AGRICULTURAL VALUE CHAIN FINANCE STRATEGY AND DESIGN

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TECHNICAL NOTE

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Forward

The technical paper written by Calvin Miller is to provide practical suggestions and policy guidelines to managers and project design teams to help in the design and implementation of projects. It is also useful for field staff, financial service providers (FSPs), government ministry employees, non-government development organizations (NGOs) and development agencies. It forms part of a larger set of works on the topic of Agricultural Value Chain Finance. Other materials on the topic can be found at the Rural Finance Learning Center website (http://www.ruralfinance.org/) and in Calvin Miller and Linda Jones’ book, Agricultural Value Chain Finance, published by Practical Action Publishing.¹ The document also fits within a series of Technical Notes on the subject of Agriculture and Rural Finance produced by the International Fund for Agricultural Development (IFAD).² The author would like to thank the participants from the Aga Khan Agency for Microfinance (AKAM), FAO, Gesellschaft für Internationale Zusammenarbeit (GIZ), IFAD, NEDWORC Association, United Nations Capital Development Fund (UNCDF) and the World Bank for their contribution in discussing the technical note and strengthening the recommendations being proposed.

¹ Additional information may be found at http://practicalaction.org/agricultural-value-chain-finance
² Additional information may be found at http://www.ifad.org/
1. Introduction

Value chain finance for agriculture has become a topic of interest for development agencies, and is an approach that is being increasingly applied by financial institutions and by those involved in value chains. Value chain finance can contribute to meeting the growing need for agricultural finance and investment in response to greater consumer demands for more processed or value added products. From a development perspective, governments and support agencies must ensure that the financial systems in their countries are able to meet these demands arising from the growth of modern agro-food value chains. *Agricultural value chain finance (AVCF)* is an approach to finance that is able to help address these issues.

The aim of this technical note is to help those involved in development agencies to understand:

- The transformation of agriculture and modern value chains how this knowledge can be used to benefit the processes of financial access and delivery;
- How to develop value chain financial services in a way that they benefit all kinds of farmers and agribusiness firms within value chains and the country as a whole; and
- The best way to develop a Programme implementation strategy that will strengthen priority value chains through interventions which address capacity needs, financing, policy and support infrastructure.

Hence, this technical note can serve as a guide in the design of appropriate program interventions which apply AVCF approaches in the development of competitive agricultural value chain. An emphasis is given to interventions which promote financial inclusiveness, and the overall development goals of governments, as well as technical and funding agencies.

Although the content of this Technical Note addresses agricultural value chain finance, it must be emphasized that financing and its application are dependent upon the nature and context of a value chain and those involved in it. For UN and large-scale development projects, the interventions must often simultaneously contemplate multiple value chains while allowing the flexibility for accommodating the specific requirements of each value chain and context.
2. Understanding Agricultural Value Chain Finance and its potential

2.1 ROLE OF AVCF IN DEVELOPMENT FINANCE

Understanding value chain finance can improve the overall effectiveness of those providing and requiring agricultural financing. Value chain finance offers an opportunity to expand the financing for agriculture, improve efficiency and repayments in financing, and strengthen or solidify linkages among participants in the chain. It can improve the quality and efficiency of financing agricultural chains by: a) identifying financing needs for strengthening the chain; b) tailoring financial products to fit the needs of the participants in the chain; c) reducing financial transaction costs through direct discount repayments and delivery of financial services; and d) using value chain linkages and knowledge of the chain to mitigate risks of the chain and its partners.

It is important to note that agricultural value chain financing is not a development goal; rather it is a means to achieve other social and economic goals. AVCF is a financial approach and a set of financial instruments that can be applied. It is an important component of value chains and their development and can facilitate increased financial access, and reduced costs and risks of financing agriculture.

2.2 DEFINING VALUE CHAIN FINANCE

The flows of funds to and among the various links within a value chain comprise what is known as value chain finance. Stated another way, it is any or all of the financial services, products and support services flowing to and/or through a value chain to address the needs and constraints of those involved in that chain, be it a need for finance, a need to secure sales, procure products, reduce risk and/or improve efficiency within the chain. It refers to both internal and external forms of finance:

1. Internal Value Chain Finance is that which takes place within the value chain such as when an input supplier provides credit to a farmer, or when a lead firm advances funds to a market intermediary.
2. External Value Chain Finance is that which is made possible by value chain relationships and mechanisms: for example, a bank issues a loan to farmers based on a contract with a trusted buyer or a warehouse receipt from a recognized storage facility.

This definition of value chain finance does not include conventional agricultural financing from financial institutions, such as banks and credit unions, to actors in a chain unless there is a direct correlation to the value chain as noted above.

- **Value Chain** – the set of actors (private, public, and including service providers) and the sequence of value-adding activities involved in bringing a product from production to the final consumer. In agriculture they can be thought of as a “farm to fork” set of inputs, processes and flows. (Miller and da Silva, 2007)
- **Value Chain Analysis** – assessment of the actors and factors influencing the performance of an industry, and relationships among participants to identify the main constraints to increased efficiency, productivity and competitiveness of an industry and how these constraints can be overcome. (Fries, 2007)
- **Value Chain Finance** – financial services and products flowing to and/or through value chain participants to address and alleviate driving constraints to growth. (Fries, 2007)
2.3 BUSINESS MODELS

The strategy for development or strengthening of value chains depends upon the business model. The term business model in value chains refers to the way it adds value within a market network of producers, suppliers and consumers. The business model encompasses the drivers, processes and resources for the entire value chain system, even if the system is comprised of multiple enterprises. The business model concept is linked to business strategy (the process of business model design) and business operations. If value chain finance is to be successful, the value chain must be viewed as a single structure, with the model of this structure providing a framework for further analysis.

A value chain is not an entire sector or subsector. It involves a specific group of interrelated producers and other actors who supply a particular end market.

