial approach that involves the collective marketing of the aggregated stored produce, sometimes with a collateral management company handling the storage and supporting the collective effort with input supply and brokerage services.

The third model is often preferred as it is found to have some strong elements of sustainability: local appropriation, strong peer pressure among borrowers, accountability with the lender, a forced savings aspect (which makes it easier to handle widely varying seasonal price movements), decentralised management and no requirement for costly collateral managers or insurance cover (AFD, CTA & IFAD, 2014). An example of warehouse receipt financing is described in Box 3.

### **Box 3. Agricultural Commodity Exchange for Africa (ACE)**

*The Agricultural Commodities Exchange for Africa is a regional commodities exchange based in Malawi, that was created by the National Smallholder Farmers' Association of Malawi (NASFAM) in 2004. The model was adopted from the Zimbabwe Agricultural Commodity Exchange (ZIMACE) where a group of committed agribusinesses created a young and thriving exchange.*

*Though the commodities exchange has been operating 15 years, they only recently received a commodities exchange license from the registrar of Financial Institutions.*

*Below is a sequence of how the system operates:*

1. *Deposit: The commodity is deposited in an ACE-registered facility where it is sampled, graded, handled, re-bagged, stacked and documented. All details are carefully recorded in the warehouse receipt.*
2. *Issuance: The storage operator issues a warehouse receipt which guarantees the quality and quantity of the commodity that has been deposited.*

3. *Finance: The depositor, should they choose to, requests financing from a preferred bank, with the warehouse receipt as their collateral.*
4. *Monitor and Sale: The depositor monitors market prices and, when ready, puts the receipt up for sale on the ACE platform.*
5. *Contract: A buyer accepts the offer of sale and the ACE platform generates a contract.*
6. *Payment: The buyer deposits the funds into the ACE settlement account.*
7. *Settlement: ACE settles the bank finance, storage costs and all other charges on behalf of the original depositor and then transfers the receipt to the new buyer.*
8. *Balance: ACE transfers the balance to the original depositor of the commodities.*
9. *Collection or Renewal: The new owner can then choose to either collect the commodity or request new financing from a bank using the new warehouse receipt.*
10. *Renewal or Cancellation: If the buyer chooses to collect the commodities, the receipt is cancelled; if not the sequence begins again.*

*Source: <http://www.common-fund.org/wp-content/uploads/2019/01/AR-2017-Agricultural-Marketing-System.pdf>*

## Access to Finance Challenge 2: (perceived) high risk

The second problem for small SMEs and farmers is that banks may not see them as potential clients. Firstly, banks may not see the finance need at all (SMEs and farmers often do not come to the bank's 'doorstep'). But even if banks do have this finance need on their radar, they might not be willing to lend to these customers because of the perceived and/or real high risk. Small farmers and SMEs often have complicated structures, where business finance needs are often entwined with family finance needs. It also goes without saying that because of their small size, their operating model may be riskier than larger companies (for instance, illness of the key worker may have an immediate impact on the small businesses result, for instance because the work cannot be done properly or because money is needed for healthcare rather than repaying the loan). Farmers operate in difficult circumstances and have to deal with unpredictable risk factors, including the weather and diseases. Banks normally do not like to deal with these additional complications and uncertainties as they make it hard to predict the (credit) risk of a loan and to price it right. An innovative way to overcome this issue is blended finance – a combination of public and private finance geared to demonstrate the creditworthiness and low risk of well-managed SMEs.

### Blended finance

Blended finance is a model for financing development projects that combines an initial investment, often from a philanthropic or government entity, with a subsequent commercial investment. Referred to as a concessional investment, this initial investment accepts a large share of the project's risk. Initial funding can take the form of first-loss capital, a grant, a government guarantee, or a subsidy. Its purpose is to get the project off the ground, even if that means accepting high levels of risk or below-market rates of return. Once the concessional funding has demonstrated that the actual risk of the project is acceptable, the project can attract private sector investors who seek (impact) market-rate returns but require lower risks, often due to regulatory requirements (Brodsky, 2019).

