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Investing in rural people

Strategy for Establishment of the Smallholder and SME Investment Finance (SIF) Fund

Note to Executive Board representatives

Focal points:

Technical questions:

Adolfo Brizzi
Director
Policy and Technical Advisory Division
Tel.: +39 06 5459 2450
e-mail: a.brizzi@ifad.org

Michael Hamp
Lead Technical Specialist − Inclusive Rural Financial Services
Tel.: +39 06 5459 2807
e-mail:m.hamp@ifad.org

Enrique Hennings
Lead Technical Specialist − Rural Markets and Enterprises
Tel.: +39 06 5459 2176
e-mail: e.hennings@ifad.org

Dispatch of documentation:

William Skinner
Chief
Governing Bodies
Tel.: +39 06 5459 2974
e-mail: gb@ifad.org

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Contents

Abbreviations and acronyms

AAF	African Agriculture Fund
BDS	business development services
FO	farmers' organization
FSP	financial service provider
IC	investment committee
M&E	monitoring and evaluation
MFI	microfinance institution
SDG	Sustainable Development Goals
SIF	Smallholder and SME Investment Finance
SME	small and medium-sized enterprise
TA	technical assistance
TAF	Technical Assistance Facility

Executive summary

1. Globally, smallholder farmers and rural agriculture businesses face challenges in improving their productivity, livelihoods and value chain participation. A critical issue for smallholder agriculture is attracting capital to stimulate growth and strengthen livelihoods, increasingly by engaging financial service providers and the private sector directly. An equally compelling challenge is the increasing and potentially destabilizing issue of unemployed rural youth and the urgency of offering alternatives to migration. Preserving existing jobs and generating new opportunities for young people will be contingent on the capacity of rural small and medium-sized enterprises (SMEs) to grow sustainably and create jobs in developing countries and emerging economies.

2. Despite growing interest among donors in supporting smallholder agriculture and rural youth, a wide gap remains between supply and demand for investment. IFAD is well positioned to address this gap through its presence on the ground, sector expertise in value chains and rural finance, and experience with investments and building multi-stakeholder partnerships.

3. In this context, IFAD plans to establish a Smallholder and SME Investment Finance (SIF) Fund as one of three pillars to drive inclusive smallholder and rural SME finance, as well as youth employment. This is an ancillary activity for IFAD to pursue its objective to mobilize additional concessional funding for agricultural development in developing Member States.

4. Pillar 1 is the existing IFAD project portfolio that will be leveraged as the SIF Fund's main source pipeline by helping to identify critical gaps in financing requirements for producer organizations and rural SMEs in a given supply chain, and create new opportunities for youth employment. Through its existing programmatic work, the IFAD portfolio will serve as a de-risking mechanism for private investments.

5. Pillar 2 will be the SIF Fund itself, which will target farmer organizations and SMEs through a mix of direct financing and financial intermediation. The SIF will initially be launched with concessional funding in the form of grants in order to establish a proof of concept. The portfolio is expected to reach between US$50 million and US$100 million within three to five years, making debt and subordinated debt investments in the range of US$25,000 to US$1 million. During the second phase, the SIF will expand its funding sources to include commercial investors to reach a target of US$150 million to $300 million, broaden its geographic coverage and add equity investments to its product offering.

6. Pillar 3 will be a Technical Assistance Facility (TAF) to complement the SIF, provide pre- and post-investment technical assistance to SIF investees and incubate young entrepreneurs and their start-ups. The TAF will also support the SIF in monitoring and evaluation (M&E) to enhance impact.

7. From a governance perspective, the SIF will be an independent entity with autonomy from IFAD, thus avoiding any transmission of financial risk while ensuring alignment with IFAD's strategic objectives and existing portfolio.

8. The SIF will include a robust M&E process that will monitor financial, operational and impact development data aligned with IFAD core indicators and measurement standards, as well as addressing specific Sustainable Development Goals.

9. The SIF Fund is expected to be formally launched in the first half of 2018.

Recommendation for approval

The Executive Board is invited to approve the following decision:

The Executive Board of IFAD approves the Strategy for Establishment of the Smallholder and SME Investment Finance (SIF) Fund as an ancillary activity in furtherance of its objective in accordance with article 7, section 3, of the Agreement Establishing IFAD.

Strategy for Establishment of the Smallholder and SME Investment Finance (SIF) Fund

I. Context and IFAD's unique opportunity

1. Achieving the ambitious targets set by the Sustainable Development Goals (SDGs) in the agriculture and rural sectors will call for rethinking the "finance for food" agenda, and inevitably seeking greater private sector involvement. Through its work with smallholder agriculture, IFAD has supported the development of a market that the private sector is increasingly looking to for business opportunities. Furthermore, private companies see IFAD as a potential ally in their efforts to work in a market segment that has traditionally been too risky to engage in. Through its portfolio, IFAD has developed a number of financial instruments to reconcile development objectives with viable business plans in an effort to reduce risks and transaction costs.

2. Creating decent jobs for young women and men in the rural economy is a pressing prerequisite in light of the risks of political instability and disruptive migration as a result of low youth employment. IFAD is committed to addressing this issue through its portfolio, which will serve as the primary mechanism for transforming the "youth bulge" of the developing world into "a demographic dividend". Investing in young people generates significant social and economic returns, making it an effective and meaningful target for financial development assistance.

3. IFAD has come to realize that there are limits to its capacity to promote private sector activities and small and medium-sized enterprises (SMEs) access to markets and finance, if investing only through sovereign loans to governments. IFAD is exploring innovative financial solutions to fulfil its mandate, including raising capital from external public and private sources as a strategic opportunity to better engage with the private sector. The corporate-level evaluation of the private sector strategy undertaken in 2011 by the Independent Office of Evaluation of IFAD had already recommended establishment of a private sector window in IFAD.

4. Despite increasing private equity investment in emerging markets, investors generally remain wary of the agriculture sector due to the high costs and risks involved, especially when providing loans of less than US$1 million in the case of smaller agribusinesses and farmers' organizations (FOs). As a result, many investors, including social investors, tend to favour larger or more mature agribusinesses. Meanwhile, local financial institutions targeting the lower end of the market, such as microfinance institutions (MFIs), are usually too risk averse to address the agriculture term finance needs of smallholder farmers and rural SMEs in a meaningful way, often restricting both the size and tenor of their investments. At the same time, commercial banks focus on larger, more secure deals, leaving a sizeable gap in investment.

5. Against this backdrop, IFAD has a comparative advantage for a number of reasons. First, IFAD has a unique pipeline development capacity stemming from its global project portfolio, last mile presence and country and sector expertise. Through its field offices and the implementation units of the projects it finances, IFAD works

with a variety of SMEs operating within different value chains, placing the organization in a unique position to source prospective pipeline efficiently. The SMEs included in this pipeline are operating within value chains already being supported by IFAD as part of the project portfolio, effectively de-risking these SMEs through IFAD's complementary programmatic work.

6. Second, IFAD has a proven capacity for raising concessional capital, particularly from sovereign sources aligned with the commitment to prioritize impact over financial returns, while applying a cost-effective approach to delivering results. Third, IFAD also has experience with fund structuring. For example, IFAD helped to create the Yield Uganda Investment Fund initially spearheaded with funds from the European Union, as a single country fund offering equity and quasi-equity financing to small and medium agroenterprises. IFAD also manages the Technical Assistance Facility of the African Agriculture Fund (AAF), with the objective of improving the performance and growth of agriculture and food related businesses across the African continent, while reducing the operational, credit and market risks related to the fund's equity investments.

II. Description of the Smallholder and SME Investment Finance (SIF) Fund

7. IFAD plans to capitalize on its considerable experience and unique portfolio to leverage investments and finance SMEs directly. For this purpose, it will establish a Smallholder and SME Investment Finance Fund to invest in smallholder organizations and rural agricultural businesses to generate rural employment opportunities and growth.

A. Competitive positioning of the SIF Fund

8. By leveraging IFAD's unique attributes, the SIF Fund is in a position to address the market of smaller rural SMEs and smallholder producer organizations that other funds struggle to reach. Notably, by leveraging alignment with IFAD's programmatic work and deep local expertise in agriculture, the SIF will be able to identify and strengthen prospective pipeline investees in ways that a stand-alone fund could not. Other types of funds generally focus on mature businesses, are diversified across sectors, and do not benefit from the same in-country networks and programmatic support that IFAD can deploy, or have access to concessional capital that would allow them to make smaller, riskier loans for rural SMEs. As they usually target larger investments they are unlikely to be in direct competition with the SIF (see figure 1). However, a number of them could be candidates for investment in the SIF itself, or for co-investment alongside the SIF to take advantage of IFAD's relative strength in developing pipelines among smallholders and SMEs and retailing capacity.