The relationship between buyers and sellers can be described through various types of linkages along a continuum: (i) the instant or spot market, where producers come to sell their commodities, and prices fluctuate; this is the most risky in terms of setting market price; (ii) a contract to produce and buy, known more generally as contract farming; (iii) a long-term often informal relationship characterized by trust or interdependency; (iv) a capital investment by one of the buyers for the benefit of the producer, characterized by high levels of producer credibility and dependence; and (v) a company that has achieved full vertical integration. Hence, moving from an uncontrolled buyer-seller relationship model towards a more integrated one, improves the prospects for financing both within and into the chain.

Because smallholder production is important for both economic and social considerations, special emphasis must be given to models which allow them to fully participate in value chains. The following table adapted from Vorley (2008), illustrates the typical organization of smallholder production and marketing – that is, the relation of farmers to the market and/or the larger system. This analysis offers a basis for value chain business models, and the accompanying finance, which is expanded upon in the following sections.

Table 2.1 Typical organizational models of smallholder production

<table>
<thead>
<tr>
<th>Model</th>
<th>Driver of Organization</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Producer-driven (Association)</td>
<td>• Small-scale producers, especially when formed into groups such as associations or cooperatives  • Large-scale farmers</td>
<td>• Access new markets   • Obtain higher market price  • Stabilize and secure market position</td>
</tr>
<tr>
<td>Buyer-driven</td>
<td>• Processors  • Exporters  • Retailers  • Traders, wholesalers and other traditional market actors</td>
<td>• Assure supply   • Increase supply volumes  • Supply more discerning customers – meeting market niches and interests</td>
</tr>
<tr>
<td>Facilitator-driven</td>
<td>• NGOs and other support agencies  • National and local governments</td>
<td>• ‘Make markets work for the poor’  • Regional and local development</td>
</tr>
<tr>
<td>Integrated</td>
<td>• Lead firms</td>
<td>• New and higher value markets</td>
</tr>
</tbody>
</table>
Producer-driven business models are driven from the bottom end of the chain. They can be successful but face two major difficulties. First, producers may not understand the market needs as well as those in the chain who are closer to the consumer. Secondly, producers often struggle for financing unless they can find strong partners and/or can get assistance for financing.

Buyer-driven models form the foundation for many of the applications of value chain financing. It is often in the buyer’s interest to procure a flow of products and use finance as a way of facilitating and/or committing producers, processors and others in the chain to sell to them under specified conditions. Most often, when financing is involved, the conditions are binding through contracts and therefore contract farming is the most common buyer-driven value chain model.

Facilitator-driven models exist in many countries where there is almost a dual agricultural system in which a developed agro-industry coexists alongside marginalized producers who are living at subsistence levels. The costs of organizing and training small producers can be deemed too high to be taken on by a large company. As a result, intermediation by development organizations, both non-government organizations (NGOs) and government agencies, facilitates opportunities for smallholder integration into commercial value chains, and financing has become a commonplace feature of such facilitation. With a goal of long term sustainability, facilitation is ideally time bound incorporating a clear exit strategy. Successful facilitation approaches to value chain development have been proven around the world. As illustrated below, with proper organization and training, incomes can be improved.

Finally, an integrated value chain model, not only connects producers to others in the chain – input suppliers, intermediaries, processors, retailers and service providers including finance – but it integrates many of these through ownership and/or formal contractual relationships. The integrated model has many of the features of the other models presented such as strong linkages with multi-party arrangements, technical guidance and strict compliance, and also incorporates an amalgamated structure of value chain flows and services.

2.4 FINANCIAL INSTRUMENTS USED IN AVCF

First and foremost, AVCF is an approach to financing. It uses an understanding of production, value added and marketing processes to determine financial needs and how best to provide financing to those involved. Many diverse and innovative financial instruments may be applied or adapted to fit the specific financial needs, and the commodities and cash flow projections can be used as to secure financing and reduce risk.

The various financial instruments which are often used in AVCF can be classified according to five categories shown below. These categories group 16 AVCF financial instruments according to the nature of the instruments. These financial instruments are described in Annex 5.1 and a synthesis of the benefits, limitations and application potential as shown in Annex 5.2.
The above-mentioned instruments can be used in isolation but the use of multiple instruments within a value chain is more common. Most of these instruments are used in many types of finance; hence they are not exclusive to AVCF. Even so, while such instruments as factoring may be common within commerce or manufacturing, their application to agricultural financing is often new and unknown. It is also important to note that the fact that one uses one or more of these financial instruments does not make it VCF; rather VCF is an approach which applies instruments as appropriate to the VC, whereby the simple use of some of these financial instruments is not defined as VCF.

The Illustrated descriptions of the 16 AVCF instruments shown in Annex 5.1 are useful for understanding the concepts, but for development programmes, it is important to understand their applications and implications. In Annex 5.2, it is noted that each instrument has specific uses and target groups who benefit most from their application in agricultural value chains. Each has its pros and cons.

Governments and donor agencies do not need to be fully versed in the VCF instruments. Yet, it is important for them to address two key aspects of their use: a) to understand the benefits and risks of the differing financial instruments on the various participants within the value chain, and b) to ensure that there is adequate regulation in place to permit and govern their application.

2.5 INNOVATIONS

Innovation has been an essential element in the growing application of AVCF. Process innovation has helped develop business models, improved contract farming systems, commodity exchange linkages, and so on. Financial innovations involve the growing use of triangular supplier-buyer-producer-bank financial arrangements to reduce cost and risk. Technological innovations -- including information and communication technologies (ITC) such as mobile banking, mobile technical support, electronic networks, etc., and improved management information systems (MIS) systems to accommodate “tailored” financial services -- have made AVCF much more feasible. Policy innovations, which have reoriented extension services toward prioritizing and strengthening value chains and investing in supportive infrastructure, are also important.
Support to Innovation is an important role for donor and technical agencies. This should not focus undue attention on the latest technological ideas but rather on all types of innovations that reduce costs and risks, and improve services.
3. Strategy and Design Recommendations of AVC and AVCF Programmes

Programme and project designers for development institutions face many challenges, having to juggle the multiple development priorities and concerns of governments, donors and beneficiaries with issues of sustainability, income and employment generation, and profit. How can the Programmes they design facilitate the desired effects? The following recommendations aim to provide practical principles and guidance in response to this question.

