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Investing in rural people

Update on the design of the Smallholder and Small and Medium-Sized Enterprise Investment Finance Fund (SIF) at IFAD

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For: Information

Update on the design of the Smallholder and Small and Medium-Sized Enterprise Investment Finance Fund (SIF) at IFAD

I. Introduction

1. IFAD is in a key position to help tackle the challenges that smallholders continue to face. Over the last 40 years, IFAD has earned the trust and respect of its government Members, smallholder producer groups and small-scale entrepreneurs, by extending over US\$17.5 billion in rural development public financing in 123 countries around the world, reaching an estimated 130 million people and benefiting 125,000 producers' organizations.
2. Nearly 75 per cent of IFAD's annual average of US\$1 billion in new investments currently include a value-chain development component, which uses public financing to enable viable business opportunities for small producers. By providing innovative solutions for financial inclusion and market access, investing in basic infrastructure and organizing farmers, IFAD helps prepare an ecosystem that allows other institutions and organizations to co-invest and benefit from its experience and relationship with governments and local institutions.
3. Nonetheless, working only through sovereign loans to governments limits IFAD's capability to promote private-sector involvement and offer new opportunities for smallholder farmers to access finance and markets. Other comparable industry actors have increasingly been deploying blended financial structures that incorporate public and private sources of capital to productively engage the private sector. IFAD shares this interest in exploring innovative financial solutions to promote small and medium-sized enterprise (SME) financing, and it seeks to increasingly leverage and involve the private sector. IFAD therefore intends to set up a new facility to promote commercial financing for value-chain development and to capitalize on its portfolio as a de-risking mechanism, to unlock responsible private-sector investments aimed at improving social and economic conditions for smallholders.
4. Despite increasing private-equity investment in emerging-market agribusiness (see the annex), investors generally remain wary of the sector owing to the manifold risks and the high cost of servicing smaller agribusinesses (e.g. loans of less than US\$500,000). As a result, many investors tend to favour larger or more mature enterprises.
5. Against this backdrop, IFAD has a comparative advantage in the space, stemming from a variety of factors. First, it has exceptional pipeline development capacity stemming from its global portfolio, last-mile presence and country/sector expertise as a way to de-risk private investments. Second, it has extensive financial experience spanning a variety of facets of fundraising and fund management. It also has experience with fund structuring and technical assistance programme development, including the African Agriculture Fund's Technical Assistance Facility and the Yield Uganda (equity) Investment Fund. Lastly, IFAD wields considerable convening power and reputation to bring together governments, financial institutions, non-governmental organizations (NGOs), and industry partners in support of multi-stakeholder initiatives for agriculture.

II. Operating environment

6. IFAD plans to introduce the Smallholder and Small and Medium-Sized Enterprise Investment Finance Fund (SIF) to invest in smallholder organizations and rural SMEs. This will be set up in an operating environment consisting of three pillars that will jointly support agricultural value chains and apply de-risking mechanisms, to

lower the risk of investments and encourage private-sector engagement (see figure 1).

Figure 1



Pillar 1

7. IFAD's existing project portfolio offers an organized market of producers and sector expertise to lower transaction costs and facilitate the development of a portfolio of investments in farmers' organizations and rural SMEs. This programmatic work, based on its sovereign lending, will identify potential investment opportunities to help develop the SIF investment pipeline. Additional opportunities for investment may arise from other activities, such as IFAD's work to promote the productive investment of diaspora remittances, which contribute to the creation of new businesses.
8. The IFAD portfolio will also help create a lower-risk environment for SIF investments by developing inclusive rural financial systems, and by addressing market failures whereby the perceived high risks and transaction costs of working with small-scale producers prevent private companies from forging market-based business relationships with smallholders. These instruments include:
 - Public-private-producer partnerships (4Ps) mechanism. IFAD uses public funds to leverage private investments to finance business plans, jointly submitted by private companies and farmers' organizations, which would otherwise not be funded by the private sector.
 - Financial instruments. Through its projects, IFAD provides a number of financial tools, including lines of credit, loan guarantees, matching grants, warehousing and agricultural insurance, which serve to promote financial inclusion and lower the inherent risks in developing innovative investment solutions. IFAD also hosts three risk-management tools: the Platform for Agricultural Risk Management, the Financing Facility for Remittances and the Weather Risk Management Facility.
 - Mobile client information platform. IFAD is developing a mobile platform that will collect information from the pool of producers' organizations in its portfolio. The data will then be made available to facilitate market access through "match-making" and business partnerships with potential investors, reduce the transaction cost of doing business, and capitalize on IFAD's "last-mile" investment capability.

