CHAPTER 2. Financing the missing middle

Blended finance can make the biggest contribution to SDG 2 by focusing on the missing middle: agrifood SMEs seeking finance between US$50,000 and US$2 million.

Recommendation: Donors and DFIs can increase the flow of finance to agrifood SMEs by:

i. building the agrifood expertise and risk appetite of domestic lenders. This includes the development of an agrifood credit risk assessment scorecard, as proposed by the United Nations Economic Commission for Africa;
ii. scaling up priority lending programmes and results-based lending incentives for domestic banks, encouraging them to use their own balance sheets to lend to agrifood SMEs;
iii. increasing financing for affordable, indemnity-based, weather-indexed and crop-indexed insurance;
iv. Incorporating bookkeeping and accounting skills into SME technical assistance programmes.

The discussion below unpacks the findings and recommendations on the missing middle. It draws from the evidence that agrifood SMEs that are servicing domestic markets are particularly challenged in accessing affordable finance. This brings into play the role of domestic investors and the skills and maturity of agrifood SMEs themselves. This discussion also covers why insurance and financial incentives can be highly affective in improving the credit risk profile of agrifood SMEs.

Understanding the missing middle

The lack of available and accessible finance appropriate to the risk profile of agrifood SMEs in developing countries remains one of the biggest market failures and a major obstacle to achieving SDG 2.

While there is no internationally accepted definition of an agrifood SME, the Smallholder and Agri-SME Finance and Investment Network (SAFIN) of IFAD defines agrifood SMEs as: "profit-oriented enterprises that are involved in the agricultural value chain either directly or by providing enabling services to value chain actors" (SAFIN and ISF Advisors, 2020, p. 2). SMEs are typically able to service an investment of US$50,000 to US$2 million, have more than 5 but fewer than 250 employees, have an annual turnover of US$100,000 to US$5 million and/or have total assets of at least US$20,000. They may include small commercial farms and farmer cooperative-owned enterprises (SAFIN and ISF Advisors, 2020).

Agrifood SMEs are therefore a diverse group of enterprises. The poorest and most marginalized depend upon subsistence farming and require long-term, or patient, donor financing. Moreover, they need several years of continuous donor financing and donor-financed capacity-building before they may be able to reach the appropriate level of maturity, professionalism and profitability to work with impact investors and blended financiers. **These agrifood SMEs seek financing under US$50,000 and are generally best served by ODA and philanthropic grants channelled through not-for-profit financing intermediaries. Microcredit is one of the most successful solutions for this group.**

The next group of agrifood SMEs, often referred to as the "missing middle", seeks financing between US$50,000 and US$2 million (Aceli Africa, 2023). Such amounts are too small to attract commercial loans at market rates from private equity groups, yet too large to qualify for ODA grants or microcredit (Doran et al., 2009).

Lending to the missing middle is particularly challenging because of the high risk of losses and costs of servicing small value loans. Lending institutions that are members of the Council of Small Holder Agriculture Finance (CSAF) reported an average loss of US$18,700 on a loan of US$665,000, excluding the cost of funds. CSAF also found that loans below US$500,000 carried an 80 per cent higher risk of default than larger loans (USAID & CSAF, 2018).

This results in an agrifood SME financing gap estimated at US$106 billion annually across sub-Saharan Africa and South-East Asia (ISF Advisors, 2022). The gap is especially large for agrifood SMEs in sub-Saharan Africa, representing 83 per cent of the total annual financing need and amounting to US$74.5 billion (see Figure 7).

Figure 7 - The agrifood SME financing gap across sub-Saharan Africa and South-east Asia is estimated at US$106 billion (66 per cent of total financing need) annually

Agrifood SME financing gap across sub-Saharan Africa and South-East Asia in billions of United States dollars