3.1 RECOMMENDATIONS FOR IMPLEMENTATION OF AVCF

*Have clear development goals.* Development goals of a government and/or development agency must be clear before decisions can be made regarding target group, region or sector, and value chain specific considerations.

*Use a development approach.* Seek to maximize returns to the overall society, and to the target groups and regions prioritized. Thus, governance, power relationships, and control and sustainability are highly valued as is the overall reach of benefits.

*Support initiatives with a strong business case.* Industry competitiveness is essential for sustainable interventions. Within the sector and sub-sector, one must then find the appropriate and competitive value chains and niches which are most competitive. Avoid interventions where the prospect for long term sustainability cannot be demonstrated.

*Acquire knowledge on the value chain.* Design of effective interventions requires an appreciation of the structure and the dynamics of the target value chain. Ensure that *value chain analysis* is conducted and that the study involves an *analysis of the value added potential* in the chain. This will reveal whether benefits can accrue to primary producers by organising the chain more efficiently and whether the cost of chain organization and financial services can be recovered from product margins.

*Before considering financial interventions, consider non-financial alternatives.* Direct support by donors to the finance requirements of (commercial) chain actors should only be considered when no alternatives exist. Possible alternatives;

- Brokerage of contacts with MFIs and other financial institutions
- Workshops bringing together stakeholders to see whether solutions can be found within ordinary business relationships (e.g. supplier finance)
- Technical assistance to producer organisations or lead actors in the chain, allowing them to meet the requirements of viable and sustainable chain operations (including related financial services).
- Facilitate linkages with exporters (or importers in Europe), offering financiers the comfort of well-established market outlets, and providing sufficient value added potential at the local level.
Avoid crowding out the private sector and other ongoing initiatives with grants. A donor should be very careful with grant funded interventions in a financial market so as to avoid the risk of market distortion. Donors should only finance gaps and do so only as a temporary, start-up measure. Grant funding should be avoided where debt financing for the same purpose is already practiced. Subsidies should be limited to parties and situations where market actors (including local MFIs and other FSPs) are not yet active and where prospects for sustainable long term VCF seem to be promising.

Create conditions for synergy between grant and debt finance. The investments of donor grants in smallholder programmes come to fruition when producer groups are ready for sustained debt finance by (local) financial institutions. In order to ensure that donor investments (generally through development NGOs) are made in promising value chains and subsectors and with partners on with whom financial service providers recognise as credit worthy, at least in the near future, it is vital that the financiers are consulted at a very early stage of the chain development process. Efforts should be made to involve them in the VC and VCF development strategy. Local financial delivery is the best route towards continuity. The graduation process towards local financing also offers an exit route for donors of grant Programmes, and is their best guarantee for substantial social and economic returns.

Use AVCF to build or strengthen credit worthiness. AVCF, with its linkages and relationships among value chain participants, can contribute to credit worthiness and therefore support the development goals of financial access and inclusiveness. It may start with embedded finance and develop a track record of responsibility and competitiveness to open more opportunities for external financing.

Financing of farmers by a processing firm (embedded finance) may be a very good solution in a situation where no external finance is available although over time financing may be better separated and left to specialized financial institutions. Hence, it is important to recognize the benefits and the limits of embedded finance as well as the potential evolution of such arrangements over time.

3.2 RECOMMENDATIONS FOR VALUE CHAIN FINANCE STRATEGY AND BUSINESS MODELS

Agricultural Value Chain Finance strategies and models must be flexible. AVCF is a comprehensive and holistic approach; it is not simply a single instrument or a defined “recipe” to follow. It involves systemic analysis of an entire value chain and the relationship amongst its actors. The actual tools and applications are dependent upon the particular VC and business model and are preliminarily identified during the VC assessment. These change when conditions change and must be able to be revised according to the interests and capacity of the partners selected and during the course of implementation of the Programme.

Promote promising VCF strategy and business model development. No strategy or model can be singled out as ‘the best’ solution, as this depends critically upon the circumstances and maturity of the value chain concerned. Development agencies can play a constructive role in discussing with their partners the merits and disadvantages of one strategy and model versus another. Ultimately there should be agreement on the trajectory to be followed, preferably laid down in a strategy plan or business plan.
Support “value chain actor driven” design. The purposeful creation of a successful value chain is an act of entrepreneurship. While a donor/financier can play a supporting role, the detailed design of the value chain strategy is more robust when coming from a leading chain actor. For design and assessment of interventions, it is critical to understand where the initiative originates. In a producer-driven initiative, the major challenge is to turn ad hoc marketing or a supply chain into a value chain (i.e. to adjust supply to demand in a new market). In a “buyer-driven” model the challenge is to identify competitive production areas and to make products conform to its needs. Sometimes a facilitator (NGO, government, technical agency) link producers and buyers in a chain. Whatever the entry point, a vital characteristic of a promising VC approach is that a leading chain actor is prepared to invest time and resources in the relations with suppliers (primary producers) and buyers higher up in the chain. Sharing of information and building of trust are good indicators of mutual interest; without this, VCF should not be contemplated. Value chain actors possess easier access to information about other value chain participants, particularly with regards to the willingness and ability of potential clients to honour contracts. These factors contribute to the improved operation of value chains when driven by an actor who understands and is part of the chain.

3.3 RECOMMENDATIONS FOR PARTNER SELECTION AND FACILITATION

Select promising partners from a value chain development point of view. As long as a producer organisation maintains a supply-driven approach, a value chain strategy may be difficult to pursue as this requires adjustment of production to the requirements of new markets. It requires some entrepreneurial spirit to venture into new products or crops. Therefore, the success of a VCF strategy crucially depends upon the selection of the right partners. Rather than waiting for partners to apply for funding, a more pro-active approach may be needed to scout for partners and promising sub-sectors. This may require scouting and reconnaissance studies by the donor, prior to partner selection.

Identify an effective lead partner in value chain finance. An active player in the chain, like a farmer marketing organisation or a processing company, can take the lead in streamlining the value chain, thus providing a degree of ‘chain governance’. Such a party can also play a role by providing embedded finance to suppliers, and/or to establish a working relationship with a FSP for financing of producers and input suppliers.

