Access to Finance

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Why is Access to Finance Important?

Financially constrained agrifood processors may not be able to fully utilize their production capacity and make sufficient investments for future business opportunities. They may also be more susceptible to external shocks. These limitations could force companies to focus on low-risk and low-return business opportunities, leading to slower growth and suboptimal impacts on national economic growth, job creation, and competitive agricultural value chains. Agribusinesses, including agrifood processors, finance their operations through internal and external sources. Their primary source is funds generated by their daily operations. However, steady expansion and responses to emergencies require external financing, both formal and informal. Agribusinesses, especially small and medium-sized enterprises (agri-SMEs), need stable access to formal external finance, which is often larger in size and offers more competitive interest rates than informal sources of finance. Such external finance is especially critical if companies aspire to grow rapidly, lack resources, or suffer from a disaster or downturn. Yet, these agribusinesses have great difficulty in accessing external formal financing (World Bank 2021). According to the Enterprise Surveys of the World Bank, about 40 percent of surveyed agrifood processors in 14 countries in Africa south of the Sahara identify access to finance as a major constraint. On average, only 11 percent of their investments are financed through banks as opposed to internal finance, which provides 74 percent (WBES 2022).[1]

Estimating the Finance Gap

Precise data are not readily available on the finance gap facing agrifood processors in Africa south of the Sahara. Existing research broadly estimates the financial gaps of smallholder farmers and agri-SMEs. For example, ISF Advisors, who define agri-SMEs "holistically as encompassing medium- and large-scale farms, agri-services companies, and the range of SMEs within value chains that facilitate input and offtake activities," estimate that there are 130,000 agri-SMEs in Africa south of the Sahara (ISF Advisors 2022, 16). Agri-SMEs are estimated to need approximately USD$90 billion annually in financing, but 86 percent of their financing needs remain unmet (ISF Advisors 2022). The report does not provide financing gap data by subsegment, including for agrifood processors.

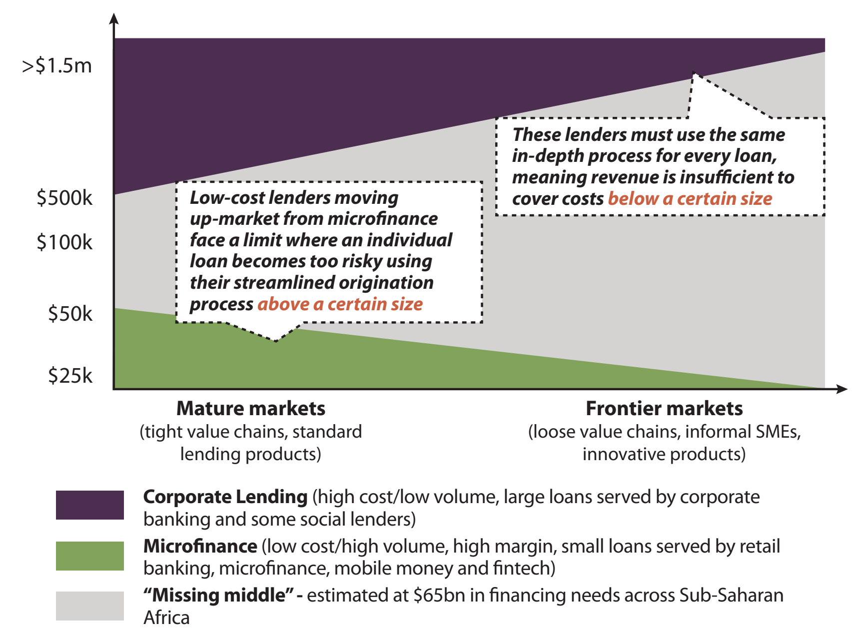
Accessibility of finance varies depending on the size and growth prospects of agribusinesses. These companies are diverse in nature, ranging from micro informal businesses to large established companies. A few larger entities are disproportionately served by formal financial institutions, especially commercial banks and impact-oriented investment funds (ISF Advisors 2022). Established agrifood processors are likely to be found in this category, together with other large entities typically in the trading sector and cash crop value chains. On the other hand, most agribusinesses are categorized as SMEs, and many of them are micro and informal. They do not have strong growth prospects and rely largely on their own funds or informal finance. However, in some markets, non-bank financial institutions (NBFIs), such as microfinance institutions (MFIs), provide financing to smaller SMEs and micro companies by upgrading their individual and group lending models. Between the large and small/micro borrowers, there is a so-called "missing middle" in access to finance. A market assessment by Dalberg and KFW Africa estimates that the missing middle—unmet financing needs among agri-SMEs seeking loans from US$25,000 to US$1.5 million—is about US$65 billion in Africa south of the Sahara (Aceli Africa and Dalberg 2021). The gap seems to widen for companies in unstructured value chains with limited and ad-hoc market access (Figure F1.1).