This model has the advantage of bringing capital to developing areas. Over three-quarters of investments in lower-income markets are below investment grade, which helps explain why many investors overlook development projects that do not have blended finance instruments. Blended finance allows governments and development agencies to correct market failures without requiring them to finance projects entirely through public funds. In addition, these deals can help draw attention to opportunities in developing regions and prove that development projects can be profitable. Using public funds can attract private investment by mitigating risks; blending public and private capital could be a win-win for both investors and global development (Business Commission, no date)<sup>1</sup>.

Still, this approach faces some challenges. Investors entering a blended finance arrangement need to ensure that projects can in fact be scaled up and made commercially viable. An analysis of 117 blended finance deals found that private sources provided more than half of the funding in only 43 cases. This suggests that this model may not be leveraging as much private capital as is needed for long-term, sustainable investing. In addition, it has been argued that blended finance could crowd out other methods of funding if it is applied to projects that do not need concessional investments to attract investors (Brodsky, 2019). Also, it is not clear that this type of financing reaches the bottom of the pyramid, where financial demand is especially high.

An example of blended finance with a primary purpose of enabling commercial entities to lend to clients who would have otherwise remained excluded is an IFC project with support from the UK. IFC signed a risk-sharing agreement with the European Investment Bank and Ecobank, a pan-African commercial and investment banking group, to be able to lend to small businesses (Box 4).

1. The Blended Finance Taskforce was established by the Business & Sustainable Development Commission to address the system challenges which prevent the market from scaling. Taking a "private sector" lens, the Taskforce has released a consultation paper, Better Finance, Better World, to develop actionable recommendations on this agenda. The paper was presented at the 2018 World Economic Forum in Davos.



#### Box 4. Blended finance lending package

*The lending package Ecobank put together with IFC and the European Investment Bank in 2015 was designed to overcome the challenges of lending to smaller business with high risk profiles in very poor countries. The UK's Department for International Development participated through IFC's Global SME Finance Facility. Helped by this risk-sharing facility, access to finance was provided to enterprises in eight African countries: Burundi, Chad, Congo, Côte d'Ivoire, Democratic Republic of the Congo, Guinea, Mali, and Togo. A risk-sharing facility supports partner banks such as Ecobank to extend their SME lending by sharing some of the downside if there are significant*

*losses. The Global SME Facility, which supported the risk-sharing structure with Ecobank, operates as a comprehensive blended finance vehicle that integrates both investment and advisory services to help banks scale up SME lending and overcome market restrictions. The facility also provides the local partner, Ecobank, with tools to build scale in SME lending, including advisory services and SME finance training. For Ecobank, the project helps to provide a broader customer base and, in time, stronger markets to lend to.*

*Source: IFC, 2018.*

## Solving issues beyond financing

Even when small farmers and SMEs can be reached and finance is provided to them, they do not automatically earn a decent income as they face many other issues beyond access to finance. For small farmers this includes lack of information about and access to quality farm input, such as seeds and fertiliser, as well as labour-saving and quality enhancing farm equipment, poor infrastructure to

transport inputs and tools from the vendor to the farm, a lack of knowledge and skills to utilise the inputs and tools to maximise produce, and lack of a reliable buyer to purchase the produce at the end of the season. This means that, to make them thrive, farmers need more than just access to finance. An example of how access to finance is merged with solutions to overcome other issues is the model applied by the One Acre Fund (Box 5).