Finance efficiently. Cost and risk reduction can be achieved by financing through the strongest chain actor or actors. By financing the stronger, less risky agribusinesses, most often those near the end of the chain, the financial costs associated with risk protection are reduced. Donor agencies and governments are recommended to not demand direct financing of smallholders if there are more efficient and effective ways to do so.

Safeguard both the connection and the distinction between financial services and value chain development. Financial service providers, whether they are MFIs, credit cooperatives or banks, rarely conduct value chain finance on their own. At the bottom of the pyramid, VC interventions are often required to link primary producers (farmers) to high value markets. Invariably it involves the transformation of a local supply chain into a value chain that meets the requirements of these new markets. While the development and finance aspects are closely linked, it is prudent to clearly separate the two. Both fields of intervention differ in nature, with VCD focussing on the creation of appropriate marketing channels and linkages, and VCF focussing on financial service provision in a sustainable manner.
Use a step-wise approach. Even when VCF may involve upon some grant finance in the inception phase, it has to move towards a sustainable form of local debt financing. After initial “seed capital”, if and only if needed in a start-up phase to fund VC development activities, ongoing services to chain actors will have to be paid out of value added revenues within the chain in order to reach sustainability. This can use benchmarks from the beginning with definitive steps for moving away from donor support.

Work towards clear separation of roles. Value chain development depends upon a range of value chain actors, facilitators and financial service providers as well as other support providers. These roles should be clearly defined, especially in emerging value chains where their functions are not yet institutionally separated. If the finance function is performed by a chain actor, like a farmer marketing cooperative, their separation in terms of institutional capacity, governance and accounting (cost centres) should be given attention. Another reason for a clear demarcation of tasks is the need to build capacities without threatening the viability of the actors concerned. An MFI or bank cannot be expected to take over responsibility for capacity building and chain organisation, even though these interventions are vital for risk mitigation. These functions are better performed by a chain facilitator with a designated budget and intervention Programme. A donor or financier can play a guiding role in this respect.

Facilitate linkages between local financial institutions and leaders in value chains. Development agencies that are probing for ideas to facilitate value chain finance can facilitate negotiations between leading chain actors and financial institutions, and provide both with training and technical assistance. Financial institutions that are not yet active in AVCF need assistance in understanding value chains and how to manage risks associated with lending to the agricultural sector.

Involve the financiers in risk mitigating measures. There are many ways in which banks or MFIs can be involved in risk mitigating measures. In general, a strong confidence building measure for financing occurs when all trade transactions pass through the financial institution concerned, thus providing real time information on chain performance. Examples are shown below.

Table 2. Risks for Financing Organizations

<table>
<thead>
<tr>
<th>Type of Risk</th>
<th>Risk Mitigation Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production risks</td>
<td>By using a comprehensive chain approach, the financing institution is better informed about the capacity of the chain partners and linkages, including producers’ capacity to ensure supply in adequate quantity and quality. The financing agency can also finance and manage financial transactions for different actors in the chain (e.g. input suppliers, storage facilities, trade) and appropriate insurance.</td>
</tr>
<tr>
<td>Supply risks</td>
<td>Strong producer organisations (farmer cooperatives) and/or group solidarity systems (mutual guarantees based upon savings) provide some assurance that contracts will be honoured and risks of ‘side-selling’ will be minimised. Reliable supply allows for collateralisation through warehouse receipts in which the FSP becomes a party.</td>
</tr>
<tr>
<td>Finance risks</td>
<td>Non repayment of credit to chain actors can be greatly reduced by incorporating a lead actor that is considered trustworthy. Such arrangements are strengthened when a</td>
</tr>
</tbody>
</table>
by the FSP or by the chain agent acting as retail-finance provider for farmers/other actors or by both.

**Marketing risks** relate to the inability to sell on time, in the right quantities, and/or at an acceptable quality standard. Fixed contracts throughout the chain help to stabilise turnover, especially when dependence upon one market can be avoided. Also, product standards and certification can reduce risks.

**Price risks** arise from fluctuations in market prices in the period between, for example, the time a farm contract is signed and the delivery date. These risks are born by producers/farmers or by the buying chain actor, depending upon the type of contract used.

leading actor (co-signatory) is able to absorb risks (equity capital, member savings) and when contingency arrangements are ready for unavoidable risks (such as crop failure). If finance is provided in a tripartite arrangement, not only is the efficiency of credit delivery improved, but also the risk of non-performing loans minimised.

Sales or export agreements are a strong asset in negotiations with financiers. Especially when they are also financing other agribusinesses within the value chain, confidence in the chain is enhanced. In niche markets, such as fair trade channels, the buyer relationship can significantly reduce marketing risks, even for small producer groups.

Through direct linkages to ultimate consumer markets fair and relatively stable prices can be promoted. Information technology is used to reduce these risks to the minimum. Transparency of contractual arrangements is needed for assessment of the risks by the FSP. Forward contracting and futures are examples of more advanced price stabilizing mechanisms in VCF.

### 3.4 RECOMMENDATIONS FOR CAPACITY DEVELOPMENT AND FACILITATION SUPPORT PLAN

**Build capacity of small producers and other weak chain partners to support growth towards maturity in the value chain.** It may also involve building the understanding and capacity of stronger partners to be able to incorporate them as chain participants. In the evolution of a value chain involving small farmers, two important steps can be distinguished: first, the effective linkage of farmers to more attractive markets which requires their ability to produce to exact product specifications required (inclusion barrier); second, is the transition towards sustainable local finance delivery (access barrier). A donor can play an important role in facilitating the graduation towards sustainable value chain finance, by giving support for the array of interventions needed to develop the chain. The success of graduation in value chain finance is measured by the degree in which it is taken care of by local MFIs and formal financial institutions. The development of credit worthiness of chain operators for debt financing is a vital step in this process. Donors and financiers should both support such medium range perspective.