1 These statements are based on the author's analysis of data from 14 country surveys: Ethiopia, Ghana, Guinea-Bissau, Kenya, Madagascar, Mauritius, Mozambique, Nigeria, Senegal, South Africa, Tanzania, Uganda, Zambia, and Zimbabwe.

Challenges in Financing Agri-SMEs, Including Agrifood Processors

Lending to agri-SMEs involves numerous challenges, from underdeveloped financial markets and enabling environments in Africa south of the Sahara (including weak infrastructure, nonexistent or inadequate insurance markets, collateral registry, and credit bureaus) to the inherent risks in agricultural value chains. Agricultural production is seasonal and susceptible to climate change, crop disease, and price volatility. Linkages with markets, including with traders and processors, tend to be weak, especially in loosely organized value chains. Agri-SMEs, including agrifood processors, are subject to these challenges in agricultural production. In addition, lenders have to assume high transaction costs in serving dispersed small SMEs. These companies generally lack financial records and assets for collateral. Given these adverse conditions, formal lenders have a strong bias toward large and established companies, to whom they provide short working capital loans. They are usually reluctant to develop capacity and suitable financial products to respond to the various needs of agri-SMEs. A recent evaluation of agri-SME lenders in Africa justifies this conservative strategy. It revealed that loans of less than $500,000 (after credit losses and overheads) had net losses due to lower interest income against fixed loan execution costs in smaller loans. In the same analysis, loans with tenors of more than 12 months were unprofitable on average and had four times the risk of impairment (USAID 2018).

FIGURE F1.1—MISSING MIDDLE IN AGRI-SME FINANCE



Source: Aceli Africa and Dalberg 2021.

Major Finance Providers

Although financing is not sufficient to meet demand, there are various financial products available, depending on business need and context. Formal external financing sources for agribusinesses vary. Major sources include commercial banks, development banks, NBFIs, and investment funds. They offer various financial products, such as short- and long-term debt, equity, and quasi-equity. The following highlights major formal financiers (ISF Advisors 2022; World Bank 2021):

Commercial banks: Commercial banks are, by far, the largest finance providers for agri-SMEs in Africa. They usually provide short- and long-term debt to a small number of agribusinesses specializing in commodities that involve a large volume of transactions and well-structured markets. Such commodities often include coffee, tea, cocoa, palm oil, wheat, and maize. These banks mainly operate in cities and large town centers. Some banks have a strong agri-focus, with specialized divisions and loan officers for agriculture lending including agri-SMEs. The banks are mainly funded through deposits and generally lack long-term finance, which limits their capacity to provide long-term loans.

Development banks: Development banks are mandated by the government to provide financial resources to countries' priority sectors, which often include agriculture and agri-SMEs. Some development banks exclusively serve the agriculture and agribusiness sector. Many development banks traditionally focus on providing long-term loans to large companies and projects. However, some banks also cater to SMEs and farmers by providing smaller loans in rural areas. Loan size varies depending on the borrowers. Some banks offer concessional loans subsidized by public sources, wholesale credit to other lenders, and credit guarantees. While there are well-performing development banks, others rely on periodic injections of capital from the government and other agencies.

Non-bank financial institutions (NBFIs): NBFIs include MFIs and cooperative financial institutions such as savings and credit cooperative societies. They traditionally serve individuals and group borrowers with small and short-term loans. Some are expanding their focus to include SMEs by upgrading their lending models and products. In some markets, NBFIs have wider networks in rural areas than other players, but they are small in size and offer smaller loans with higher interest rates than banks, partially due to limited capital and loanable resources.