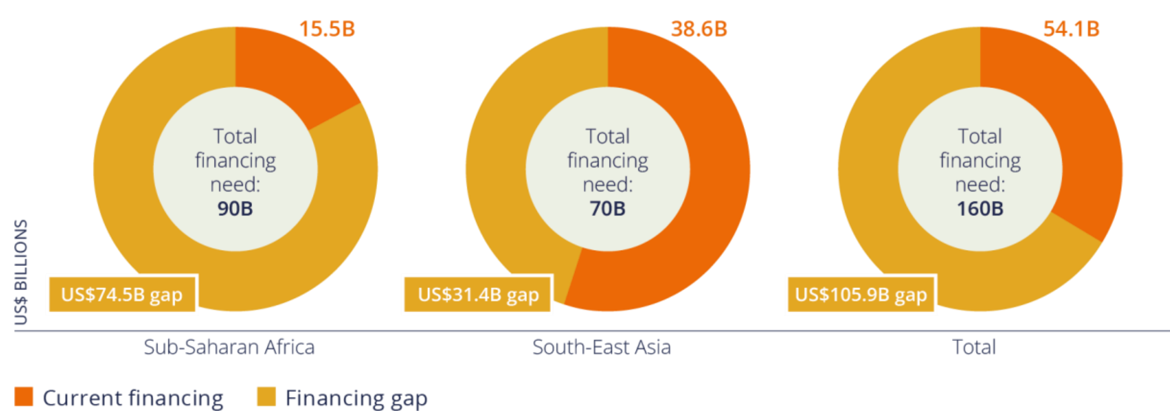

Chart: Lysiane Lefebvre. *Source:* ISF Advisors, 2022

Challenges facing agrifood SMEs supplying domestic markets

Impact investors, commonly referred to as “social lenders” in the finance community, provide affordable financial and technical assistance to domestic lenders and borrowers in developing countries. They accept purchasing contracts and contract farming agreements as guarantees, which allows them to provide loans without requiring collateral.

However, such contracts are in hard currency, since impact investors seek to avoid risks associated with exchange rate fluctuations (as they receive their own financing in hard currencies). A significant proportion of impact financing therefore flows to SMEs producing for export. This results in a situation whereby those agrifood SMEs producing grains, fruits and vegetables for local markets and working in local currency are largely being left out. While impact investors are starting to finance domestic producers in local currencies, the many risks associated with lending to this segment remain a barrier.

In 2022, lenders from CSAF primarily directed their lending to cash crop value chains (CSAF, 2023a). Agrifood SMEs and farmer organizations involved in coffee, cocoa, cashew nuts, soya beans and quinoa received most of the loans, with only 24 per cent going to value chains in crops for domestic consumption in 2022 (see Figure 8) (CSAF, 2023b).

According to one fund manager interviewed:

> *"If you are growing organic coffee designed for foreign markets, you can find lenders. But if you are growing cassava or carrots for local markets and want lending in local currency, there is practically nobody. Local lenders have to fill this gap. They are not doing so because sustainable agrifood businesses are not often profitable in the shorter term, and because local lenders do not understand the agrifood sector."*
>
> *(Fund manager, Shamba Centre enquiry into sustainable finance, 2023)*

Figure 8 - Most financing is going to cash crops destined for export rather than food crops meant for domestic consumption

