

STRENGTHENING THE FIRST MILE

Enabling small and medium agribusinesses to unlock development in Tanzania, Uganda and Kenya



END HUNGER >>> GROW FARMING
FARM AFRICA

FARM AFRICA has been working in East Africa since 1985.

We aim to reduce poverty permanently by unleashing smallholder farmers' ability to grow their incomes and manage their natural resources sustainably through:

- increased production of quality cash/nutritious crops
- sustainable management of livestock and fisheries
- establishment of market linkages
- development of agro-enterprises
- integration with value chains
- improvement of natural resource management
- climate resilience

Farm Africa is committed to supporting men and women as well as youth to play an equal role in agriculture and natural resource management.

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Strengthening the first mile is the synthesis of a report that was researched and prepared for Farm Africa by OGIVES Ltd.

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EXECUTIVE SUMMARY

It is now widely accepted in the development sector that assisting smallholders and subsistence farmers alone is not enough to bring about widespread development in Africa.

For more than 30 years, Farm Africa has been providing assistance to smallholder farmers as a key to the development of their regions, countries and the continent. We now recognise that support is needed not only for small-scale farmers, but also for the rural agriculture small and medium-sized enterprises (SMEs) that buy produce from small-scale farmers, and supply goods to them.

We call these 'first mile' businesses.

The 'first mile' connects small-scale farming to wider markets. For example, first mile businesses amalgamate crops from a number of farmers and sell their produce together to larger food manufacturers. They provide goods and services such as milling, cleaning, packaging, fuel, transport and equipment to small-scale farmers.

This report maps the various financial instruments that should be provided for agricultural SMEs' needs, enabling them to grow. It has uncovered a major gap in provision for this particular size and type of SME. They are not getting the finance they need to invest, professionalise or develop.

The 'first mile' market is failing.

Without a healthy and vibrant sector of services that connect small-scale farming to wider markets, smallholders cannot upscale their businesses and their development is stifled.

This research finds that SMEs are not applying for the finance that might help them to grow. Among the reasons for this are:

- SMEs do not know about the range of products available to them, nor how they work
- They find lending from banks and other financial institutions too expensive to use profitably
- They do not have the experience, managerial capacity or business planning skills to apply for loans successfully

It also finds that financial institutions are failing to finance agricultural SMEs. Financial institutions regard SMEs as:

- too risky and unprofitable to lend to
- poorly managed, inexperienced and lacking sound business plans
- undercapitalised and without sufficient assets such as land against which to lend

The research concludes that there is a 'missing middle' of financial products that are suitable for agricultural SMEs and that this is holding back their growth.

Agricultural SMEs tend to be too big for very small-scale loans offered by NGOs and others, but too small to be able to borrow money from commercial lenders affordably and viably. There is a need for an innovative platform to bring tailor-made loan products to agricultural SMEs.

Farm Africa's Maendeleo Agricultural Enterprise Fund (MAEF) is a 'non-returnable investment' mechanism that can be directed at these first mile SMEs.

Alongside providing short- and longer-term finance to agricultural SMEs, the MAEF model has at its heart the provision of training and capacity building for the businesses it works with. This intensive training will make the SMEs more robust, better managed, better prepared for growth and, vitally, a safer prospect for commercial lending in the future.



The 'missing middle' of financial products

'First mile' agricultural SMEs are not getting the finance they need to invest, professionalise or develop

Microbusinesses



SMEs





Large businesses



Financial products available:

-  Small-scale grants from NGOs
-  Loan guarantees from NGOs
-  Loans from micro-finance institutions
-  Business angel financing

Financial products available:

-  Commercial loans
-  Bank overdrafts
-  Asset leasing and finance
-  Venture capital, equity finance and growth capital
-  Trade finance

THE MISSING MIDDLE

Number of firms

Size of business

INTRODUCTION

Farm Africa has been working to support small-scale farming in East Africa for more than 30 years.