**Base interventions on a solid assessment of the needs for capacity building.** For each of the financing opportunities in a value chain, corresponding capacity building needs may be identified. Especially in emerging value chains, it is likely that many intervention areas need to be addressed. While financial service providers will not take prime responsibility for these interventions, their involvement is crucial to arrive at a joint strategy. Moreover they also need to build up their own capacity to deal with these issues, to develop appropriate products and to appraise clients from a value chain finance point of view.

**Develop business and service alliances.** Globalization puts greater pressure on individual businesses to be part of competitive industries. Shared knowledge and lasting relationships that are mutually beneficial are characteristics of durable value chains and the businesses in the chain.

**Facilitate knowledge management and training.** The concepts and many of the instruments of value chain financing are not well understood. Universities, bank training institutes and development
organizations should be encouraged and supported to develop the training packages needed to build the capacity required.

Development agencies, agribusinesses and financiers can and should make a major contribution to knowledge management in AVCF, based upon their global experience and their connections to knowledge centres.

3.5 RECOMMENDATIONS FOR PROGRAMME MANAGEMENT AND MONITORING

Agree on key performance indicators. Unlike the microfinance sector, there are no generally agreed performance indicators for AVCF. Indicators to be considered include:

- Increased involvement of target primary producers (number and level of participation)
- Increased sales volume of primary producers (gross sales)
- Increased value added of primary producers (incomes)
- Credit worthiness (increased access towards commercial funding, on all VC levels)
- Quality of credit portfolios (% repayment of obligations, loans or in-kind deliveries)
- Sustainability of the financial services concerned (lending cost vs interest and fees (if applicable) and/or % repayment)

Target and monitor Return on Investment (ROI). Similar to interventions in the microfinance sector, grant support for value chain finance should be assessed as an investment that produces a social return. The social returns can be measured in terms of agreed key performance indicators. The ratio between total donor investment and total increase of value added (income) for primary producers may be used as one indicator that these objectives have been achieved.

Ensure good governance. Embedded finance arrangements must be monitored on ‘fairness’ vis-à-vis the stakeholders, especially primary producers. It should also be checked whether such arrangements could hamper scaling up to larger numbers of producer groups. A donor can perform a constructive role in designing and encouraging symbiotic business relationships. Through transparent pricing mechanisms for goods and financial services, with related monitoring, the risk of ‘predatory’ exploitation of a dependency relationship can be reduced.

Plan your own Exit. The realisation of self sustaining operations and credit worthiness should open the door for local FSPs to fully take over VCF. This is the natural exit strategy for donors as far as grant-funded Programmes are concerned. The conditions for exit, and the performance indicators used to assess it, need to be well defined in the business plan underlying the intervention.

3.6 GENERAL PRINCIPLES AND INSIGHTS FOR DEVELOPMENT AGENCIES

Diversify among value chains. Diversification and other forms of mitigation of concentration of risk in value chain activities are important considerations. Caution is noted regarding a singular focus on any one sector or value chain. While specialization is an important ingredient in achieving competitiveness, it also has associated risks for both the businesses within the chain as well as the financiers.
Weakness at any link in the chain can increase financing risk at all levels. Value chain finance decisions derive from the health of the chain or sector, including its cash and commodity flows, rather than on traditional collateral of an individual business or category of actor.

The viability of value chain finance depends on ‘insider knowledge’. The drivers of a value chain, who are often the businesses involved in the processing and marketing of agricultural outputs, know the business and the other actors in the chain in a way the financial institutions by themselves do not.

Infrastructure is a critical component. Agricultural communities often lack the infrastructure that would enable them to thrive and contribute to a nation’s food security and/or exports. Too often, there are gaps in basic services: inadequate electricity for operating machinery and processing equipment, lack of storage facilities to ensure product quality, undeveloped road systems to promote fast delivery and reduced spoilage, no greenhouse structures to prolong seasons and increase yields, and insufficient water and technologies for irrigation and other farm activities. It is costly and policy makers must make agriculture a priority to overcome these obstacles.

Supportive legislation. Policy makers have a critical role to play in the creation of enabling environments. Legislation may target financing issues from the regulations that govern microfinance institutions to those that support the development of managed warehouses that enable collateralization of inventory. Alternatively, legislation can support the certification of agricultural inputs, the registration of agribusinesses, the development of industry standards, the opening of domestic and international markets, and a host of other supporting regulations for agricultural sub-sectors. For value chain stakeholders, facilitators and policy makers, understanding the regulatory bottlenecks, and how to overcome them, can result in significant changes in legislation and the enabling environment.

Understand the Limitations of Value Chain Finance. Two caveats must be understood. First, value chain integration may not be good for all those involved. The least powerful in the chain may become marginalized in certain value chains. Value chain finance cannot address inequities that may be inherent in some value chain relationships. Governance through policies and enforcement may be required. Secondly, value chain finance can only address financial needs related to the chain; the conditions for promoting broad-based financial services to all households and businesses must also be pursued.

Value chain finance has an important place in agricultural finance which augments but does not replace conventional finance; most important is its comprehensive, structured and market-competitiveness approach that complements conventional finance increasing access to capital and reducing risk for both clients and financiers.
4. Frequently Asked Questions

• Where does AVCF fit within agricultural development finance, and vice versa?
AVCF is one approach for financing agriculture that works well for sectors where there are organized or at least partially organized value chain market linkages, i.e. not ad hoc sales scenarios. AVCF is part of development finance in that it can lower transactions costs and risks thereby improving the outreach and inclusiveness of agricultural finance.

• Should a donor or development bank provide direct financing for a value chain?
Often it is not advisable for a donor or development agency to directly lend or invest into a value chain or a set of value chains being developed, but rather to use its funding to help attract local, or if needed, international funding and investment.

• What is the difference between a value chain and a supply chain?
The two words are often used interchangeably. However, the term value chain gives emphasis to the value added in each of the chain processes. Both concepts work toward supplying a particular end market.

• Is it recommended for international development agencies to develop AVCF projects?
Generally AVCF is an approach which can be used within a development project but AVCF itself is not a goal but a means that contributes toward a broader goal. If the development intention is to demonstrate the use and understanding or VCF and/or if the goal is to expand financial access, then AVCF projects can be recommended.