Figure 1
Competitive positioning of the SIF

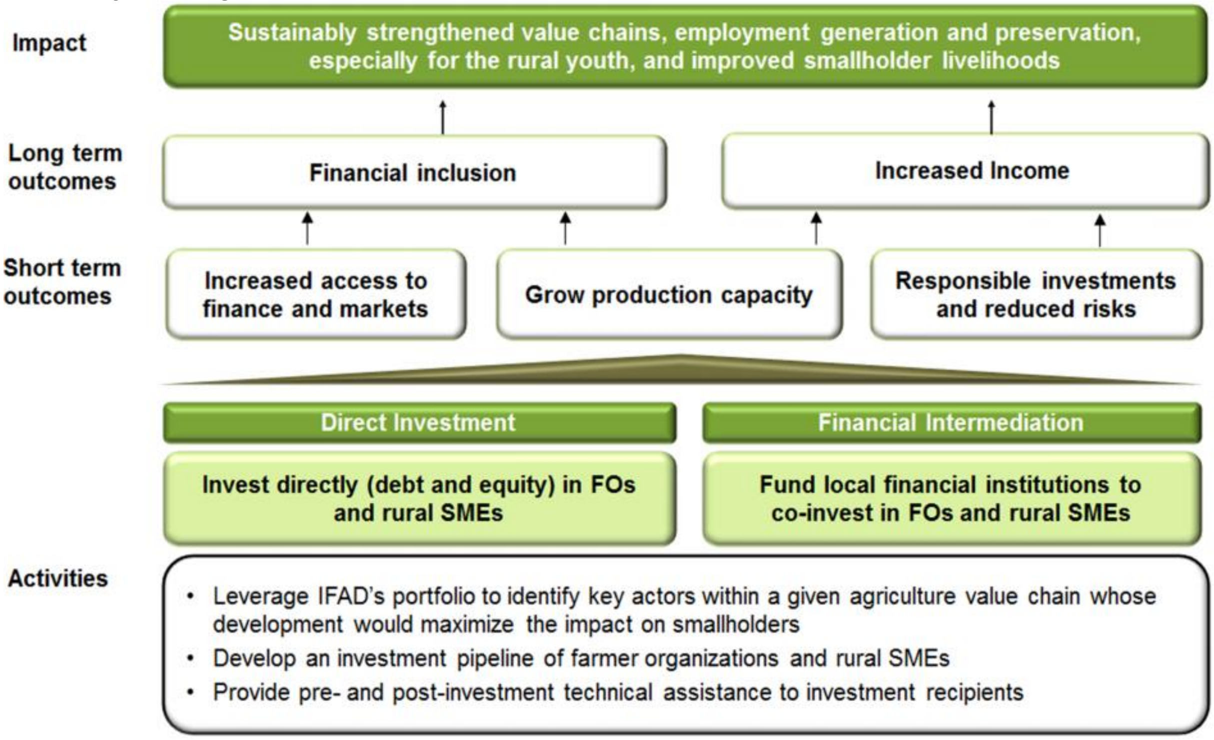
		"Frontier plus" agriculture funds	*Early stage venture funds*	*Local or small regional funds*	*Niche impact funds*	*Wholesale multi-sector or agriculture funds*
Examples	SIF Fund	• Root Capital • ResponsAbility	• Factor(E) • Africa Enterprise Challenge Fund • Acumen	• AAF • Lending for Africa Farming • Annona Sustainable Investment Fund • Tropical Landscapes Finance Facility Indonesia	• Althelia Ecosphere • Clarmondial • ABN AMRO Group value chain fund	• Department for International Development Impact Fund • Arise • Africa Agriculture and Trade Investment Fund (KfW Development Bank)
Mission focused on smallholders	Yes	Yes	No	Not a core focus	In some cases	Limited
Specialized agriculture expertise	Yes: leveraging IFAD expertise	Yes	No: Typically diversified	In some cases	In some cases	In some cases
Deep local expertise	Yes: leveraging IFAD footprint	No: Global focus	No: Global/ regional focus	Yes	No	No
Supplementary source of pipeline	Yes: Ready access via pillar 1	No	No	No	In some cases: Value chain clients	No
Aligned technical assistance funding	Yes: Via pillar 3	Rarely	In some cases	In some cases	In some cases	In some cases
Aligned programme support	Yes: Via pillar 1	No	In some cases	No	In some cases	No
Access to concessional capital	Yes	Yes	Yes	In some cases	Typically no	Yes
Able to offer small loans (<US$500,000)	Yes	Rarely	In some cases	No	No	No

B. Theory of change

9. The SIF aims to generate positive and measurable social impact for actors in agricultural value chains together with financial return for investors. In the short to medium term, the combination of direct investments and financial intermediation is expected to provide targeted investees with sources of financing they are currently unable to tap. This will enable them to develop their operations within value chains to enhance growth and lower investment risk.

10. In the longer term, investees will develop a track record of successful loan repayments that will enable them to access financial services from traditional lenders. Meanwhile, the increased activity resulting from their growth will lead to higher transaction volumes, to and from smallholders. Ultimately, these investments will help generate stronger and more sustainable value chains leading to better performing SMEs, improved livelihoods of smallholder families and rural youth employment as an alternative to migration (see figure 2).

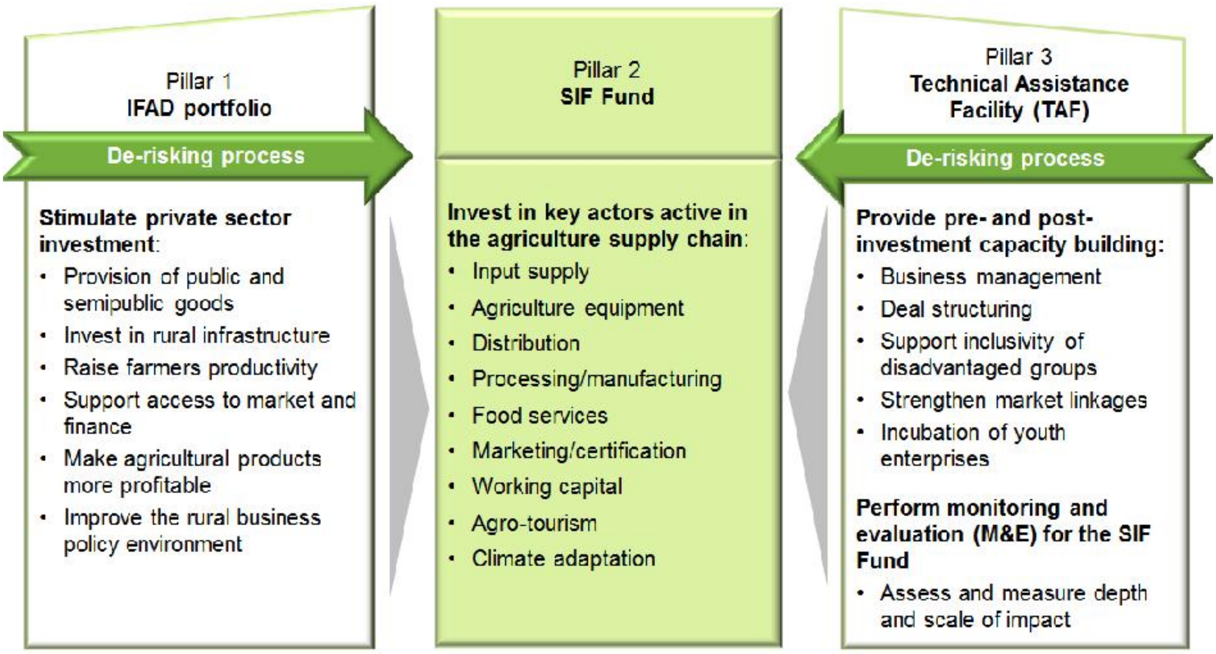
Figure 2
SIF theory of change



C. Operating environment

11. The SIF will be established in the context of an operating environment consisting of three pillars that will work together to support agricultural value chains, apply de-risking mechanisms and encourage private sector engagement (see figure 3).

Figure 3
SIF operating environment – three pillar approach



12. Pillar 1: IFAD portfolio – IFAD's sovereign lending project portfolio offers an organized market of producers that will help lower transaction costs and facilitate the development of a pipeline of investments in FOs and rural SMEs within specific value chains. Additional opportunities for investment may arise from other activities, such as IFAD's work to promote productive diaspora investments and remittances, which help create new businesses and strengthen existing ones, as well as through referrals from the TAF (pillar 3) and independent prospecting from SIF investment managers.

13. The IFAD portfolio will also contribute to creating a lower risk environment for SIF investments by deploying tools for inclusive rural finance and private sector engagement mechanisms under the public-private-producer-partnership approach, with a focus on smallholders in agricultural value chains targeted by the SIF. This will address market failings in which the perceived high risks and transaction costs of working with small-scale producers prevent private companies from forging market-based business relationships.