With other NGOs we have come to understand that supporting smallholders and subsistence farmers alone is not enough.

These farms are dependent on a sector of 'first mile' agricultural small and medium-sized businesses that provide the link between their own front gate and larger regional, national and even international markets.

Without a healthy 'first mile' those small-scale farmers cannot operate efficiently, nor can they profitably sell the goods they produce.

It has become clear that supporting the smallest scale farmers also requires support for these agricultural SMEs. The focus has to be on both farm production, and the linkages between that production and wider markets.

In order to explore support for smallholders in eastern Africa, Farm Africa commissioned research into the 'first mile' market in the three biggest countries in the region, Tanzania, Uganda and Kenya, and their access to finance.

The analysis draws on a review of the literature and World Bank Enterprise Surveys data, supplemented by consultations with key informants, interviews with financial sector players, and structured questionnaires administered to selected SMEs.

The research aimed to explore the size of the sector and what constraints agricultural SMEs were facing on their growth.

This report outlines the key findings of the mapping exercises, draws some conclusions about why agricultural SMEs are not getting the finance they need, and proposes an innovative Farm Africa tested model for filling the finance gap SMEs are facing.



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80% of the population in East Africa depend on agriculture.

SECTION 1

THE FIRST MILE: DRIVERS OF ECONOMIC EMPOWERMENT

The economy in East Africa is very heavily reliant on small-scale, private and mostly rural agriculture. By far the majority of employment and earning is done at a family scale, with farmers and smallholders depending on their crops and livestock farming for their livelihoods.

Some 80% of the population depends on agriculture, which accounts for approximately 30% of regional Gross Domestic Product in Kenya, Tanzania and Uganda. More than 80% of farmers engaged in agricultural activities are smallholders with less than two hectares of productive land. Many smallholders work at subsistence levels, and women constitute the majority of farmers, producing more than 70% of food.

However, to operate efficiently and to grow, this major smallholder sector depends on a sector of so-called ‘first mile’ services that connect the small farm’s front gate with larger markets that buy their produce, and that supplies farmers with the equipment and resources they need to meet market need.

Such agricultural small and medium-sized enterprises for example, may act as wholesalers for smallholders’ crops, as providers of transport to markets, as providers of equipment, seeds and resources to farmers, and as brokers between groups of farmers and larger buyers.

They provide the “push” in terms of productive services and technologies needed to meet the “pull” provided by the first level buyers of smallholder products. A highly successful example of this is the Kenyan horticulture export industry, where farmers with less than one acre of land supply vegetables to Europe’s leading supermarkets, via first mile aggregators.

80% of the population depend on agriculture

The majority of farmers are **women**, producing more than **70%** of food

Agriculture accounts for **30%** of regional **Gross Domestic Product**

First mile businesses

The following is just a sample of the types of services that SMEs provide and illustrates how they are a vital connection between small-scale farming and wider markets.

- commercial millers and other foodstuff processors
- packagers of produce for national and international markets
- wholesalers, aggregating produce from a number of small-scale farmers
- transport providers
- milk processors, bottlers, pasteurisers
- suppliers of farming equipment, fuel and resources

As such, agricultural SMEs are one of the most important players in the development of the agricultural economy. Without agricultural SMEs, the small-scale farming economy in East Africa cannot grow, which means that economic development in those countries is restricted. It is clear that the rural economy will not develop without a strong agribusiness sector.

When agribusinesses are strengthened in the region, there are also a number of additional positive impacts for small scale farmers and underserved communities, as well as for the SMEs themselves and for the wider economy.

Enabling local growth

When agriculture is able to grow at a local level, farmers are able to earn more capital that can be reinvested locally, enhancing capacity and efficiency, and growing returns. Families are able to move from subsistence farming into more profitable farming businesses. According to other research¹ (GIZ 2011), when a major agribusiness gets involved in a supply chain, for example as processors, large traders, exporters, or financial service providers, that supply chain is strengthened.