Investment funds: Investment funds consist of private equity (PE) and venture capital (VC) funds as well as impact-oriented funds that place a strong emphasis on development return. While PE/VC funds remain underdeveloped in Africa south of the Sahara, especially for the SME segment, many impact-oriented funds for agri-SMEs focus on Africa. Even in the SME segment, they tend to target larger companies due to high fixed costs in investment sourcing and management relative to their investment portfolio. The funds that pursue market return mainly use equity and focus on larger investments of at least US$3–5 million. However, some impact-oriented funds target smaller investments (from US$250,000 to US$2 million) by offering debt and equity.

Recent Developments in Agri-SME Finance

Digital financial services (DFS), or the provision of financial products and services through digital channels, are changing the SME finance space. Globally, they have become essential to closing the SME financing gap (World Bank 2022), and digital innovations are also rapidly evolving in Africa. DFS can reduce transaction costs by automating processes in SME financing such as onboarding, underwriting, due diligence tasks, and collection of payments. In addition, new sources of data and advanced analytics such as Artificial Intelligence (AI) and machine learning can unlock financing for SMEs that often lack proper credit records and bookkeeping (World Bank 2022). In the African SME finance space, new players are emerging in countries like Kenya, Nigeria, and South Africa, and traditional lenders are employing new technologies and upgrading their processes. Digital payments are already widely available for individuals and SMEs, especially in East Africa. In addition, DFS can provide new solutions such as factoring, reverse factoring, peer-to-peer lending, and trade finance (World Economic Forum 2015; World Bank 2022).

Climate finance may become a new financial source for agri-SMEs. However, despite the urgency around climate change and global interest in financing climate mitigation and adaptation, agri-SMEs in Africa are not yet major recipients of climate finance, particularly those focused on adaptation. According to a recent analysis, non-OECD countries receive only a small fraction of climate finance resources, which are overwhelmingly funded by public founders targeting large-scale initiatives with grant and concessional debt (ISF Advisors 2022).

Expanding Access to Finance

Developing the agrifood processing sector and expanding access to finance will require a stable macroeconomy and political environment that pave the way for the long-term growth and stability of the financial and agribusiness sectors. This will boost confidence among private sector players about financial prospects and encourage investments. Similarly, financial sector development is an important prerequisite to expanding access to finance for agrifood processors; this includes savings mobilization and financial infrastructure such as credit registries, collateral registry, and capital markets. Agriculture policies need to create a conducive business environment for strong value chains and vibrant private sector participation. Physical infrastructure, including telecommunication, is indispensable to lower the transaction costs of financial intermediation and facilitate innovation. On the demand side, other sections of the report discuss general challenges among agrifood processors, but limited managerial capacity and weak financial bookkeeping are among the biggest barriers to accessing finance.

On the supply side of finance, commercial banks, development banks, and NBFIs require specific skills and products to finance agrifood processors, especially SMEs, given their exposure to unique risks in agriculture. The introduction of DFS and the digitization of lending operations are increasingly important to promote SME finance. In addition, the following solutions may address the supply side of finance:

- Tools for risk management, such as partial credit guarantees and insurance products (for agricultural production and SMEs)
- Financial resources for lending, including savings mobilization, wholesale long-term credit lines, capital market development, and equity investment to investment funds
- Blended finance, including technical assistance (for agri-SMEs including agrifood processors and financial providers), matching grants, and concessional credit that helps mobilize private sector resources

Case: 4G Capital

Since its inception in 2013, 4G Capital has provided working capital loans totaling more than $195 million to more than 1.5 million small businesses in Kenya and Uganda. Agri-SMEs are their largest client segment, accounting for 36 percent, and 77 percent of their total borrowers in rural areas. To underwrite its loans, 4G Capital uses machine learning technology to analyze borrower risk and affordability. Disbursement and repayments are done through mobile money, and loans do not require collateral. In addition to loans, the company provides bespoke business training programs and credit guidance via mobile apps and in person at its 90 branches. As a result of the borrowings , 84 percent of clients have experienced an increase in sales, and more than 94 percent of loans have been repaid within 30 days (4G Capital 2018 and 2022).