Pillar 2

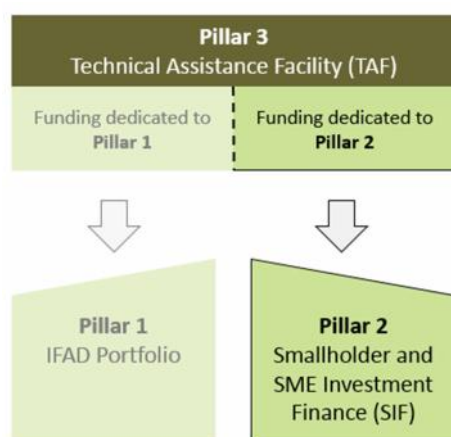
9. The SIF structure will raise a blend of capital on commercial and concessional terms to fund investments that maximize the impact on smallholder farmers in developing countries, while limiting risk and remaining attractive for private- and public-sector investors. The SIF intends to provide mostly debt finance in the range of US\$25,000-US\$500,000 – lending directly to SMEs and through financial intermediaries to the larger and more structured rural producers' organizations. This will fund working capital to manage farm operations, term loans, farm renewal, plantations, irrigation, certification, new technologies, equipment for processing, transformation, or for climate adaptation. The SIF would eventually also seek equity

and semi-equity investments, possibly coupled with guarantee and insurance mechanisms, including through other partners.

Pillar 3

10. To facilitate and accompany the SIF's business initiatives, IFAD will set up and manage a technical assistance facility (TAF) to provide advisory services to farmers' organizations and SMEs, thereby allowing them to access new opportunities for partnership and business development. The TAF is expected to include pre-investment technical assistance that will run in parallel with the SIF's due diligence process, as well as post-investment, where the SIF and TAF will focus on leveraging impact and monitoring performance. The TAF will seek to raise grant funding and to partner with institutions such as United Nations agencies, consultancy firms, and specialized technical agencies, to provide support for SIF operations and private-sector development under both pillar 1 and pillar 2 (see figure 2). The facility's governance structure will include representation from both pillars to guide activities, but will be formally separated from them.

Figure 2



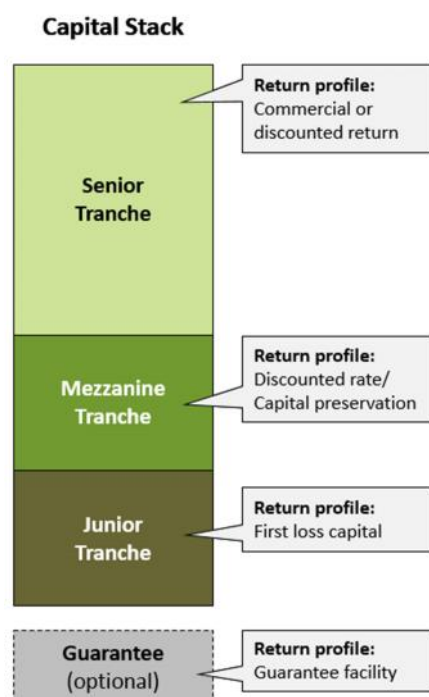
III. SIF window

11. Investment strategy. The SIF will be structured in a way that allows it to maximize financial efficiency and impact. The investment strategy will draw on IFAD's in-country knowledge and experience as relates to local agriculture value chains, to identify the critical gaps in financing required to expand productivity throughout the supply chain.
12. Investments made through financial intermediation will involve cofinancing initiatives with selected local financial institutions that are able to on-lend at the lower US\$25,000-US\$250,000 range, using the pipeline developed through IFAD's existing project work. Direct investments, in contrast, will mostly include debt finance in the range of US\$100,000-US\$500,000 made directly to farmers' organizations and SMEs for working capital and term loans. The SIF will consider including convertible debt options, as well as making strategic equity and quasi-equity investments for counterparties with a proven track record through debt financing. Both, debt and equity will provide an affordable funding channel to producers' organizations and SMEs committed to environmental sustainability, climate adaptation and social practices in accordance with IFAD's Social Environmental and Climate Assessment Procedures (SECAP).
13. Financial structure. SIF will be launched with initial combined investments of US\$50 million, targeting a limited number of countries (about five) in both hard and local currency. These first beneficiaries will primarily be selected from among recipient countries where IFAD has active programmes, under criteria to be agreed with the donors. Currency-risk mitigation strategies will be implemented, potentially

in the form of a first-loss reserve dedicated to absorbing currency-risk losses or to cover hedging costs. Both total assets and the country focus will grow significantly and diversify over the lifetime of the fund, reaching a range of US\$100-US\$150 million and some 15 countries within the first five years, at which point an active currency diversification strategy will be implemented.