Access to a large, untapped, underserved market

By building the capacity of SMEs they become capable of increasing investment and profit, and become bankable enterprises, thus enabling financial institutions to expand their loan business.

Increased brand value engagement with communities and policymakers

Successful SMEs will have an impact on rural communities with whom they will develop strong partnerships, become pioneers in agricultural venture philanthropy, and build long-lasting legacies.

Increased social impact

Women farmers' access to better markets facilitates greater spending on family welfare, nutrition, and girls' education. A strong gender-sensitised SME sector enables women smallholder farmers to sell their produce and

access credit and agronomic support. Social impact investors in project areas gain a better entry-point for action – such as, for instance, to address youth unemployment.

The financial sector has around 100 commercial banks (Kenya – 43, Tanzania – 34, Uganda – 23) and financial institutions are aggressively courting private business. All banks interviewed expressed a strong commitment to serve the SME sector. Most of the banks have SME departments with varying degrees of understanding of what constitutes an SME, whether by annual turnover, number of employees, or financing needs. A number of banks are also trying to formalise their relationships with SMEs through 'Business Clubs' for SME managers and overseas trips to market trade finance products.

In Farm Africa's work with smallholders over the last 30 years in this region, and in the experience of other NGOs, it has become clear that this vital SME sector is in fact failing to grow and develop as needed. As a result, development of the small farmers sector is restricted.

It is clear that financial institutions are not lending to agricultural SMEs (the 'supply' side). And SME agribusinesses are not applying for finance (the 'demand' side).

This research aimed to examine the state of the agricultural SME sector in rural East Africa, as well as the finance available to them, to understand why the market is failing.

The research aims to draw conclusions about:

- why financial institutions are not lending to SMEs
- why SMEs are not accessing the finance that should be available to them
- what barriers are restricting the financial market for SMEs
- how those barriers can be overcome

¹ German International Development Agency, 2011

SECTION 2

KEY FINDINGS OF THE RESEARCH

What is an agricultural SME?

Lack of data means the exact number of SMEs, especially agribusinesses, is unknown. There is also a very flexible and sometimes very wide definition of SMEs in the agribusiness sector. The only consensus is that an SME must be a formally registered entity.

But there are estimated to be far more agricultural SMEs that are not formally registered, operating under the official radar either because their owners do not recognise themselves as formal businesses, or because they wish to avoid formal 'red tape', or simply because they do not know about legal requirements with which they are expected to comply.

For the purpose of this report, four main criteria have been applied to define an agricultural SME:

- Number of employees: five to 150
- Turnover below US\$5 million
- Net assets below US\$100,000
- Financial requirements between US\$5,000 and US\$500,000

But it should be noted that SMEs vary widely within even these definitions.

GrowFin, a specialist development financier across Africa, has suggested that the definition should instead be based on what SMEs are currently unable to do: they are considered too large to access very small-scale micro-finance such as personal loans from development agencies. But they are considered too small and/or risky to access commercial finance on decent terms.

An important finding is that rural agricultural businesses are generally far smaller than the mean SME, so financial and other pressures due to small size are likely to be exacerbated among agricultural SMEs.

This research revealed a pattern of poor access to finance specifically because of the small size, relative youth and informality of the agricultural SME sector.

For example, lenders considered agricultural SMEs to lack professionalism and to be poorly structured (which is likely to be down to their relative immaturity, as well as their sole ownership), that they were weak, vulnerable and unstable (which is likely to relate to their small size, and very localised operations), and that their profit margins were low, unpredictable and depended on low volumes of production (also likely to relate to their small size, and localised nature).




Various reports, surveys and government data have revealed a number of characteristics of the SME sector as a whole in East Africa.

Enterprises are relatively young <20 years old




Predominantly **male-owned** and managed



Women full-time workforce

| SME Size | Percentage |
|-------------|------------|
| small SMEs | 43% |
| medium SMEs | 36% |
| large SMEs | 22% |



75% of establishments employ fewer than 50 people

Financial instruments and barriers to SMEs

The major part of this research was to assess the various finance vehicles available to agricultural SMEs in rural East Africa. Specifically, Farm Africa looked at whether lenders were extending finance to SMEs, and whether SMEs were taking up these finance instruments.