14. Pillar 2: SIF Fund – The SIF will be implemented under a phased approach. It will initially be launched as an impact fund with a company structure, targeting a total first raise in the range of US$50 million to $100 million in concessional funding in the form of grants and operating in a capital preservation mode with the objective of establishing a proof of concept and building a robust pipeline over a period of three to four years. During this first phase, the SIF aims to provide debt and subordinated debt finance in the range of US$100,000 to US$1 million directly to SMEs and to larger, more structured rural producer organizations for working capital, term loans, farm renewal, agro-tourism, climate adaptation, input supply, plantations, irrigation, marketing, certification, distribution, food services, new technologies and equipment for processing or transformation. Loans will also be provided through financial intermediation in order to reach the lower range of investment needs (US$25,000 to US$250,000). The fund's capital structure could potentially be coupled with a first loss credit guarantee mechanism.

15. Building on the success of the first phase, the SIF will transition into a second phase, larger in scope and broader in product diversification to include equity and convertible debt products. It will include concessional sources of funding and leverage commercial investors targeting a total blended capital amount of US$150 million to US$300 million. The SIF will continue to maximize impact on smallholder farmers and job creation for youth, while limiting risks and remaining attractive for private and public sector investors.

16. Pillar 3: Technical Assistance Facility – IFAD will set up a TAF to provide advisory services to FOs and SMEs, enabling them to build business development capacity while helping de-risk SIF investments. A portion of the TAF's activities could be dedicated to address youth employment opportunities and capacity-building to incubate young people's enterprises that could eventually become eligible for SIF financing.

17. The TAF offering is expected to cover both pre-investment technical assistance (TA) in parallel to SIF investments, and post-investment supervision whereby the SIF and TAF will monitor performance, provide TA services when required and measure impact. The expected TA needs include institutional strengthening for the preparation of business deals, brokerage services for business partnerships between private sector and FOs, product development, etc.

18. 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. The TAF's governance structure will be developed by IFAD in partnership with external service providers, or may be outsourced.

D. Investment strategy

19. The SIF will be structured to maximize financial efficiency and impact. The investment strategy will leverage IFAD's in-country knowledge and experience with local agriculture value chains to identify critical gaps in financing required to boost productivity. To remain cost effective while generating the desired impact, the SIF will engage in both direct investment and financial intermediation, focusing on the lower range of investment that is largely left unserved by existing investment providers.

20. The SIF intends to intervene in a market segment (the US$25,000 to US$1 million range) that is relatively more risky (further down in the smallholder pyramid) and more expensive (smaller deals with lower capacity clients). Therefore, SIF will prioritize impact rather than investor returns. For smaller deals (US$25,000 to US$250,000) IFAD will minimize risks by working through cofinancing arrangements with local financial service providers (FSPs). The SIF will finance FSPs through wholesale investments of between US$2 million and US$5 million in the form of debt and subordinated debt instruments. FSPs will then on-lend the funds through a portfolio of smaller investments in rural SMEs and FOs. In parallel, such investments are expected to provide a catalysing effect on FSPs to increase their exposure to the rural market.

21. Direct investments, chiefly debt and subordinated debt finance in the range of US$100,000 to US$1 million, will be made directly to FOs and SMEs for working capital and term loans. The SIF will have some latitude on investment size and tenor outside the stated range, in order to maintain the flexibility to capture strategic investment opportunities while avoiding mission drift towards the upscale market. Furthermore, the SIF will also consider co-investing in specific projects with other existing local or international funds, providing they are aligned with the SIF's mission.

22. Besides the expected organic growth in job opportunities for young people along the targeted agricultural value chains as a result of investment, the SIF will consider dedicating a portion of its portfolio to direct interventions promoting youth employment, including financing for youth-owned enterprises and start-ups.

23. Over time, 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 serve as affordable channels of money to producer organizations and SMEs committed to a sustainable environment, climate adaptation and social practices in accordance with the Social, Environmental and Climate Assessment Procedures of IFAD.

24. Country selection: In the first phase, the SIF will prioritize sub-Saharan Africa countries, while remaining open to operating in other geographic regions. As the fund transitions into its second phase, it will progressively expand the number of countries following a diversification strategy, to be developed by the fund manager, that will take into account regional, political, and sector specific risks, as well as currency.

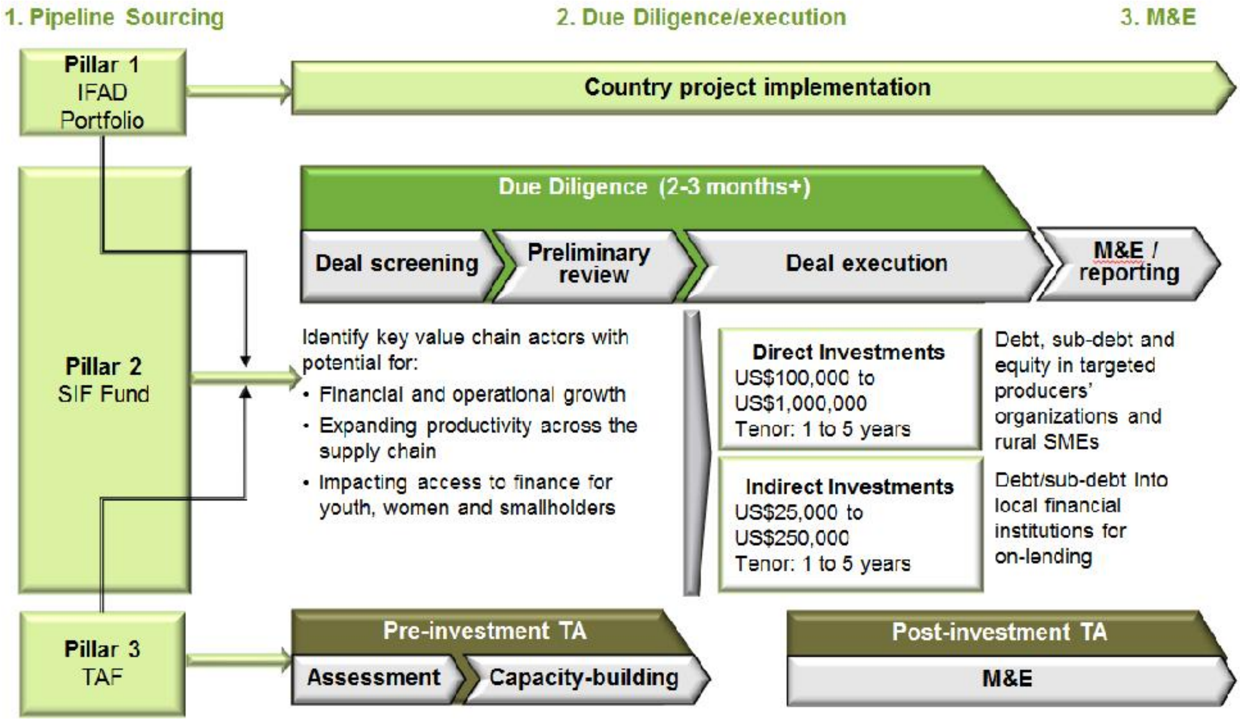
E. Investment process

25. The investment process (see figure 4) will begin with pipeline sourcing, comprising the identification of key actors within a given value chain and a preliminary assessment of the value chain's potential impact and the need for TA. Deals will be sourced in four main ways: from IFAD programmatic work (pillar 1); referrals from the TAF (pillar 3); independent prospecting activities from SIF investment managers; and engagement with regional FOs and federations with which IFAD has already developed strong partnerships through the Farmers' Forum, and through initiatives of the Support to Farmers' Organizations in Africa Programme (SFOAP) and the Medium-Term Cooperation Programme (MTCP) with Smallholder Farmers in Asia and the Pacific.[1] This step will be followed by deal screening, whereby basic information and documentation is collected and reviewed to shortlist investees with the highest potential impact. This includes an evaluation of their investment readiness and adherence to IFAD social and environmental standards.

26. The next step is a preliminary review of financials and business plans, accompanied by an initial discussion with the entity's senior management. This review will determine whether to consider the deal for direct investment or through financial intermediation. Selected candidates will then reach the final stage of due diligence: deal execution. This stage involves a deeper, more exhaustive analysis of the entity and site visits by investment managers. A recommendation for investment and TA will be presented to the investment committee (IC) with the SIF executive director and TAF manager present as observers. The IC will determine the final investment decision and use of pre-investment TA.

27. Once investments are made, the SIF investment team will focus on portfolio control, or the monitoring and reporting of financial, social and environmental indicators and milestone achievements, to be reported to the board of directors on a quarterly basis.

Figure 4
Investment process



[1] The SFOAP, being financed by the European Union, the Agence Française de Développement and the Swiss Agency for Development and Cooperation; and MTCP, financed by the European Union and Swiss Agency for Development and Cooperation.

F. Governance and staffing

28. The SIF is expected to operate as an independent entity registered as an investment fund under the laws of an IFAD Member State, with arm's length autonomy from IFAD – i.e. implementing its own processes, balance sheet and governance structure – but aligned with IFAD strategic objectives and existing portfolio (see figure 5). As no IFAD core resources will be invested in the SIF capital there will be no transmission of financial risk to IFAD.