Volume of lending by value chain in millions of United States dollars, 2013–2022

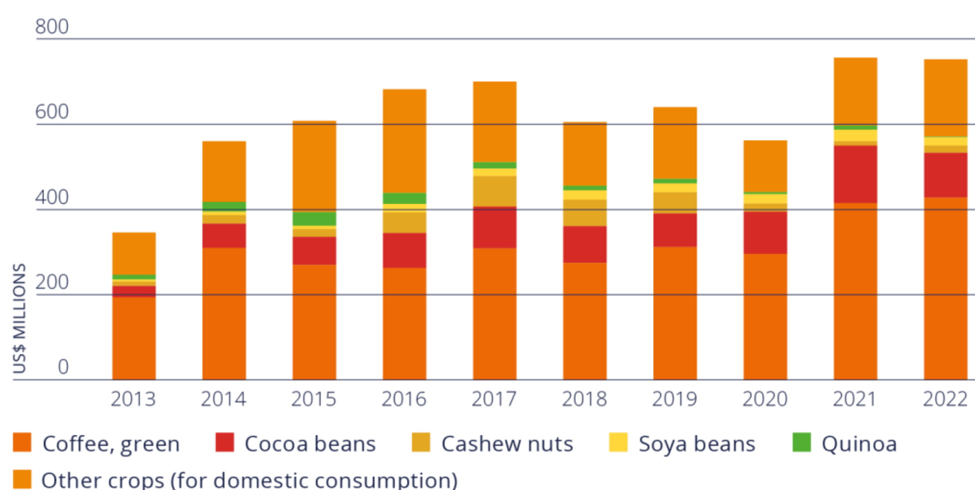

Chart: Lysiane Lefebvre. *Source:* CSAF, 2023a

Domestic lenders remain on the sidelines. As discussed earlier, **the financial demand of agrifood SMEs in sub-Saharan Africa and South-East Asia is estimated at US$160 billion.** However, only US$54 billion of this total demand being financed by and through domestic lenders.

- Domestic and regional commercial banks only meet US$40 billion of this need. Because of prudential banking regulations and low-risk appetite, commercial banks seek to minimize risks and typically only provide short- and medium-term financing to mature agrifood SMEs with strong collateral and stable cash flow, despite often being backed by donors and government guarantees and incentives to encourage lending (ISF Advisors, 2022).

- Domestic and regional non-bank financial institutions such as credit unions and leasing service providers meet US$6 billion of this demand (ISF Advisors, 2022). Because non-bank financial institutions do not have a full banking licence and thus less rigorous and prudential regulations, they can often offer financing with less stringent collateral requirement. Given the additionality of these institutions in serving the underfinanced segment of agrifood SMEs, further engagement with them is critical.

- Domestic development banks meet US$4 billion of this demand. Driven by their economic development agenda, these state-sponsored banks provide a mix of grants, concessional and commercial loans (ISF Advisors, 2022).

- Social lenders and impact funds meet US$4 billion of this demand. These entities can be domestic and foreign funds working through local intermediaries.

The critical role of domestic investors lies in their vast networks, reaching large numbers of borrowers, and their knowledge and specialized expertise in serving a specific segment of agrifood SMEs. However, these domestic investors hesitate to lend to agrifood SMEs because of the high transaction costs of making loans, the small value of the loans required, the perceived risk of lending to agrifood SMEs and the reality that many agrifood SMEs are not investment ready. More concerted action to engage with these stakeholders is therefore a prerequisite for servicing the missing middle.

Domestic lenders also lack data and expertise on the agrifood sector. The accuracy of the credit risk assessments undertaken by financial institutions prior to making lending decisions depends on the availability and quality of data. According to stakeholders interviewed, the gap between the actual and perceived risks in the agrifood sector is driven by lack of data, knowledge and transparency. It prevents domestic lenders from financing agrifood enterprises and optimizing credit lines and guarantees provided by donors and DFIs.

Historically, financing for agriculture from domestic lenders in developing countries has been very low. For example, the proportion of total credit in Africa extended to the agricultural sector increased from 3.9 per cent in 2000 to 4.3 per cent in 2019 (Koloma and Kemeze, 2022).

Domestic lenders also have little incentive to take the time to explore new business opportunities when revenues from government bonds remain far more lucrative. One fund manager interviewed said:

> *"If lenders are better informed on the agriculture sector, it can also have a big impact on their appetite to lend – even if returns are less lucrative than other sectors."*
>
> *(Fund manager, Shamba Centre enquiry into sustainable finance, 2023)*

> *"When banks in developing countries do so well by investing in sovereign bonds, they have no motivation to explore new opportunities, especially those that require additional effort to source lenders, assess credit risks and settle loans. This is perhaps the biggest hurdle in agrifood finance."*
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> *(Donor agency, Shamba Centre enquiry into sustainable finance, 2023)*

Stakeholders continue to debate if priority lending and results-based financing can be more effective than credit lines and loan guarantees to crowd in domestic lenders. The reality is that credit lines and loan guarantees do little to increase the interest of domestic banks in exploring the agrifood sector, differentiate between the real and perceived risks, and encourage them to use their own money to lend to agrifood SMEs. According to stakeholders interviewed, the suboptimal use of these credit lines and guarantees by domestic banks is due to their lack of expertise and tools to assess credit risks in the agrifood sector. To address this issue, many governments and donors continue to experiment with priority lending and results-based financing targeted at domestic banks (see Box 2).

Box 2 - What is priority lending?