The findings are outlined in the table below.

| Table 1: Financial instruments available to SMEs | |
|---|---|
| Financial instruments | Barriers to SMEs |
| <p>Short-term loans, bank overdrafts and lines of credit</p> <p>Working capital allows SMEs to pay suppliers and meet ongoing operational expenses. In agribusinesses, which rely on anticipated orders and supplier credit, access to short-term capital is vital to bridge the gap between paying suppliers and getting paid by customers.</p> | <ul style="list-style-type: none"> ■ The supply of affordable short-term finance is generally insufficient, and expensive money lenders fill the gap. ■ SMEs often don't take advantage of this form of finance due to ignorance, unfavourable terms and risk aversion among financial institutions. ■ Interest rates are relatively high compared with profit margins achieved by agricultural SMEs – making borrowing an unprofitable way of pursuing growth. ■ There is a shortage of financial products that can be used for short-term working capital. Businesses are forced instead to opt for traditional loans which entail lengthy approval procedures and higher costs. |
| <p>Medium and long-term loans</p> <p>Agribusinesses require medium- and long-term loans for investment in their businesses, to enable growth.</p> | <ul style="list-style-type: none"> ■ Demand for this type of finance is relatively high among these SMEs, and significantly higher than the regional supply. ■ Most SMEs required medium- and long-term loans for their latest business growth (90% in Tanzania, 71% in Kenya, 68% in Uganda) but only a minority were able to get the loans (20% in Tanzania, 39% in Kenya, 17% in Uganda). They reported interest rates were too unfavourable or application processes too complex. ■ In contrast to agribusinesses' expectations, rejection rates were actually very low for loans in all countries, with unacceptable co-signers and incomplete applications the leading reasons for rejection. ■ SMEs with ongoing personal relationships with their banks were more likely to get favourable lending and support for a loan application. ■ Financial development surveys have identified that financial institutions are unwilling to lend to SMEs in general, and agribusinesses in particular, because they tend to be risky, uninsured and cannot show how they mitigate risk. ■ Availability of medium- and long-term finance is not the primary problem, rather the inability of agribusinesses to access it because of stringent terms, cumbersome procedures, conservative lending by financial institutions and high costs. |

Asset leasing and asset finance

Agricultural SMEs require assets such as buildings and vehicles to operate. Most businesses prefer to buy assets outright: either by complete purchase, or by borrowing to make the purchase (asset financing). But the option of asset leasing is also available, and it is growing in the region.

- Asset financing is available in all three countries, with borrowers able to obtain up to 80% of the value of an asset over six to 60 months.
- Affordability of asset finance remains a key problem for these SMEs. It is considered an expensive way for them to acquire the equipment, land or buildings they need.
- Asset leasing is still in its infancy, though the trend is increasing.
- Asset leasing is regarded as a favourable alternative, but it is not well known among agricultural SMEs. There is far more supply than demand. The recent move by governments to adopt leasing has raised its profile, but it will take time to gain popularity.
- Leasing is virtually absent in rural areas due to the high costs involved in management, monitoring and repossession of assets. Agribusinesses, therefore, find it difficult to access the services.
- Most asset leasing products require 20-30% of the cost of the equipment as downpayment. This is a large outlay of capital to commit upfront.
- Because the sector is immature, there is a lack of robust governance and legal framework for asset leasing. This restricts financial institutes leasing to those companies with a good track record.

Grants and guarantees

A number of national and international organisations, including NGOs, provide non-repayable grants to agribusinesses, or to act as guarantors for loans that would not be secured any other way. This type of finance would allow agribusinesses to access additional finance elsewhere, leveraging more potential for investment.