14. Pending conclusion of the legal analysis, the working hypothesis is that funding for the SIF will be sourced from non-replenishment resources (supplementary funds). The bulk of funding will be raised in the form of blended capital from impact-oriented investors (i.e. private-sector financiers, high net-worth individuals, development finance institutions (DFIs), and others). Investments will be captured through three sets of tranches with different return profiles, including a senior (commercial or discounted returns), mezzanine (capital preservation) and junior tranche (first loss). A guarantee facility, which would likely be financed by a partner DFI, is also being considered to further lower risk by absorbing losses or serving as collateral (see figure 3).

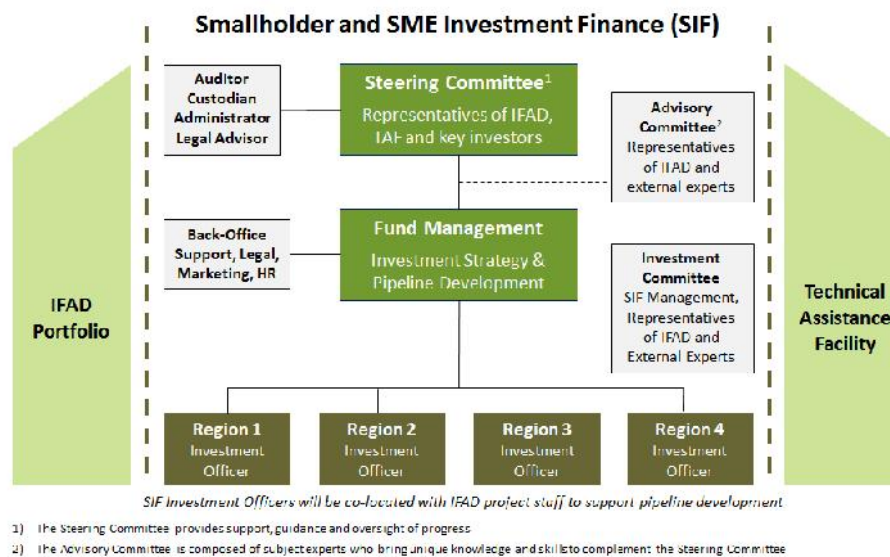
Figure 3



15. Governance and staffing. The SIF is expected to operate as an independent legal entity with arms-length autonomy – i.e. implementing its own processes, balance sheet and governance structure – while remaining aligned with IFAD project work (see figure 4). To this end, the SIF is likely to have its own governing body in the form of a steering committee, with representatives from the SIF main stakeholders, IFAD and key investors (DFIs, foundations, government institutions and commercial entities). As the fund's ultimate governing body, the steering committee will ensure legal and tax compliance, offer guidance to the mission and vision, raise funds, and act as ambassadors to the wider community of agricultural development actors.
16. Additional expertise will be provided through an advisory committee, which will be composed of select individuals who contribute unique knowledge and skills that augment that of the steering committee, particularly in areas relevant to the SIF's investment activities and objectives.
17. In terms of day-to-day management, the SIF is expected to be launched with a lean but experienced fund management team to be hired by IFAD. Central to this process is the selection of a fund manager tasked with defining and overseeing the

SIF's investment strategy, ensuring its alignment with the steering committee's objectives, and implementing a sound risk-management strategy. The investment process will be undertaken in-country by investment officers with expertise in the agriculture sector and co-located within IFAD regional offices, where they will be better able to leverage IFAD's project work and staff expertise.

Figure 4



18. Cost and risk management. The level of risk involved can limit potential upside returns, particularly on smaller investments. To manage this, the SIF will need to attract funding on concessional terms, prioritizing impact in exchange for a discount on financial returns, while also providing risk-mitigation facilities to absorb potential credit and currency losses in the form of dedicated first-loss guarantees.
19. Other risks that the SIF will face include: (i) fund management capacity, as IFAD does not currently have staff with the skills and experience needed to manage a private-sector fund. This will be addressed by recruiting an experienced fund management team; and (ii) branding and reputation, as IFAD's entrance into this investment space may seem at odds with its sovereign portfolio in the eyes of some of its government partners. To address these potential concerns, the SIF will undergo a branding process to develop a distinct corporate culture separate from IFAD's programmatic work, and provide it with its own identity as a social impact fund.