29. The SIF will have a governing body in the form of a board of directors comprised of representatives of the main stakeholders, such as IFAD and key investors/donors, as well as independent members contributing external expertise in the areas of investment fund management and smallholder agriculture and SMEs.

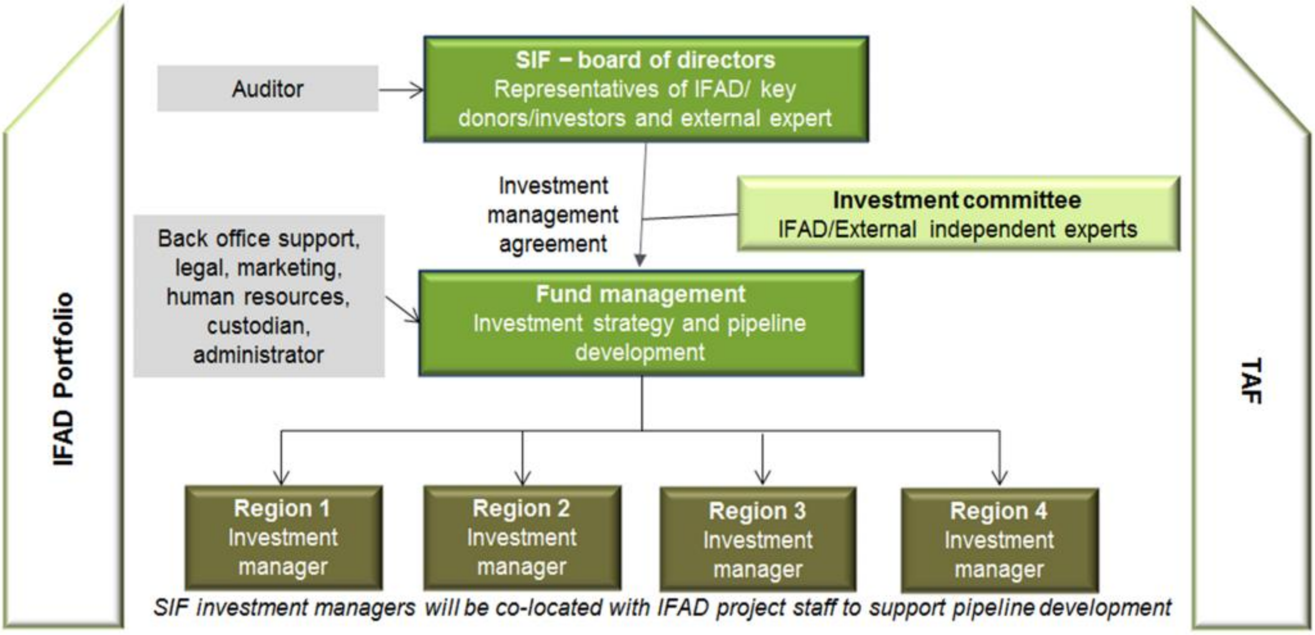
30. The board of directors will have overall responsibility for management of the business, provide leadership and ensure successful fund operation. Its functions will include standard board responsibilities for the fund's supervision and oversight, particularly in regards to safeguarding values and strategies, alignment with IFAD objectives, enforcement of policies and procedures, and ensuring that the organizational structure and capabilities are appropriate. The board will appoint the fund manager and have approval authority over any SIF governance changes, as well as any new funders.

31. Financial investment expertise will be provided through the IC, which will be composed of select individuals independent of the fund management structure in order to maintain an arm's length decision-making process and to contribute specialized knowledge and skills, particularly in areas relevant to investment activities and objectives. The IC will be composed of an IFAD representative and two to three independent members with investment experience in private-sector agriculture who will make decisions based on majority voting. The IC will convene on a monthly basis or as required, and will include non-voting participation by the managing director of the SIF Fund management team and the manager of the TAF, in addition to the SIF investment managers, who will be responsible for presenting investment opportunities to the committee. The key tasks of the IC will be investment review and approval, for which a procedure will be developed to ensure efficient decision-making.

32. The day-to-day affairs of the Fund will be administered by a lean but experienced fund management team to be identified by IFAD and its key partners for the launch of the SIF. Central to this process is the selection of a fund manager (which may be an independent investment company) to be responsible for strategy, investment decisions, portfolio management, investor relations and risk management. The fund management team will have a minimum of four members, including the managing director to implement the investment strategy, the chief operating officer and chief financial officer responsible for all operational and financial activities, and an investment manager tasked with pipeline development and monitoring.

33. The investment process will be performed in-country by investment officers with expertise in the agriculture sector, and specifically with investing debt and equity in smallholder organizations and rural SMEs. SIF investment officers will be co-located within IFAD field offices in order to better leverage IFAD project work and staff expertise as well as work with local FSPs for financial intermediation. To keep the team lean, the first few investment managers/officers may cover multiple countries.

Figure 5
Governance structure

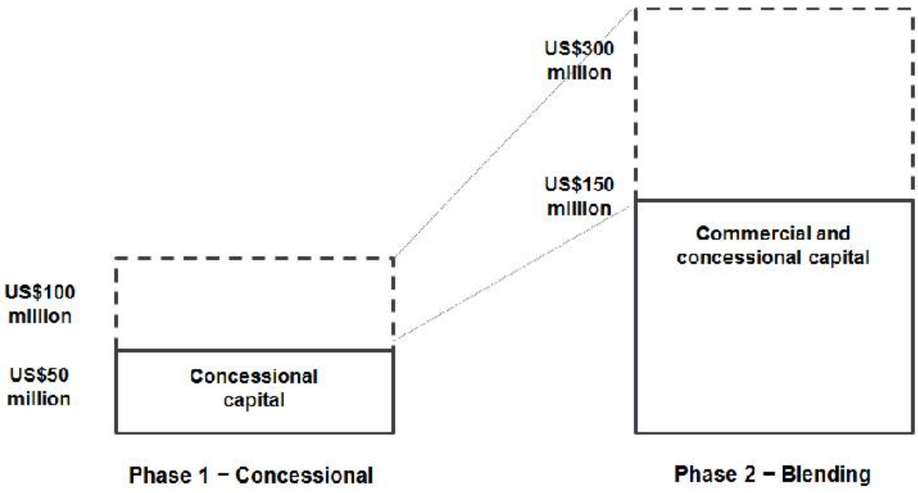


G. Financial structure

34. The SIF Fund will be launched as an investment company. In its first phase it will target between US$50 million and US$100 million in concessional funding, operating in a capital preservation mode for a lifespan of up to five years. Initially, investments will be deployed in debt and subordinated debt directly and through financial intermediaries. A guarantee facility, which could be financed by a partner agency, is being considered as well to further lower risk by absorbing losses or serving as collateral. Providers of concessional funds may choose to either transfer the money through IFAD or provide it directly to the fund.

35. The SIF will transition towards a blending facility and include commercial investors, expanding the scope and type of financial products to include equity in addition to debt and subordinated debt, both direct and through intermediation. By accessing new sources of capital beyond concessional funding the fund will have the potential to reach a size in the range of US$150 million to US$300 million over the next 10 years (see figure 6).

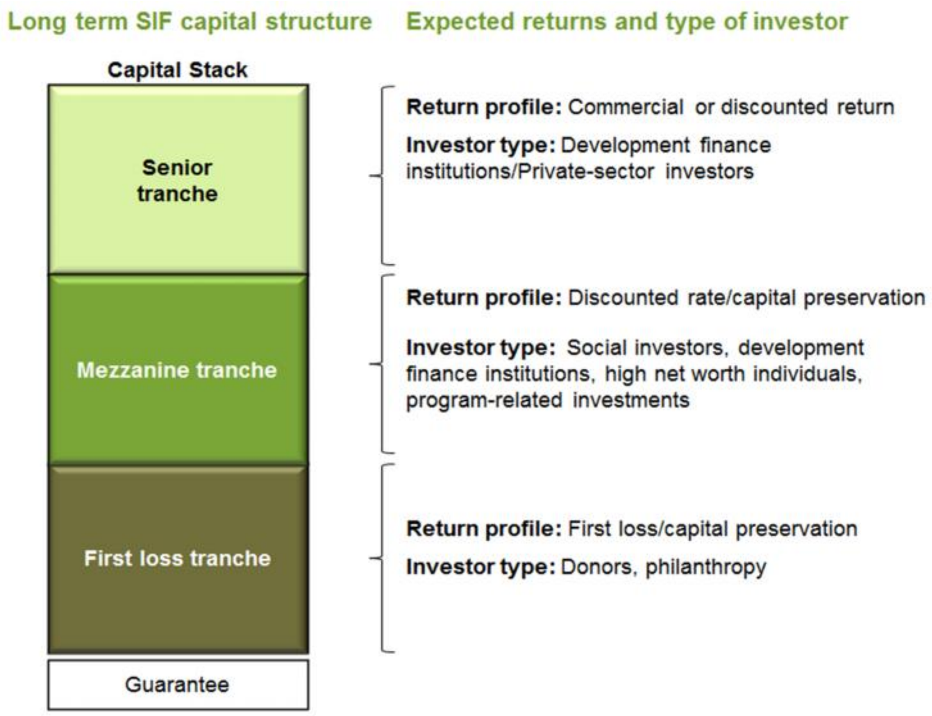
Figure 6
SIF Fund evolution



36. During the second phase of development the long-term capital structure of the SIF is expected to include blended capital from other impact-oriented investors seeking different rates of return ranging from commercial to highly concessional. Investments will be captured through three sets of capital tranches corresponding to different return profiles, including a senior (commercial or discounted returns), mezzanine (capital preservation) and first loss tranche (see figure 7).