Priority sector lending programmes are designed and led by central banks to increase lending to economically important but less profitable sectors of the economy that would otherwise not receive affordable and timely credit. Sectors usually targeted by priority lending programmes include agriculture, SMEs, health and education. They are part of the regulatory framework for commercial banks and financial institutions in many countries, both developing and developed (Kumar et al., 2016).

Priority lending programmes are implemented by issuing retail banks with sector-specific lending targets that are accompanied by tradable priority sector certificates. Banks exceeding their lending targets can trade their surplus certificates with those that fall short. In the absence of tradable priority certificates, central banks can require banks that do not meet lending targets to lend to public institutions at very low interest rates.

The terms and conditions of priority lending do not include lower interest rates or unsecured lending, which would distort the market. Rather, the objective of this policy is to encourage banks to develop expertise in and comfort with the priority sectors.

What is results-based, or outcome-based, financing?

'Results-based financing' refers to any programme that offers a reward, whether monetary or otherwise, to incentivize the achievement of specific outputs or outcomes. These rewards are contingent upon verification that the agreed-upon results have been successfully delivered. Incentives may be directed towards service providers, beneficiaries or both parties involved. Payments or rewards are withheld until the satisfactory delivery of results or performance (Musgrove, 2011).

Results-based financing is also a strategy to increase the impact of an investment by linking payments for results that would otherwise not have been achieved at the same pace, scale or timeframe. These results are hence additional development impacts. For example, results-based financing can be used to meet the transaction costs of small-value loans. It can also be used as an incentive payment to encourage domestic banks to do business with women and rural entrepreneurs who lack the required credit profiles. Results-based financing can also be designed as payments for ecosystem services to meet the additional costs of restoring soils, lowering nutrient run-off and increasing habitat for pollinators.

According to one impact fund manager:

> *"Traditional loan guarantees provided by donors to local banks don't often result in lending, as they don't increase the risk appetite of the local banks to explore the food and agriculture sector. What we therefore need are incentives that motivate and even prompt local banks to say: 'we are being invited to explore a new market and donors will pay for us to do it.' In good times, these banks will develop expertise and appetite in the sector and donors can hopefully then step aside."*
>
> *(Fund manager, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*

For example, Aceli Africa, an incentive facility funded by the Swiss Agency for Development and Cooperation (SDC), the United Kingdom Foreign, Commonwealth & Development Office (FCDO), the United States Agency for International Development (USAID), the IKEA Foundation and Convergence, is experimenting with results-based incentives for domestic banks (see Box 3).

Box 3 - Aceli Africa

Aceli Africa provides results-based financial incentives to domestic lenders in Kenya, Rwanda, the United Republic of Tanzania and Uganda. In the absence of these incentives, local lenders would not be lending to agrifood SMEs. The incentives are designed based on lending data from 31 financial institutions, including local banks, international social lenders and members of CSAF.

- A partial loan guarantee is given to domestic lenders for loans between US$25,000 and US$1.75 million.
- Origination incentives for domestic lenders cover the costs of providing loans of between US$25,000 and US$500,000 to SMEs in remote areas or for specific value chains, such as local food crops.
- Impact bonuses are given to domestic lenders for loans extended to SMEs that meet higher requirements on environmental and social performance, gender inclusion, food security and nutrition.
- Aceli Africa accompanies these incentives with technical assistance to agrifood SMEs and capacity-building for domestic lenders.

Aceli Africa's budget for 2020–2025 is US$75 million, more than 50 per cent of which is used to provide incentives. As of October 2023, Aceli Africa's incentives have supported 1,404 loans totalling US$142 million (60 per cent of loans to first-time borrowers). The SMEs receiving loans employ 25,000 workers and provide market access to 834,000 smallholder farmers. Enterprises returning for a second loan have increased revenues by 27 per cent.

Sources: SDC, 2022; Milder, B., personal communication, 12 October 2023

Using insurance to improve credit risk profile

Despite the economic importance of the agrifood sector, agricultural insurance in developing countries remains rudimentary, with low coverage rates and a limited range of products. For example, out of the 600 million farmers in Africa, only 600,000 have insurance coverage (Stevens, 2023).