- Both national and regional grant schemes exist, but most operate in isolation without collaboration with banks and financial institutions. Their financial leverage is therefore curtailed, meaning agribusinesses are not finding grants unlocking further finance for their growth.
- Kenya and Tanzania have well structured, government-backed, credit guarantee schemes. Most have at least one international provider behind them. Given the reluctance of banks to lend to SMEs, the potential for credit guarantees in this sector is immense.
- However, SMEs are either unaware of the existence of guarantee schemes or do not know which financial institutions are managing them.
- Operation of credit guarantee schemes is opaque and appears secretive, meaning the target beneficiaries do not use them.
- Partner financial institutions are not encouraged, as part of loan guarantee schemes, to lend for long-term capital growth (preferring to lend for short-term working capital). This restricts the impact guarantees can have in transforming the agribusiness sector in the long-term.

Venture capital, equity finance and growth capital

Investors provide funding in the form of loans and/or equity in exchange for a stake in, and control of, a business. In the region, this form of finance is in its infancy. It is composed mainly of social investors and quasi- government investors that obtain their funds from external sources.

- According to infoDev there were 21 national and regional investment funds operating in East Africa in 2013, with funds ranging from \$1 million to \$170 million.
- Agribusinesses feature considerably in this form of finance, but usually only for investments of over \$500,000. Two-thirds of funds do not engage in smaller deals, restricting access to this form of finance for established businesses looking for modest growth or investment in new machinery or products. New start-ups or early-stage ventures (requiring \$25,000-\$200,000 investments) are poorly catered for.
- The minimum investment size is generally beyond the size and capacity of most agricultural SMEs in the region.
- SME are not accessing this form of finance because they do not know about it, but also because they are reluctant to cede control of their businesses.

Trade finance

This includes import and export letters of credit, trade insurance, advances of foreign currency, and more.

- This is a developed sector in the region, with the majority of commercial banks offering trade finance. Moreover, banks expressed a commitment to financing SMEs through trade finance. It is clear, though, that their concentration is on larger corporations.
- Competition in the trade finance sector is low, meaning loans can be expensive. This is the biggest barrier to SMEs accessing trade finance, making its use unprofitable.
- At the same time, insurance to cover trade finance loans is expensive or restrictive because of political risks in export countries.
- The biggest restriction to SMEs accessing this form of finance is their lack of management capacity, technical skill and awareness of the market. Most banks find structuring trade finance with SMEs arduous.
- There is an immature legal and regulatory framework for trade finance in this region. Dysfunctional systems for registering, monitoring and enforcing repayment for financed goods is a key obstacle to lending to the SME sector.
- All transactions must be carried out through an accredited lawyer, and stamp duty is applicable, making this form of finance too expensive for many SMEs.

Business angel (investment club) financing

This is informal financing, through family and friends, philanthropic investment and investment clubs.

- This is an under-researched sector in East Africa.
- The confidential nature of most business angel investment makes it difficult to draw conclusions about the use and restrictions of this form of financing.
- There is a number of other similar innovative financial vehicles in the region, such as mezzanine financing and buyout capital, but information about them is very limited.



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SMEs struggle to find finance for vital assets such as buildings.

Other finance-related restrictions on SME growth

As well as the limited availability of financial products to agricultural SMEs, Farm Africa also identified other weaknesses in the agribusiness and financing sectors that are holding back SME growth.

Lack of professional staff

Agricultural SMEs are managed by semi-professional people who rely on grants from international organisations and business angels. They have difficulties employing competent professionals because of unaffordable salaries. They generally lack the capacity for strategic planning and management systems. A majority of their employees have limited skills, and most often are family members or relatives of senior officials.

Uncertainty

They operate in unpredictable and chaotic environments, hence present a weaker and unstable supply chain. Financial institutions are highly averse to and have limited capacity to handle unpredictable and devastating events. Unpredictable government interventions to minimise the impact of catastrophic events, such as the common decrees to write-off agricultural loans, shift unreasonable burdens to financial institutions.