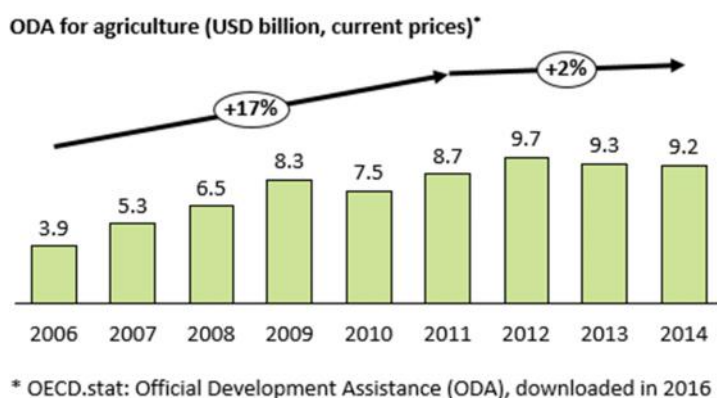
IV. SIF design activities and timeframe

20. To set up the SIF, IFAD will implement several activities within the following timeframe:
- By mid-2017, IFAD will have further defined the potential markets, initial pipeline, monitoring and evaluation approach, legal and governance structure and requirements, domiciliation options, and design of the TAF.
 - In September 2017, IFAD plans to present the SIF to its Executive Board.
 - By end-2017, IFAD will have recruited a fund management team and developed a detailed financial model, investment policy and procedures, risk management, currency hedging mechanisms, and compliance requirements.

Agricultural funding landscape - supply of agriculture funding

1. The world's 500 million smallholder farmers are a critical part of food systems in developing countries, yet their farms are generally constrained by limited resources and suboptimal practices which result in low yields. While 70 per cent of the world's "bottom billion" are employed in agriculture¹ in low-income countries, GDP growth in agriculture has proven five times more effective at reducing poverty than growth in other sectors. Beyond food security, nutrition, and livelihoods, agriculture is an important part of the climate and conservation agenda, accounting for 70 per cent of global water withdrawals² and 50 per cent of greenhouse gas emissions.³

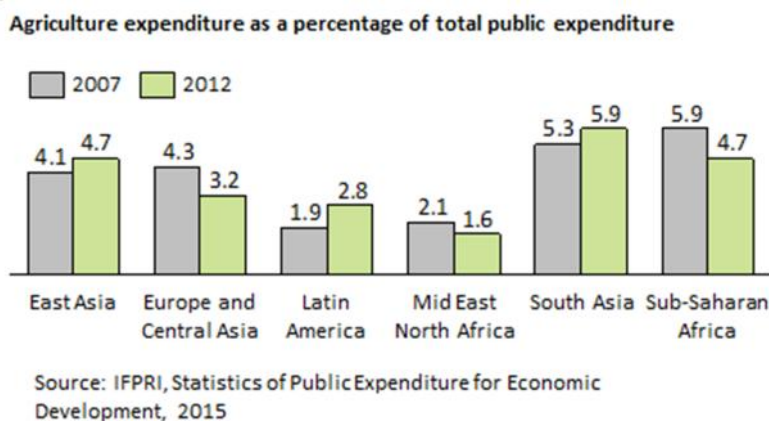
Figure 1



2. In terms of supply, the agricultural funding landscape has shifted in recent years. Although overall interest in the sector continues to grow, traditional sources of funding in the form of official development assistance (ODA) to agriculture have faded, particularly compared to the substantial rise in the

wake of the 2007-2008 food crisis (see figure 1). Meanwhile, trends in public expenditure for agriculture are less clear, owing to outdated data and regional variability. As of 2012 however, the share of public expenditure allocated to agriculture was decreasing in Europe and Central Asia, the Middle East and North Africa, and also in sub-Saharan Africa (see figure 2).