Continued donor financing is needed to increase affordable, indemnity-based, weather-indexed and crop-indexed insurance for the missing middle. Insurance is particularly important as climate change intensifies. It enables SMEs to maintain their income, recover faster and continue to operate despite weather events and failed harvests. Insurance also increases the eligibility of SMEs for pre-harvest financing to cover the costs of seeds, fertilizers, equipment and more (see Box 4).

Box 4 - National Agriculture Insurance Scheme, Rwanda

Despite the participation of local insurers and international underwriters, the launch of an agricultural insurance pilot in Rwanda in 2011 was met by low demand. This was due to the high cost of premiums and low awareness of the benefits of insurance for agrifood SMEs and smallholder farmers.

In 2019, the Ministry of Agriculture and Animal Resources of Rwanda launched a new programme, the National Agriculture Insurance Scheme, in partnership with three insurance companies: SONARWA, PRIME Insurance and Radiant Insurance. The scheme included government subsidies that covered 40 per cent of the premium payments for weather-indexed and yield-indexed insurance. This increased the eligibility of smallholder farmers and SMEs for pre-harvest financing.

The One Acre Fund, supported by donor concessional finance, is also a key participant in developing Rwanda's agricultural insurance market. In 2023, the Once Acre Fund, in partnership with the International Finance Corporation (IFC), the United States International Development Finance Corporation (DFC) and the African Risk Capacity Group, launched the One Acre Fund Re, a reinsurance facility to provide risk transfer projects to smallholders.

Source: Access Finance Rwanda, 2020; One Acre Fund, 2023

The case for a food and agriculture credit risk assessment tool

The representatives from the United Nations Economic Commission for Africa, as well as several impact investors participating in the enquiry, recommended the development of a credit risk assessment scorecard for domestic lenders, including both banks and non-bank institutions.

Armed with such a scorecard, domestic lenders would be better placed to evaluate agrifood enterprises. Based on the internal rating methodologies and loan-specific details such as the value, maturity and borrower's track record, domestic lenders will be able to accurately price the risk of loans and distinguish between real and perceived risks in agrifood lending.

Such a scorecard can also increase the appetite of domestic lenders to make better use of donor-funded guarantees and credit lines. Moreover, they can collaborate with impact investors and DFIs. The scorecard should be designed to address full spectrum financial risks, including the Know Your Customer regulations (to prevent financial institutions from being used for money laundering, terrorist financing, fraud and other illicit activities), agrifood business-specific risk, climate risks, and environmental, social and governance (ESG) aspects.

Developing SMEs' financial skills

Many stakeholders participating in the enquiry expressed concern about the financial literacy of agrifood SMEs and farmer cooperatives and their minimal skills in bookkeeping and accounting. Moreover, even when financial skills exist, many SMEs do not maintain records of their cash flow. Investors are therefore not able to estimate the financial health of SMEs, further exacerbating the lending gap that results in the missing middle.

During the enquiry, several blended funds were categorical on the challenge of assessing market share, which is a key element in investment decisions. Market share is typically assessed by estimating the total addressable market: the revenue opportunity from equity and loans if 100 per cent of the market share were achieved. From then on, investors continue to estimate the total serviceable market: the number of clients the borrowing SME could realistically seek to reach. These estimates are important, since they show investors the growth potential of both the borrowing SMEs and the market in which they operate.

Investors remain cautious regarding estimates of the addressable market, since very few SMEs have the maturity and accounting skills to make such calculations, manage loans and financially administer the growth of their business. In fact, the lack of financial management skills partly explains why most SMEs maintain poor or no records of their financial performance and the fluctuations of their cash flows across months and years (Mang'ana et al., 2023). This skill gap is therefore another contributor to the missing middle.

Impact investors and donors participating in the enquiry also commented that most technical assistance programmes are yet to include financial literacy and baseline skills on financial management. Rectifying this could result in truly transformative improvements in SME financing.

> *"There are few investable agribusinesses that are ready for blended and commercial capital. This speaks to the inherent risks in agriculture that are made worse by poor infrastructure, complexity around land ownership and market distortions from badly conceived policies."*
>
> *(Fund manager, Shamba Centre stakeholder enquiry into sustainable finance, 2023)*