Cashflow

Late payment by buyers and inability to generate their own finances or access to finance from formal sources make most agricultural SMEs undercapitalised and dependent on informal lenders for short-term liquidity.

Weak business plans

High financial and business illiteracy among SMEs means they have an inability to prepare and present business plans. This is the single most important reason why SMEs do not apply for credit, and why banks decline credit applications.

Limited market data

Inadequate quantitative data about the agribusiness market or SMEs makes it difficult for banks to assess market needs, size, and risk. Where data is available it is often incomplete and not accurate; would-be commercial financiers encounter significant difficulties and spend substantial resources in loan approval decisions.

Isolation

Most enterprises operate for years without complying with regulatory certification and licensing requirements. Their operations and products therefore remain outside the formal market systems. Due to legal, regulatory, and socio-cultural barriers, the majority of the agricultural SME owners do not belong to any business associations or any other platform where they can air their views. It means these SMEs operate independently, limiting opportunities and leading to under-representation in the formal sector.

Low output

Small producers lack working capital to finance production, leading to low volumes (low output, poor quality). Agribusinesses travel long distances to collect small uneconomical quantities from sparsely located producers which increases the cost of aggregation. Moreover, small producers prefer spot cash payment arrangements, which forces agricultural SMEs to allocate significant outlays of capital to support production and purchase produce.

| Table 2: Characteristics of SMEs | Kenya | | Tanzania | | Uganda | |
|---|--------------|--------|-----------------|--------|---------------|--------|
| | Small | Medium | Small | Medium | Small | Medium |
| Age of the establishment (years) | 16.8 | 21.7 | 13.0 | 14.9 | 9.9 | 11.1 |
| Privately held Limited Liability Company (%) | 11.4 | 14.4 | 2.9 | 9.3 | 3.6 | 8.5 |
| Sole proprietorships (%) | 42.5 | 23.1 | 79.5 | 66.0 | 72.8 | 38.8 |
| Firms with female participation in ownership (%) | 50.9 | 47.7 | 23.5 | 28.6 | 26.8 | 26.0 |
| Firms with a female top manager (%) | 18.5 | 8.0 | 13.2 | 18.3 | 16.8 | 10.5 |
| Permanent full-time workers that are female (%) | 30.7 | 27.1 | 46.0 | 39.6 | 40.6 | 41.4 |
| Firms having their own website (%) | 32.5 | 63.0 | 16.4 | 36.6 | 13.5 | 42.7 |
| Firms using e-mail to interact with clients /suppliers (%) | 61.1 | 87.8 | 22.2 | 49.2 | 34.7 | 56.5 |
| Firms with audited annual financial statement (%) | 74.2 | 93.2 | 35.0 | 52.3 | 48.0 | 73.8 |
| Capacity utilisation (%) | 69.4 | 72.0 | 80.9 | 79.8 | 69.3 | 76.8 |
| Annual employment growth, 2009-2012 (%) | 1.5 | 3.4 | 10.7 | 9.9 | 0.6 | 8.0 |
| Firms exporting at least 1% of sales (%) | 25.5 | 39.6 | 11.0 | 18.2 | 10.6 | 30.5 |
| Firms exporting directly at least 1% of sales (%) | 12.0 | 32.4 | 3.5 | 10.6 | 3.3 | 11.9 |
| Total sales that are domestic sales (%) | 81.4 | 80.0 | 94.4 | 92.0 | 96.0 | 86.6 |
| Firms offering formal training (%) | 35.2 | 40.3 | 27.4 | 40.0 | 29.8 | 60.6 |
| Workers offered formal training (%) | 45.4 | 49.9 | 48.3 | 52.9 | 36.2 | 55.3 |
| Number of permanent full-time workers | 8.3 | 37.5 | 7.7 | 31.9 | 8.0 | 24.3 |
| Number of temporary workers | 2.9 | 12.7 | 2.9 | 8.7 | 2.4 | 9.7 |
| Firms reporting inadequately educated workforce as a major constraint (%) | 33.7 | 20.7 | 38.8 | 47.2 | 13.9 | 9.2 |

Source: WBES Online

SECTION 3

CONCLUSIONS

After looking at the financial instruments in East Africa and the reasons why agricultural SMEs are not accessing the finance that should be available to them, Farm Africa draws the following key conclusions.