Figure 2



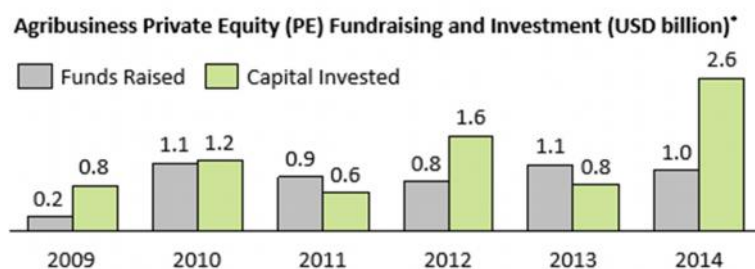
3. The data show steady growth in capital invested through private equity in emerging-market agribusiness; but such investments account for only a small share of the industry (<2 per cent), mainly because investors remain wary of the unpredictability of the market and uncertainty of returns (see figure 3).

¹ IFAD, "Rural Poverty Report," 2011.

² Food and Agriculture Organization of the United Nations, AQUASTAT.

³ Source: Genetic Resources Action International (GRAIN): includes production, land use change, deforestation, processing, transport and retail.

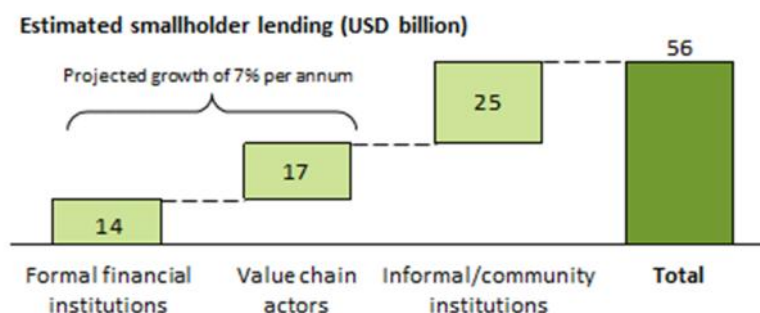
Figure 3



* Credit Suisse, CDC, EMPEA, IFC, and WWF, "Private Equity and Emerging Markets Agribusiness: Building Value Through Sustainability," 2015

4. At the smallholder-farmer level, much of the sector has long relied on informal and community-based financial service providers (FSPs), which include rotating savings and loan associations, as well as local moneylenders, who continue to play an important role in providing smallholders with access to credit. Nonetheless, recent years have seen a growing number of FSPs of various types entering this space and specifically targeting the smallholder-finance sector with dedicated agriculture teams. These include formal financial institutions, such as microfinance institutions, commercial banks, impact investors and NGOs, providing a range of financial services, which, in some cases combine additional facilities such as technical assistance. They also include value-chain actors, which provide agricultural working capital loans to commercial smallholder farmers as a way to increase product availability and make this more reliable (see figure 4).

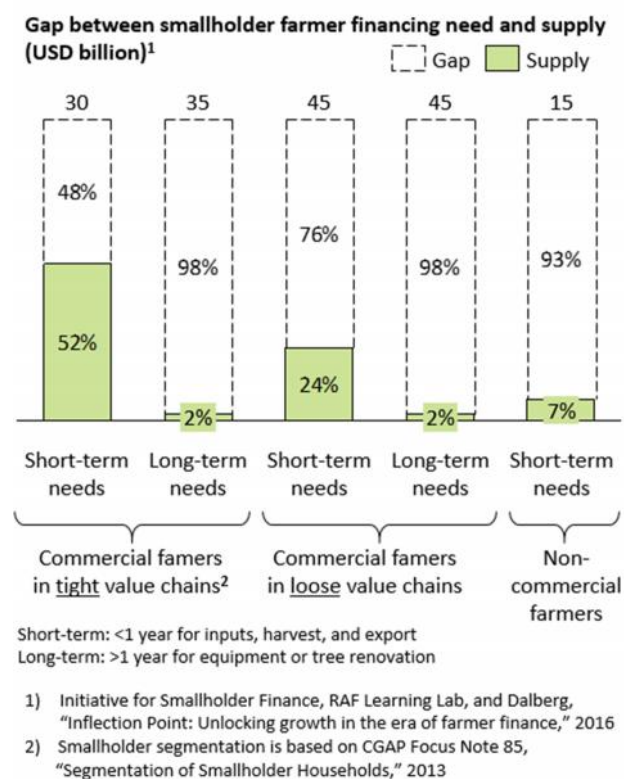
Figure 4



Source: IFPRI, Statistics of Public Expenditure for Economic Development, 2015

- Funding gap in the agricultural sector
5. The financing needs of smallholder farmers in Latin America, sub-Saharan Africa, and South and Southeast Asia exceed US\$200 billion, of which less than US\$60 billion is available (see figure 5). Despite the continued entry of new players, the combined growth of formal financial institutions and value-chain actors is only projected to reach 7 per cent per year through 2020, which will do little to bridge the wide gap that exists between the demand for smallholder finance and its supply. This shortfall in the provision of financial services for smallholder farmers effectively limits their ability to improve their productivity, livelihoods, and value-chain participation.