37. During the first phase IFAD plans to provide financing from its administrative budgetary resources towards the costs of design studies, initial pipeline development, upfront set-up and running costs, for both the SIF and the TAF.

Figure 7
Capital structure



H. Monitoring and evaluation process and impact measurement

38. The SIF will aim to deliver significant impact and track results, with a special focus on creating and preserving rural youth employment and building the capacity of rural SMEs to grow sustainably.

39. The SIF aims to deliver on important SDGs such as ending poverty (SDG 1), eliminating hunger (SDG 2), offering decent work and economic growth opportunities (SDG 8) and reducing inequalities (SDG 10).

40. The M&E process will be aligned with IFAD strategic objectives and measurement methodologies, and will be conducted on three separate levels:

(a) Fund performance measurement – indicators related to the performance of the SIF Fund.

(b) Investees performance – building on the data collected during the due diligence process: financial, operational and impact related data on SIF investees.

The first step will involve the collection of core indicators on increasing poor rural populations' productive capacities and benefits from market participation. Output indicators will include:

(i) Number of SMEs/FOs reached;

(ii) Number of beneficiaries served by SMEs/FOs;

(iii) Number of rural youth/women employed;

(iv) Number of SMEs/FOs using formal financial services;

(v) Number of SMEs/FOs benefiting from TA services; and

(vi) Volume of produce marketed.

(c) Smallholder farmers – selected projects will undergo more extensive impact evaluations to assess: (i) the use of blended finance solutions; (ii) long term financial sustainability of investments; (iii) youth retention capacity of rural areas; (iv) financial performance of the financial intermediaries; and (v) impact on income of smallholder producers/youth.

41. The M&E system will require the design of a full set of investee reporting and evaluation tools to monitor financial and operational development, as well as alignment with portfolio targets. The M&E methodology may be developed and implemented in collaboration with partners. Collected data will go through a process of disaggregation by gender, head of household, SME owners or group leaders, and age bracket of beneficiary. Actual implementation of the M&E process and impact measurement activities will be supported by the TAF team.

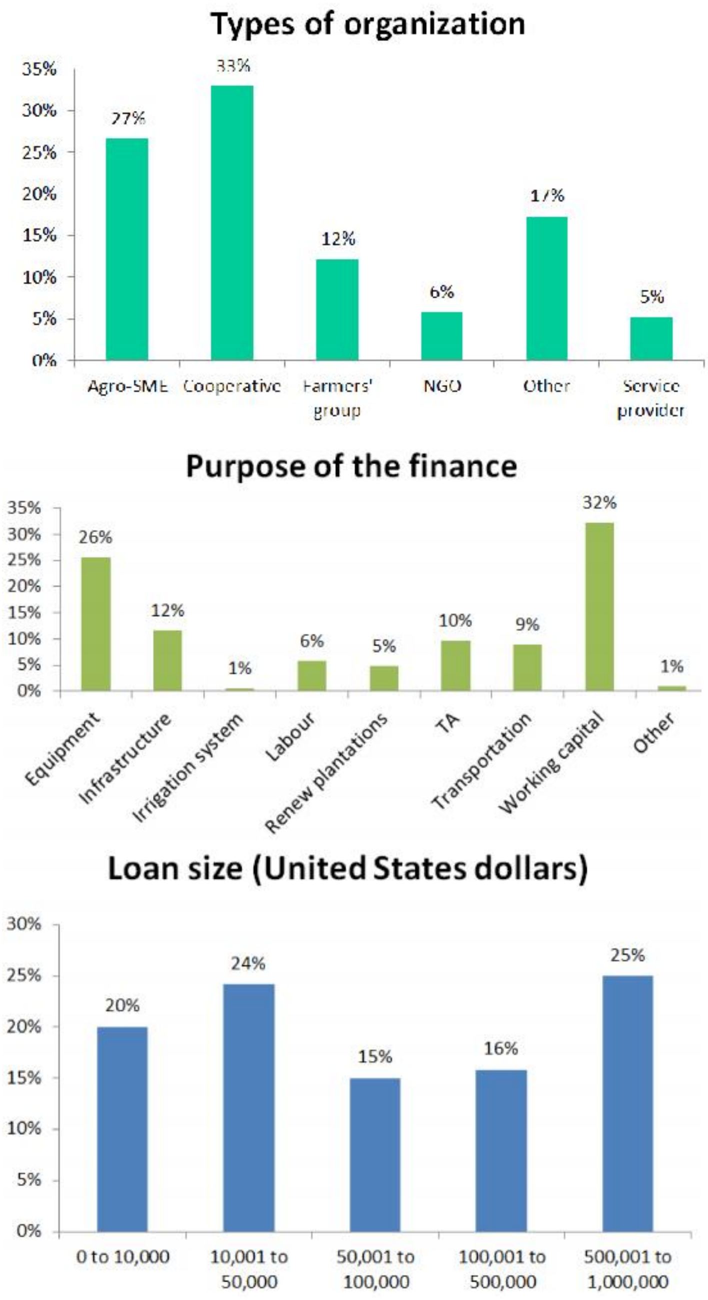
I. Pipeline development

42. The pipeline of potential SIF investment opportunities will be provided through four primary sources: (i) the IFAD portfolio (pillar 1); (ii) co-location of SIF investment managers/officers with IFAD staff in field offices, focusing on identifying prospective investees within value chains targeted by IFAD programmatic work; (iii) referrals from the TAF (pillar 3); and (iv) engagement with regional FOs.

43. A survey conducted in September 2017 by IFAD in 12 countries revealed 260 requests for investment originating from different types of entities − agro-SMEs, cooperatives and farmer groups − in line with SIF investment targets. Survey responses revealed a diverse range of requested investment amounts with a majority of respondents falling on the low and high ends of the size range. Roughly 60 per cent of respondents sought up to US$100,000 and are most likely to be reached through FSPs, while the rest would be accessible through direct financing by the SIF (US$100,000 to US$1 million and above). These results demonstrate

significant potential for generating a pipeline by leveraging IFAD's in-country portfolio (see figure 8).

Figure 8
Pipeline survey figures



J. Financial model

44. The financial model will be developed and refined in alignment with the SIF investment strategy, and based on pipeline composition. During the first phase, these parameters will determine the portfolio allocation according to product type, investment recipient and country. This will drive the expected resources and associated cost structure required to successfully prove out the SIF concept and fund structure before transitioning to the second phase. In year one a number of upfront costs will be incurred to cover initial set-up and domiciling, as well as staff

recruitment and any advisory services required. Under current assumptions, the fund is expected to reach the break-even point by year three.

K. Risk management

45. At IFAD level, safeguards are in place to avoid any possible reputational risk or perceived conflict of interest. The SIF will develop its own branding and marketing tools, distinct from those of IFAD. There will be no transmission of financial risks from the SIF portfolio to IFAD, and IFAD will not be liable for any shortfalls or losses that the SIF may incur. Reporting, accounting and controls will be separate.

46. The SIF Fund manager will identify, measure, monitor and communicate investment risks, ensuring that they are well understood while continuously evaluating investment returns to determine whether the fund is being adequately compensated for the level of risks taken on. The key investment risks are macroeconomic, market, portfolio and operational. The SIF will also address currency risk with hedging, and conflict of interest and money laundering as defined in its investment policy.

47. The fund's total active risk will be measured by the management team using appropriate risk management systems and managed to a range defined in the investment policy statement to be drafted and approved by the board of directors.

L. Design activities and time frame

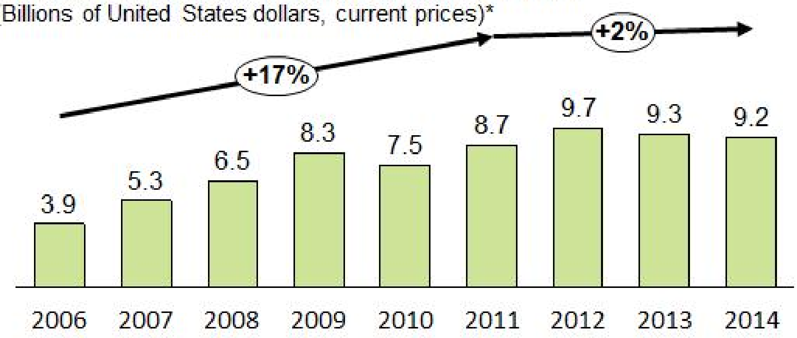
48. Going forward, IFAD will focus on key activities such as fund domiciliation, identification of board and IC members, contracting a fund manager, and pursuing pipeline development and fundraising activities. The SIF Fund will be formally launched by IFAD in the first half of 2018.