• Donor support to innovation is recommended – how is this best achieved?
Process innovation and risk reduction are two areas of need. Knowledge sharing, exchange visits and other information and idea enhancing opportunities are some examples. Shared costs and/or partial assuming of risks when new innovations fail can also be considered.
### ANNEX 1. DESCRIPTION OF AGRICULTURAL VALUE CHAIN FINANCE INSTRUMENTS (FROM MILLER AND JONES, 2010)

<table>
<thead>
<tr>
<th>INSTRUMENT</th>
<th>BRIEF DESCRIPTION</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. PRODUCT FINANCING</strong></td>
<td></td>
</tr>
<tr>
<td>1. Trader Credit</td>
<td>Traders advance funds to producers to be repaid, usually in kind, at harvest time. This allows traders to procure products, and provides a farmer with needed cash (for farm or livelihood usage) as well as a guaranteed sale of outputs. Less commonly, trader finance can also be used “upward” in the chain whereby the trader delivers products to buyers with delayed payments.</td>
</tr>
<tr>
<td>2. Input Supplier Credit</td>
<td>An input supplier advances agricultural inputs to farmers (or others in the VC) for repayment at harvest or other agreed time. The cost of credit (interest) is generally embedded into the price. Input supplier credit enables farmers to access needed inputs while increasing sales of suppliers.</td>
</tr>
<tr>
<td>3. Marketing Company Credit</td>
<td>A marketing company, processor or other company provides credit in cash or in kind to farmers, local traders or other value chain enterprises. Repayment is most often in kind. Upstream buyers are able to procure outputs and lock in purchase prices and in exchange farmers and others in the value chain receive access to credit and supplies and secure a market for selling their products.</td>
</tr>
<tr>
<td>4. Lead Firm Financing</td>
<td>A lead firm either provides direct finance to value chain enterprises including farmers, or guaranteed sales agreements enabling access to finance from third party institutions. Lead firm financing, often in the form of contract farming with a buy-back clause, provides farmers with finance, technical assistance and market access, and ensures quality and timely products to the lead firm.</td>
</tr>
<tr>
<td><strong>B. RECEIVABLES FINANCING</strong></td>
<td></td>
</tr>
<tr>
<td>5. Trade Receivables Finance</td>
<td>A bank or other financier advances working capital to agribusiness (supplier, processor, marketing and export) companies against accounts receivable or confirmed orders to producers. Receivables financing takes into account the strength of the buyer’s purchase and repayment history.</td>
</tr>
<tr>
<td>6. Factoring</td>
<td>Factoring is a financial transaction whereby a business sells its accounts receivable or contracts of sales of goods at a discount to a specialized agency, called a factor, who pays the business minus a factor discount and collects the receivables when due. Factoring speeds working capital turnover, credit risk protection, accounts receivable bookkeeping and bill collection services. It is useful for advancing financing for inputs or sales of processed and raw outputs that are sold to reliable buyers.</td>
</tr>
<tr>
<td>7. Forfaiting</td>
<td>A specialized forfaitor agency purchases an exporter’s receivables of freely-negotiable instruments (such as unconditionally-guaranteed letters of credit and ‘to order’ bills of exchange) at a discount, improving exporter cash-flow, and takes on all the risks involved with the receivables.</td>
</tr>
<tr>
<td><strong>C. PHYSICAL ASSET COLLATERALIZATION</strong></td>
<td></td>
</tr>
<tr>
<td>8. Warehouse Receipts</td>
<td>Farmers or other value chain enterprises receive a receipt from a certified warehouse that can be used as collateral to access a loan from third party financial institutions against the security of goods in an independently controlled warehouse. Such systems ensure quality of inventory, and enable sellers to retain outputs and have opportunity to sell for a higher price during the off-season or other later date.</td>
</tr>
<tr>
<td>9. Repurchase</td>
<td>A buyer receives securities as collateral and agrees to repurchase those at a later date.</td>
</tr>
</tbody>
</table>
Agreements (Repos) | Commodities are stored with accredited collateral managers who issue receipts with agreed conditions for repurchase. Repurchase agreements provide a buy-back obligation on sales, and are therefore employed by trading firms to obtain access to more and cheaper funding due to that security.

10. Financial Lease (Lease-Purchase) | A purchase on credit which is designed as a lease with an agreement of sale and ownership transfer once full payment is made (usually in instalments with interest). The financier maintains ownership of said goods until full payment is made making it easy to recover goods if payment is not made while allowing agribusinesses and farmers to use and purchase machinery, vehicles and other large ticket items without requiring the collateral otherwise needed for such a purchase.

D. RISK MITIGATION PRODUCTS

11. Insurance | Insurance products are used to reduce risks by pooling regular payments of many clients and paying out to those affected by disasters. Payment schedules are set according to statistical data of loss occurrence; and mitigate the effects of loss to farmers and others in the value chain from natural disasters and other calamities.

12. Forward Contracts | A forward contract is a sales agreement between two parties to buy/sell an asset at a set price and at a specific point of time in the future, both variables agreed to at the time of sale. Forward contracts allow price hedging of risk and can also be used as collateral for obtaining credit.

13. Futures | Futures are forward contracts – see definition above – that are standardized to be traded in futures exchanges. Standardization facilitates ready trading through commodity exchanges. Futures provide price hedging, allowing trade companies to offset price risk of forward purchases with counter-balancing of futures sales.

E. FINANCIAL ENHANCEMENTS

14. Securitization Instruments | Cash-flow producing financial assets are pooled and repacked into securities that are sold to investors. This provides financing that might not be available to smaller or shorter-term assets and includes instruments such as collateralized debt obligations, while reducing the cost of financing on medium and longer term assets.

15. Loan Guarantees | Agricultural loan guarantees are offered by 3rd parties (private or public) to enhance the attractiveness of finance by reducing lending risks. Guarantees are normally used in conjunction with other financial instruments, and can be offered by private or public sources to support increased lending to the agricultural sector.