Figure 5



6. Agricultural SMEs face similar problems. Their development is constrained by a variety of factors, such as limited access to credit, lack of collateral, low levels of technology and poor management skills, limited access to markets, the existence of laws, regulations and rules that impede the development of the sector, and weak institutional capacity. Generating employment opportunities for rural youth and offering alternatives to migration will depend on the capacity of SMEs to grow sustainably. This will not happen without a more proactive approach to facilitate access to finance and the development of better financial products that can blend funding sources and address risks.

7. Closing the gap
Increasingly, blended capital solutions have been emerging to form a diverse landscape of investment funds with unique strategies, resulting from the formation of partnerships and multilateral initiatives. These bring together development finance and philanthropic funds to mobilize private capital flows to developing and emerging agricultural markets. Many of the more niche funds include sidecar technical assistance facilities; yet this practice remains rare overall (see figure 6). The most effective alignments of technical assistance and investment have governance structures that link the two (technical assistance and investment) in a strategic manner, while maintaining flexibility to adapt to new opportunities.

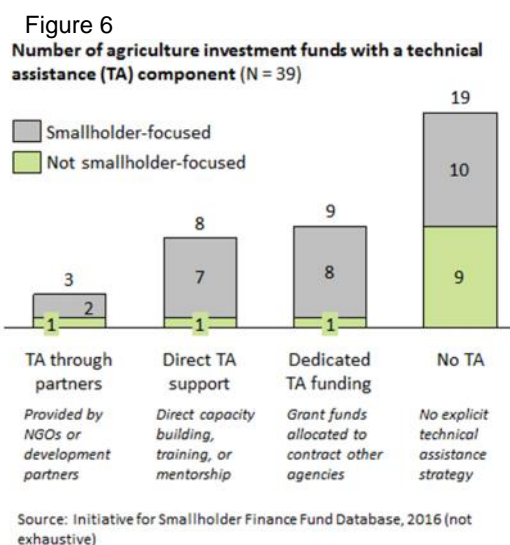
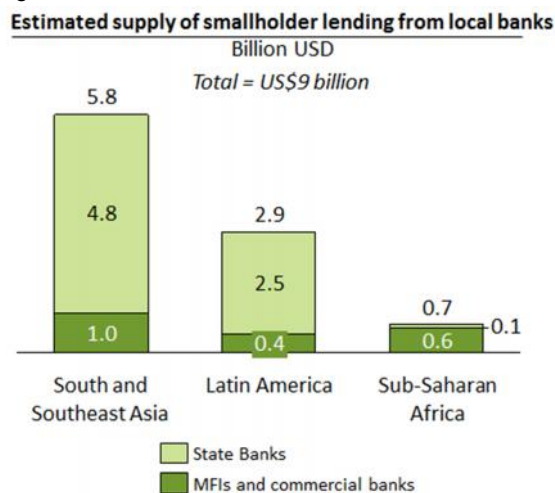


Figure 7



8. Nonetheless, the frontier of smallholder finance, particularly smaller SMEs and farmers' organizations, remains a very difficult niche to operate in. The primary challenges in financing this segment of agriculture are high costs and low returns coupled with high risks (e.g. weather, price, production risks). Smaller loans (<US\$200,000) are particularly difficult, because operating and due-diligence costs are broadly fixed and thus proportionately larger relative to the amount lent. For these reasons, blended finance solutions are particularly well suited, as they typically use low-cost capital coupled with lean operations; and they may

include internal cross-subsidies from larger loans and/or external subsidies from philanthropic funders.

9. An alternative approach to providing smaller loans directly to SMEs and farmers' organizations in emerging markets is to work through financial intermediation, whereby investors target local financial institutions that already serve smallholder farmers in a given market, and offer solutions to expand their existing portfolios (see figure 7). Strategies for financial intermediation often include: (i) financial tools such as guarantees or interest rate buy-downs; (ii) aligned technical assistance to develop products and agricultural expertise; (iii) partnerships to cultivate pipeline financing and deploy it through value-chain relationships; and (iv) digital solutions to reduce transaction costs and/or use alternative forms of data for credit scoring.