Agricultural finance landscape

Supply of agriculture funding

1. Although the world's 500 million smallholder farmers are critical to food production in developing countries, their yields are low owing to limited resources and suboptimal practices. With 70 per cent of the world's "bottom billion" employed in agriculture[2] in low-income countries, GDP growth in agriculture is 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, representing 70 per cent of worldwide water withdrawals[3] and 50 per cent of greenhouse gas emissions.[4]

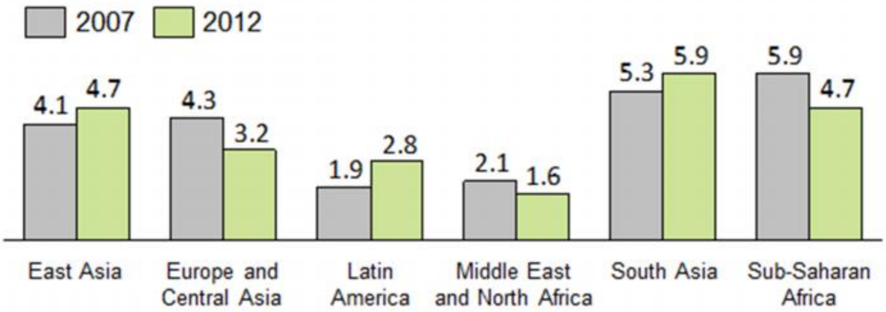
Figure 9
Official development assistance (ODA) for agriculture
(Billions of United States dollars, current prices)*



* Organisation for Economic Co-operation and Development (OECD), OECD.Stat: Net ODA, downloaded in 2016.

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 ODA to agriculture have slowed, particularly as compared to the substantial rise in response to the 2007/08 food crisis (see figure 9). Meanwhile, trends in public expenditure for agriculture are less clear owing to outdated data and regional variability. However, as of 2012 the share of public expenditure allocated to agriculture has been declining in Europe and Central Asia, the Middle East and North Africa, as well as sub-Saharan Africa (see figure 10).

Figure 10
Public expenditure on agriculture
Agriculture expenditure as a percent of total public expenditure*



* International Food Policy Research Institute, *Statistics on public expenditure for economic development* (2015).

3. As for capital invested through private equity in emerging market agribusiness, data shows a continued increase, but such investments remain a modest share of

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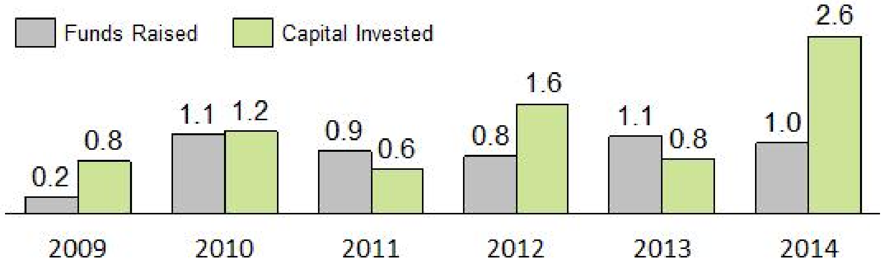
[2] IFAD, *Rural Poverty Report 2011.*
[3] Food and Agriculture Organization of the United Nations, AQUASTAT. See www.fao.org/nr/water/aquastat/main/index.stm.
[4] Grain, "How much of world's greenhouse gas emissions come from agriculture?", 20 October 2014. See www.grain.org/article/entries/5272-how-much-of-world-s-greenhouse-gas-emissions-come-from-agriculture.

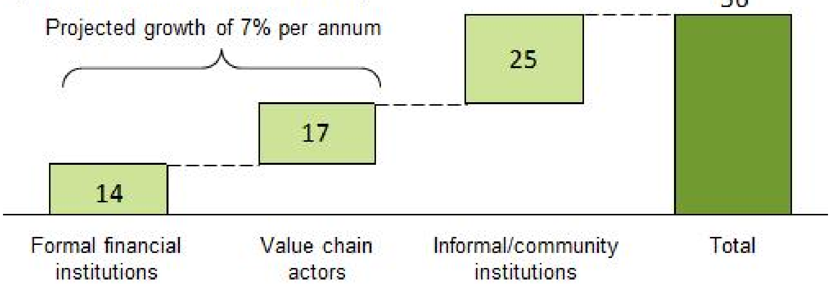
the industry (<2 per cent), mainly because investors remain wary of the unpredictability of the market and uncertainty of returns (see figure 11).

Figure 11
Agribusiness private equity fundraising and investment
(Billions of United States dollars)



* Andrew Aulisi, et al. "Private Equity and Emerging Markets Agribusiness: Building Value Through Sustainability," 2015.

Figure 12
Estimated smallholder lending
(Billions of United States dollars)*

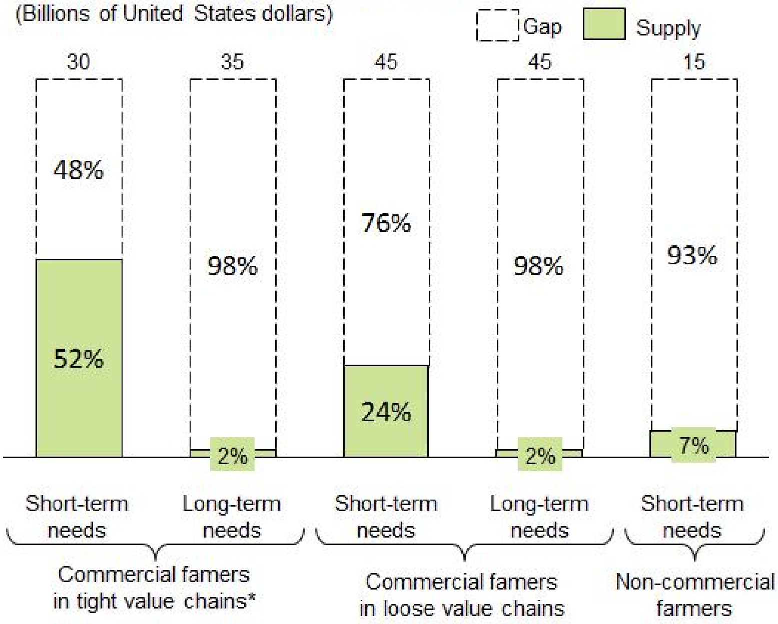


*Dalberg Global Development Advisors Initiative for Smallholder Finance, Rural and Agricultural Finance Learning Lab, "Inflection Point: Unlocking growth in the era of farmer finance," (2016).

4. At the smallholder farmer level, much of the sector has long relied on informal and community-based 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. However, recent years have seen a growing number of FSPs of diverse types entering this space and specifically targeting the smallholder finance sector with dedicated agriculture teams. These include formal financial institutions such as MFIs, commercial banks, impact investors and NGOs providing a range of financial services that in some cases combine additional facilities such as TA. They also include value chain actors, which provide agricultural working capital loans to commercial smallholder farmers as a way to reinforce and increase the reliability of product availability (see figure 12).

Resource gap in the agricultural sector

Figure 13
Gap between smallholder farmer financing need and supply
(Billions of United States dollars)



Short-term: <1 year for inputs, harvest, and export
Long-term: >1 year for equipment or tree renovation

* Smallholder segmentation is based on Consultative Group to Assist the Poor Focus Note 85, "Segmentation of Smallholder Households: Meeting the Range of Financial Needs in Agricultural Families," (2013).

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 13).[5] Despite the continued entry of new players, the combined growth of formal financial institutions and value chain actors is projected to reach no more than 7 per cent per year through 2020, which will do little to bridge the sizeable gap between the demand and supply of financing to smallholder finance. The wide gap in the provision of financial services for smallholder farmers effectively limits their ability to improve their productivity, livelihoods and value chain participation.