16. Joint Venture Finance | Joint venture finance is a form of shared owner equity finance between private and/or public partners or shareholders. Joint venture finance creates opportunities for shared ownership, returns and risks, often with complementary partner technical, natural, financial and market access resources.
## ANNEX 2. SUMMARY ANALYSIS OF AGRICULTURAL VALUE CHAIN FINANCE INSTRUMENTS

<table>
<thead>
<tr>
<th>INSTRUMENT</th>
<th>BENEFITS</th>
<th>LIMITATIONS</th>
<th>APPLICATION POTENTIAL</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. PRODUCT FINANCING</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Trader Credit</td>
<td>• Farm-gate finance with ease of transaction</td>
<td>• Non-transparency of true market value</td>
<td>• “Middleman” traders will remain important but as chains integrate will lessen in importance</td>
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<tr>
<td></td>
<td>• Culturally accepted and well known at all levels</td>
<td>• Often informal with potential for side-selling</td>
<td>• Tendency of traders toward acting as agents of wholesalers</td>
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<td></td>
<td>• Secures sale/purchase and price of seller and buyer</td>
<td>• Quality and quantity uncertain when given pre-harvest</td>
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<tr>
<td>2. Input Supplier Credit</td>
<td>• Buyers obtain needed inputs</td>
<td>• Input costs may be excessive</td>
<td>• Focus on reducing administration and risk with multi-party links with banks and produce buyers are promising – for direct payments from sale</td>
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<tr>
<td></td>
<td>• Suppliers secures sales</td>
<td>• Lack of security in repayment</td>
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<td></td>
<td></td>
<td>• Lack of competitive suppliers in many regions</td>
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<td></td>
<td></td>
<td>• Smallholder's safe use and application of inputs is often weak</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>3. Marketing Company Credit</td>
<td>• Secures product quantity and price</td>
<td>• May not be directly accessible to small farmers</td>
<td>• Value chain control through contract farming is growing in importance</td>
</tr>
<tr>
<td></td>
<td>• Funds advanced as needed; payments often discounted directly</td>
<td>• Credit advances increase financial outlay and administration</td>
<td>• Value chain approaches reduce transaction costs and risks</td>
</tr>
<tr>
<td></td>
<td>• Uses contracts to set finance, price and product specifications</td>
<td>• Compliance of contracts is often not respected</td>
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<tr>
<td>4. Lead Firm Financing</td>
<td>• Secures market and price</td>
<td>• Less access for small farmers</td>
<td>• Growing use and strong potential to provide access to markets, technical assistance and credit</td>
</tr>
<tr>
<td></td>
<td>• Technical guidance for higher yields and quality</td>
<td>• Restricts price rise gains to producer</td>
<td></td>
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<tr>
<td></td>
<td>• Less side-selling options due to closer monitoring</td>
<td>• Cost of management and enforcement of contracts</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Enforceable contracts with less side-selling due to closer monitoring</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Lead firm can often hedge price risk</td>
<td></td>
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</tr>
<tr>
<td><strong>B. RECEIVABLES FINANCING</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Trade Receivables Finance</td>
<td>• Reduces finance constraints for exporters and ease repayment</td>
<td>• Requires a proven track record</td>
<td>• Is used for import-export transactions by companies for durable commodities</td>
</tr>
<tr>
<td><strong>6. Factoring</strong></td>
<td>Provides a means of capital for operations</td>
<td>Is complex and requires a factoring agency</td>
<td>Its use in agriculture is less common but is growing</td>
</tr>
<tr>
<td></td>
<td>Facilitates business and finance by passing collection risk to a 3rd party (factor)</td>
<td>Is not yet allowed in some countries</td>
<td>Is best used for processors and input suppliers where product flows and accounts are stable</td>
</tr>
<tr>
<td></td>
<td>Can be cheaper than bank loan alternatives</td>
<td>Is a lack of knowledge and interest by financial markets</td>
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</tr>
<tr>
<td><strong>7. Forfaiting</strong></td>
<td>Like factoring, it makes capital available</td>
<td>Forfaiting requires to sell the accounts at a discount</td>
<td>Is less common but similar in principle to factoring</td>
</tr>
<tr>
<td></td>
<td>It takes care of collection risks and cost.</td>
<td>Is complex and requires the presence of specialized forfaiting or factoring agencies</td>
<td>Invoice instruments are negotiable but complex, limiting their application potential</td>
</tr>
<tr>
<td></td>
<td>Can be selectively used for specific project funding or accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>C. PHYSICAL ASSET COLLATERALIZATION</strong></td>
<td>Uses inventory as collateral to increase access to financing</td>
<td>Commodity traded must be well-standardized by type, grade and quality</td>
<td>Is relatively well known with interest to increase use</td>
</tr>
<tr>
<td><strong>8. Warehouse Receipts</strong></td>
<td>Where organization and trust are built, can also work on a less formal basis without the official WR legislation in place</td>
<td>Increases costs</td>
<td>Can be used at various VC levels and growth potential</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Often requires special legislation</td>
<td>Currently is used for durable commodities but with increased processing and improved storage, the range of it use can expand</td>
</tr>
<tr>
<td><strong>9. Repurchase Agreements (Repos)</strong></td>
<td>Can reduce financial costs and has proven successful in selected commodities with well functioning commodity exchanges</td>
<td>Is complex and requires commodities to be stored with accredited collateral managers and requires commodity exchanges</td>
<td>Limited potential in near future and used infrequently by exporters for some commodities</td>
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<td></td>
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</tr>
<tr>
<td><strong>10. Financial Leasing (Lease-purchase)</strong></td>
<td>Provides more loan security and ease of asset repossession in case of default</td>
<td>Requires coordination of seller, buyer and financier</td>
<td>High potential use for equipment if legislation allows</td>
</tr>
<tr>
<td></td>
<td>Is especially good where legal system for loan collection is weak</td>
<td>Only feasible for medium-long-term purchases of non-perishables</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Often are tax benefits</td>
<td>Often requires insurance</td>
<td></td>
</tr>
<tr>
<td><strong>D. RISK MITIGATION PRODUCTS</strong></td>
<td>Reduces risk for all parties in value chain</td>
<td>Is costly, requiring subsidy, when applied to agricultural production</td>
<td>High interest by many donors and governments is increasing use.</td>
</tr>
<tr>
<td><strong>11. Insurance</strong></td>
<td>Is commonly used and easily applied for fire, vehicles, health and death insurance</td>
<td>Insufficient data limits weather indexing use in insurance</td>
<td>Growth without subsidies will be modest for production insurance until sufficient data is available</td>
</tr>
<tr>
<td></td>
<td>Crop and livestock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Forward Contracts</td>
<td>Companies can hedge price risk, thus lowering financial risk and cost</td>
<td>Requires reliable market information</td>
<td>Is frequently used by larger companies and for major commodities</td>
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</tr>
<tr>
<td></td>
<td>Can be used as collateral for borrowing</td>
<td>Commodity traded must be well-standardized by type, grade and quality</td>
<td>Has potential to increase significantly wherever reliable market information is available</td>
</tr>
<tr>
<td></td>
<td>Are not dependent upon commodity exchanges</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Benefits can flow though chain when one party forward contracts and can offer forward or fixed prices to others</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13. Futures</td>
<td>Is used globally in agricultural commodities to hedge risk</td>
<td>Commodity traded must be well-standardized by type, grade and quality</td>
<td>Has growing use and potential when commodity exchanges function</td>
</tr>
<tr>
<td></td>
<td>Futures serve as price benchmarks for reference trade</td>
<td></td>
<td>Use is limited to larger producers, processors and marketing companies</td>
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<td></td>
<td></td>
<td>Requires a well-organized futures market</td>
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<tr>
<td>E. FINANCIAL ENHANCEMENTS</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>14. Securitization Instruments</td>
<td>Has potential to reach lower-cost capital market funding where homogenous pooling is possible</td>
<td>Is costly and complex to set up</td>
<td>Has limited potential for agricultural value chain investments of similar tenor and cash flow</td>
</tr>
<tr>
<td></td>
<td>Has been successfully used in microfinance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15. Loan Guarantees</td>
<td>Reduces risk of finance and/or the business venture creating more access for funding</td>
<td>Is costly and often subsidized in agriculture</td>
<td>Is occasionally used as incentive for stimulating capital flows to infrastructure, new markets and exports and occasionally production</td>
</tr>
<tr>
<td></td>
<td>Can facilitate investment needed in a value chain</td>
<td>Can reduce lender responsibility and accountability</td>
<td></td>
</tr>
<tr>
<td>16. Joint Venture Finance</td>
<td>Provides equity capital and borrowing capacity</td>
<td>Is hard to attract suitable investors of common vision</td>
<td>Has growing potential in globalizing world</td>
</tr>
<tr>
<td></td>
<td>Reduces financial leverage risk of investors</td>
<td>Dilutes investor returns</td>
<td>Strategic partnership, including public and private, is increasingly important in value chains</td>
</tr>
<tr>
<td></td>
<td>Often brings expertise and/or markets</td>
<td>Is hard for small producers to participate</td>
<td></td>
</tr>
</tbody>
</table>
ANNEX 3. SMART AID ISSUES IN VALUE CHAIN FINANCE: QUESTIONS FOR SELF-ASSESSMENT BY DONORS AND FINANCIERS.³