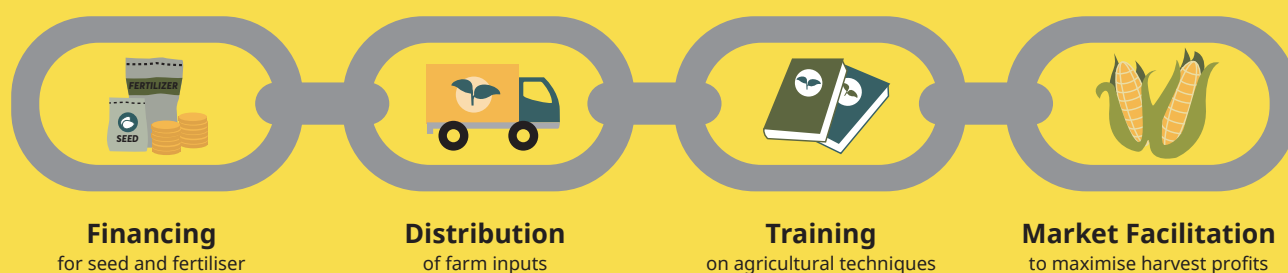
Photo: Tristan Bayly



## Box 5: One Acre Fund

*One Acre Fund is a non-profit, market-based financing model that goes beyond providing access to finance. Farmers pay for a subsidised portion of the services, with donor funding providing the remainder. One Acre Fund offer a complete bundle of services, using a market-based model, including:*

- **Asset-based loans.** Farmers receive high-quality seeds and fertiliser on credit, and a flexible repayment system is offered that allows them to pay back their loans in any amount throughout the loan term.
- **Delivery.** Inputs are delivered on-time to locations within walking distance of every farmer served.
- **Training.** Farmers receive training throughout the season on modern agricultural techniques.
- **Market facilitation.** Crop storage solutions are offered, and farmers are trained about market fluctuations, so that they can time crop sales to maximise profits.



*The underlying idea is that every link in this chain is important; if one is missing, then the others will also have less impact. One Acre Fund thereby provides (in kind) credit and supports farmers in optimising productivity. This is done through promoting better yields (by timely use of higher quality inputs, proven tools, skills to spot and fight diseases, diversification) and generating a better price (better quality inputs, and storage facilities to enable sales when prices are more favourable). As a result of this approach, the small farmers working with One Acre Fund on average increase their incomes on supported activities by 40%, reduce food insecurity in their households, and are able to invest profits into education for their children, new businesses, and other productive assets.*

*This approach also enhances the likelihood of repayment of loans. In 2019, One Acre Fund served more than 1 million farm families across Burundi,*

*Kenya, Malawi, Rwanda, Tanzania and Uganda with 97% of farmers paying their loans in full and on time. Providing services with blended finance down at the bottom of the pyramid, however, comes at a cost; farmer payments covered only 73% of One Acre Fund's field operating costs, with the rest covered by donor contributions. Furthermore, programme management at the level of SMEs is costly and in 2018 (latest financial report available) just over 50% of the total programme services and management costs of One Acre Fund could be recovered in revenues and repayments. This includes the cost of research and development and expansion into new countries. Thus, further work and donor engagement is required to achieve sustainable blended finance models.*

*Source: <https://oneacrefund.org/what-we-do/our-model/>*

# Conclusions

Smallholder farmers and SMEs in the developing world face major challenges to gain access to finance for their business activities. This is often caused by their inability to provide collateral and the (perceived) high risks associated with investing in such entrepreneurs. Innovative models have been emerging that address some of these challenges, for instance, factoring, leasing and warehouse receipt financing. However, even when the lack of access to finance is solved, many small SMEs and farmers still lack the proper inputs, tools, knowledge and access to markets to earn a decent income. In order to solve this problem, some NGOs and social companies have developed a more holistic approach that does not

only involve finance, but also supports farmers and entrepreneurs with other issues. By becoming more financially sustainable, they not only improve their (family) incomes but also become more 'bankable' or 'investable' for traditional finance organisations. Finally, in the commodity chain or ecosystem of getting a product to a customer, all parties depend on each other. Working together more closely and (financially or otherwise) supporting each other will therefore benefit all parties involved. This is even more tangible during the COVID-19 pandemic: it is indispensable that everybody in the commodity chain 'survives' and the chain will not be broken.



Photo: Anita Kucserova



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