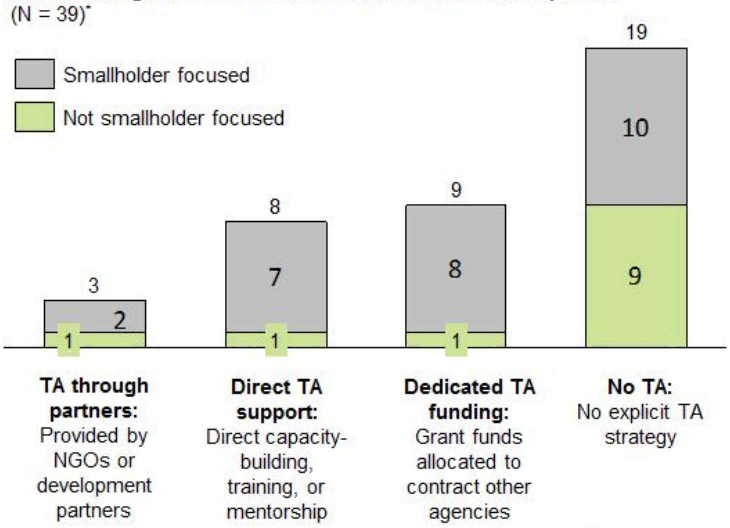
6. Agricultural SMEs face similar problems and their development is constrained by a number of factors such as limited access to credit, lack of collateral, low levels of technology and management skills, limited market access, a regulatory environment that impedes sector development and weak institutional capacity. Generating employment opportunities for rural youth and offering alternatives to migration will be contingent 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 risk.

[5] Dalberg Global Development Advisors Initiative for Smallholder Finance, Rural and Agricultural Finance Learning Lab, "Inflection Point: Unlocking growth in the era of farmer finance," (2016).

Addressing the gap

7. Increasingly, blended capital solutions have emerged to form a diverse landscape of investment funds with unique strategies, resulting from the formation of partnerships and multi-lateral initiatives bringing 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 TA facilities, yet this practice remains rare (see figure 14). The most effective alignments of TA and investment have governing structures that strategically link TA and investment while maintaining flexibility to adapt to new opportunities.

Figure 14
Number of agriculture investment funds with a TA component
(N = 39)*

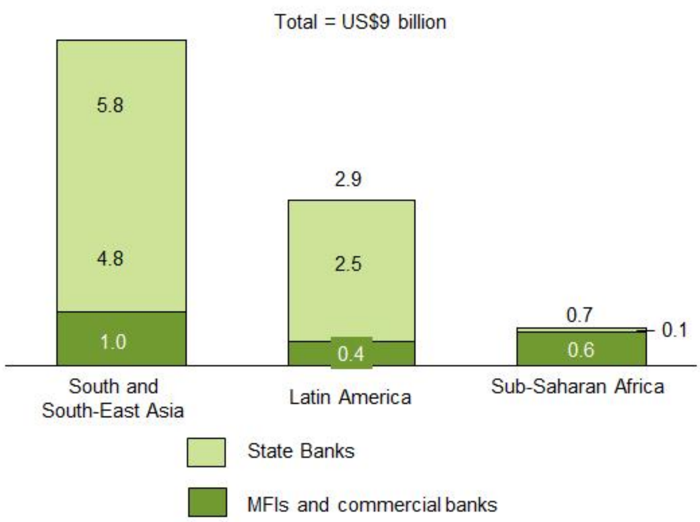


* Source: Initiative for Smallholder Finance fund database, 2016 (not exhaustive).

8. Still, smallholder finance, particularly smaller SMEs and FOs, remains a very difficult niche to address. The primary challenges in financing this segment in agriculture are high cost and low returns coupled with high risks (e.g. weather, price, production risks). Smaller loans (<US$200,000) are particularly difficult because operations and due diligence costs are relatively fixed and thus account for a higher proportion of small loans. For these reasons, blended finance solutions are particularly well suited, as they typically use low-cost capital coupled with lean operations and 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 FOs 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 15). Strategies for financial intermediation often include: (i) financial tools such as guarantees or interest rate buy-downs; (ii) aligned TA to develop products and agriculture expertise; (iii) partnerships to cultivate pipeline and deploy financing through value chain relationships; and (iv) digital solutions to reduce transaction costs and/or use alternative forms of data for credit scoring.

Figure 15
Estimated supply of smallholder lending from local banks*
(Billions of United States dollars)



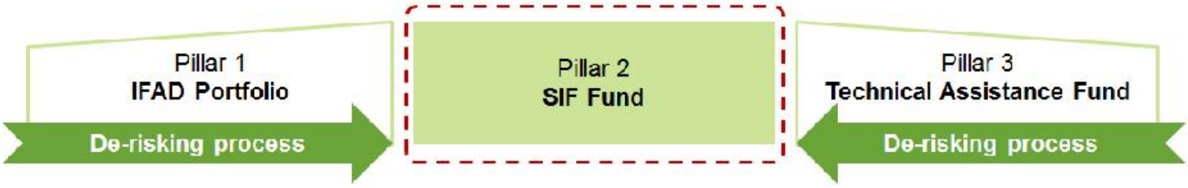
* Initiative for Smallholder Finance, "Briefing 02 – A roadmap for growth: Positioning local banks for success in smallholder finance," (2013).

Technical assistance facility (TAF) of the Smallholder and SME Investment Finance (SIF) Fund

Introduction

1. This note elaborates on pillar 3 of the SIF operating environment, the TAF. The SIF will be established in the context of an operating environment consisting of three pillars to support agricultural value chains and lower the risk of investments to encourage private-sector engagement (see figure 16).

Figure 16
SIF operating environment



(a) Pillar 1 is the existing IFAD portfolio of value chain projects that will be leveraged to identify critical gaps in financing required to expand productivity throughout a given supply chain and reduce the transaction cost of servicing the producers' organizations and rural SMEs not being reached by existing financing.

(b) Pillar 2 will be the SIF Fund itself, which will target FOs and SMEs through a mix of direct debt financing and financial intermediation. Direct debt financing will focus on investments between US$100,000 and US$1 million, while financial intermediation will be used to address a lower range of investments between US$25,000 and US$250,000 by co-investing with financial institutions.

(c) Pillar 3 corresponds to a TAF that IFAD will set up and manage to complement the SIF and provide pre- and post-investment technical support to SIF investees. The TAF will also support the SIF in its M&E process to enhance impact. The three pillars together will significantly reduce the risks of SIF investments. To simplify reading, throughout this note the term "SMEs" will also encompass cooperatives and other formal types of FOs/associations.

Rationale

2. IFAD's experience with similar funds that IFAD such as the AAF and Yield Uganda Investment Fund indicates that TA plays a key role in support of financial services and investments in SMEs. TA will lower the investment risk and improve returns and impact by: (a) preparing SMEs to receive and use the financing (pre-investment TA); (b) support the SMEs during the investment period in overcoming strategic, financial, operational, management, legal or technical obstacles (post-investment TA); and (c) monitor the performance of the SMEs and measure the development impact of the fund and associated services.

3. Therefore, IFAD will set up and manage a TAF exclusively focused on SIF investees or potential investees. The TAF will provide advisory services to SMEs, allowing them to grow and expand their opportunities for partnerships and business development. The TAF will pay particular attention to young entrepreneurs that may need help in starting up or improving the performance of their businesses. The TAF is expected to cover pre-investment business development services (BDS) that will run in parallel to SIF due diligence process, and post-investment BDS where TAF will focus on improving performance, impact and monitoring.

Objective

4. The objective of the TAF is to improve the performance of SMEs in developing countries while reducing the operational, credit and market risk around SIF investments. The TAF duration will be the same as that of the SIF.

Activities

5. The TAF activities and interventions will vary according to: (a) pre- or post-investment TA; (b) whether the investment is in the form of debt or equity; and (c) the size and capacity of the SMEs. There are also cross-cutting activities that will serve the entire portfolio. Illustrative activities of the TAF are presented below. Most TA will be in the form of short-term BDS, to be delivered over a three to four month period, up to a maximum of six months per TA project.

Table 1
Type of TA activities delivered by TAF

Pre-investment TA	*Post-investment TA*
Debt and subordinated debt	**Debt and subordinated debt**
• Building a pipeline of investment-ready SMEs • Preparing selected SMEs for possible SIF loans • Short-term BDS for: business strategy development; marketing studies and strategy; portfolio management; business planning and operations; strengthening market linkages; company governance systems; financial management, reporting, accounting and auditing; human resources management and training; information systems upgrading; product development; pricing; trade negotiations; tax compliance; strategy to improve efficiency or reduce costs; contract preparation and management; legal issues; quality, certification and safety standards; risk management; improving inclusivity of disadvantaged groups; etc.	• Short-term BDS (similar to pre-investment TA) and implementation of pre-investment recommendations Note: Group training could be envisaged for clusters of smaller SMEs (i.e. microenterprises).
Equity	**Equity**
• Building a pipeline of investment-ready SMEs (larger SMEs) (equity will mostly target bigger and higher-end SMEs that should not need pre-investment TA)	• Same BDS as for debt
Cross-cutting activities	
• Participate in SIF pipeline development by identifying SMEs with strong potential for investment, including young entrepreneurs requiring particular support • Developing tools to scope and identify TA needs of SMEs • Monitoring and evaluating SME performance and TAF impact • Lessons learned and knowledge management • Communication and reporting to donors and investors	

Budget

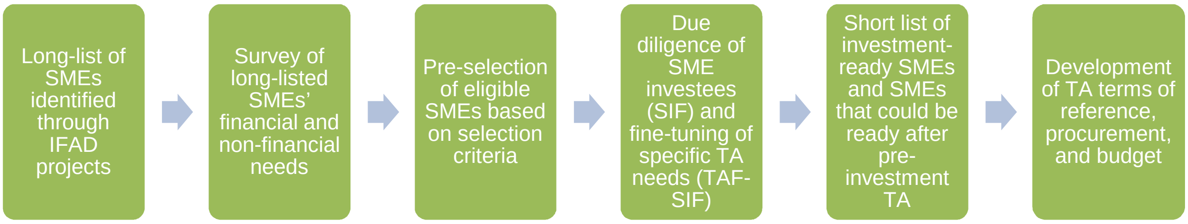
6. Total TAF resources will be 15 per cent to 20 per cent of the SIF Fund, which is the average in similar funds. Of this, 80 per cent will be used to fund the TA projects and conduct the cross-cutting activities such as M&E, and 20 per cent will cover the TA management and administrative costs.