Key questions on Strategic Clarity
- What is the approach of our organization on VC-finance? Do we have an organisational policy or guideline?
- What is the niche where we can make a difference?
- Are our interventions in VC-finance in line with emerging good practice?
- Does an agency-wide commitment exist towards this policy and good practice principles?
- Is compliance with this policy and good practices checked all stages of the project cycle?

Key questions on Staff Capacity
- Do we have staff with value chain development and finance expertise to ensure quality of design, implementation, and monitoring of programs?
- Do we have a focal point(s) with experience and responsibility to provide technical advice to program developers and managers?
- Do we make resources available for technical expertise to be involved in the design of VC-development/VC-finance programs?
- Do we have VC specialist staff in countries/regions where it is most needed?

Key questions on Accountability for Results
- Do we have the systems in place to ensure the transparency and performance-based management of VC-finance programs?
- Do we have systematic tracks and reports on performance indicators for VC-finance programs or components?
- Do we use performance-based contracts?
- What are the performance indicators?
- Do we have any measure for cost effectiveness or “return on investment”?

Key questions on Knowledge Management

- Do we have systems to create, disseminate, and incorporate learning from our own experience and from others?
- Do we have mechanism(s) in place for exchanging learning on our VC-finance programs and latest developments throughout headquarters and field offices?
- What expertise is contracted from outside?

Key questions on Appropriate Instruments

- Do we have appropriate instruments for VC-finance that are used in a flexible manner and adapted to market needs?
- Are we able to work directly with private actors (companies)?
- How do we manage the support for VC-development and for VC-finance: are they sufficiently separated and yet well coordinated?
- Is the nature and use of instruments consistent with our strategy and with the requirements for supporting VC-development and VC-finance?
- What role can we play in unleashing funding for agricultural investments?
- How could brokerage and alliance building functions best be organised?

**Good donor practice for microfinance.** Value chain finance can benefit from the experience of microfinance, as this sector has developed in the past decades into a mature industry, with global standards for performance indicators, benchmarks and ‘good practice’. Value chain finance as an entry point for development aid is a relatively new endeavour, in which best practices are still in the process of being documented, analysed and evaluated. Hence, for donor policy the parallel between VC-finance and microfinance is worth considering.4

The justification for the comparison lies in the fact that in both fields (social) enterprises are supported that aim to achieve viable and self-sustaining operations. In both cases the role of donors is not just to kick-start the finance process, but also to build the capacity of the institutions involved and to allow effective and sustainable financial service delivery. Donor involvement should be temporary, connected with a clearly defined exit strategy.

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4 For further exploration of these criteria reference is made to: “Donor Guidelines on Good Practice in Microfinance” of CGAP, and to Smart Aid criteria and related scoring methodology of donors (as shown in the above diagram).
References

3. ibid.