TAF operational model and delivery

(a) Developing the TAF pipeline

7. In each country where the SIF will operate, the SIF investment officers, armed with information from the IFAD portfolio, will scope and identify a long list of potential SMEs that could receive SIF investments. A preliminary survey of the long list of SMEs will identify the needs of the SMEs in terms of SIF funding and TAF needs. Based on eligibility and selection criteria developed by the SIF Fund manager and the TAF manager and fully integrated into the SIF investment process, eligible SMEs may be pre-selected at different stages of the process for further due diligence and a refinement of TA needs, including whether the SME will need pre- or post-investment TA, or both. The TAF manager can also independently conduct his/her own scoping exercise to identify eligible SMEs for further due diligence and TA support. Particular attention will be given by TAF to help incubate young entrepreneurs and their start-ups. Figure 17 below summarizes the steps in the selection of SMEs and development of TA services.

Figure 17
Steps in SME selection for delivery of TA services



(b) TAF eligibility and selection criteria

8. The eligibility and selection criteria for SMEs will be aligned with the SIF's, but specific to the purposes of TA, the following criteria will apply.

- SME is formally registered
- SME is linked to an IFAD value chain project, directly or indirectly
- SME size is as defined by the SIF
- SME is financially viable and displays high potential for growth and impact, which is likely to be realized through SIF investment
- Number of rural poor people supplying or receiving services from the SME
- Number of women served or benefiting from the SME
- Number of jobs that the SME could create, in particular for rural youth

(c) Identifying TA needs

9. In each country, once the list of eligible SMEs is narrowed down, the TAF will fine-tune the TA needs of each potential investee company, develop a TA plan for the eligible companies, and draw up an agreement with the investee SME on the TA services to be delivered. On this basis the TAF will prepare terms of reference, a procurement procedure for the TA service providers, and a budget for the TA to be delivered, either pre-investment, post-investment or both. In preparing the terms of reference and other details, the TAF manager will consult with the SIF staff and the SME investees themselves.

(d) Business development service providers

10. At the establishment of the TAF, the TAF manager will create a database of potential BDS providers categorized by region/country, thematic speciality, specific competencies, and commodity/sector focus if any. The database will be constructed

based on prior knowledge and a call for expression of interest to BDS providers to work with TAF at country level. Selection criteria for the BDS providers will be developed by the TAF to include the best qualified providers in the database.

(e) Procurement

11. Procurement of BDS providers will be (a) sole-sourced for contracts less than US$50,000 and (b) competitively recruited for contracts higher than US$50,000 based on a limited call for proposals. Sole-sourcing of BDS providers for contracts higher than US$50,000 can be justified under specific circumstances to be spelled out in the operational manual and approved by the TAF evaluation committee (see below). BDS costs average 10 per cent of the individual SIF investment.

(f) Match funding

12. Depending on the TA to be delivered, match funding may be requested from the recipient SME. The amount, type, criteria and disbursement modality for match funding will be specified in the TAF operational manual following consultations with all stakeholders. For equity investees, this is usually a requirement.

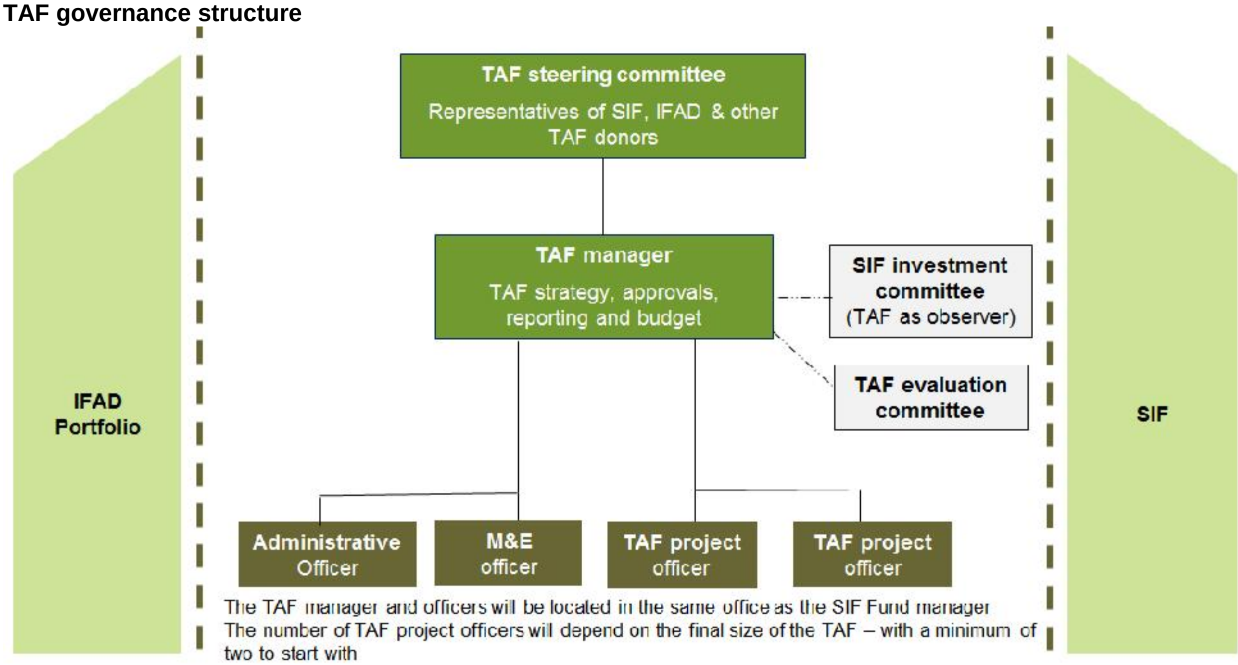
Management and governance

13. The TAF will have a senior manager, two TAF project officers, a M&E officer and an administrative officer. The manager will be responsible for managing the TAF staff, budget, major decision-making, results and reporting. He/she will also chair the TAF evaluation committee and represent the TAF at major meetings with other stakeholders (SIF, IFAD, donors, TAF steering committee, etc.), including the SIF IC, which he/she will attend as an observer. The two TAF project officers will develop, design, monitor, supervise and report on the individual TAF cases. Additional TAF project officers can be recruited depending on the final size of the TAF. The administrative officer will be responsible for TAF financial reporting, procurement and contracting of service providers, and disbursement of TA funds. The M&E officer will be responsible for M&E, impact measurement and reporting (see below on reporting and measuring results and impact).

14. A TAF steering committee will be established to provide strategic guidance to the TAF, and to approve the TAF project pipeline and annual workplan and budget. The steering committee will meet two or three times a year, and will be composed of representatives of IFAD, SIF Fund, TAF (which will act as secretary to the steering committee), and representatives of the TAF donors.

15. For TA projects above US$50,000 the TA projects are to be approved by a TAF evaluation committee. The TAF evaluation committee will review the TAF proposals submitted by BDS providers and will approve or decline the TAF projects following the TAF selection criteria and operational manual guidelines. It will be composed of one representative each from the SIF IC, TAF and the related SME investee. Independent evaluators can also be called upon under special cases where a particular expertise is needed. For TA projects below US$50,000, the TAF manager will be responsible for the approval process.

Figure 18
TAF governance structure



Reporting and measuring results and impact

16. One of the major functions of the TAF will be to monitor and report on the results and impact of the SIF and TAF. The SIF will include a robust M&E process that will monitor financial, operational and impact development data aligned with IFAD core indicators and measurement standards, as well as addressing a number of SDGs. The TAF will develop key output and impact indicators and a M&E results plan at the beginning of the establishment of the TAF in collaboration with the SIF. The indicators will cover performance of the SMEs before and after the SIF and TAF investments (margins, returns, profits/number of SME jobs generated, particularly for rural youth), number of rural poor people providing or receiving services from the SMEs, and number of women served by or benefiting from the SMEs.