1.

Agricultural SMEs are not demanding the lending they need to grow.

- This research shows the financial sector in the region may be immature, but it does offer a diverse and growing array of instruments suitable for SMEs. However, SMEs are not accessing these financial instruments.
- Many agricultural SMEs do not know about the financial products available to them, nor who the lenders are, or how the products work.
- Agricultural SMEs are risk-averse, particularly when it comes to high-capital investment. They do not see borrowing as a viable way to invest in buildings, production equipment and other capital assets, because they fear that level of investment might be too risky. Most borrowing is short-term to ease cashflow, rather than for long-term growth.
- Most enterprises do not have the capacity, management expertise or experience to make the most of any finance they might access. SMEs do not regard borrowing as a way to grow their businesses because they do not have the knowledge or experience of making it happen. For the same reason, lenders see lending to SMEs as unduly risky.
- Many enterprises are not 'investment ready'. They have low profitability, little capital of their own to invest, and few or no assets to borrow against. They have inadequate technical skills, poor market information, and poor infrastructure.

2.

Financial institutions are not supplying the financial products that SMEs need.

- The research identified a supply side problem to access to finance for agricultural SMEs. Lenders were not providing the financial products that SMEs need, at rates that SMEs can afford, or with conditions that SMEs were able to accept.
- The financial sector in the region is not yet sufficiently developed to support the financing needs of the SME sector. Although the range of financial instruments varies from country to country, the system is not diversified, lacking various specialised institutions such as leasing companies, factoring and forfeiting institutions, and risk insurers. Only a few capital investment funds have emerged to promote longer-term financing.
- Lenders are generally disinterested in SME lending, and very few banks are lending to new businesses or to businesses with which they don't already have a relationship. Serving SME bank clients presents inherent challenges of low revenue per client and a high risk of credit losses.
- Financial institutions see agricultural SMEs as risky because of the reasons already stated: they are low profit, under-capitalised, poorly managed and lacking in capacity. As a result, many finance products are either not available to SMEs, or their interest rates are set too high for SMEs to use them profitably.
- SMEs are considered too small for investment. Several investment funds currently operate (or are about to start operating) in at least one of the three countries, with funds ranging from \$1 million to \$170 million. But most funds focus on investments requiring at least \$500,000, and only one-third focus on smaller deals (below \$200,000) and even fewer actively consider early-stage ventures.



Table 3:
Top three obstacles of SME operations

| Constraint | Kenya | Uganda |
|------------------------------|-------|--------|
| Access to finance (%) | 37.2 | 41.9 |
| Access to land (%) | 30.4 | 29.1 |
| Business license/permits (%) | 32.4 | 29.1 |

Table 4:
Selected reasons cited by SMEs not applying for a loan/line of credit

| Reason | Kenya | Uganda |
|---|-------|--------|
| Unfavourable interest rates (%) | 41 | 50 |
| Complex application procedures (%) | 15 | 7 |
| Collateral requirements too high (%) | 13 | 16 |
| Insufficient loan amount and tenure (%) | 7 | 3 |
| Did not think it would be approved (%) | 4 | 9 |

3.

There is a 'missing middle' of financial services for SMEs.

- SMEs are a size where there are few financial products available to them. They are considered too big to access the very small-scale loans made by NGOs and others to small family and micro-businesses. But they are too small to access investment or loans provided by commercial lenders, either because loans are unaffordable or because their minimum lending thresholds are far too large for SMEs to meet.
- There appears to be a 'missing middle' of financial products to serve agricultural SMEs, and this is stifling growth in the sector. The knock-on effect is that growth among small-scale rural farmers is hindered also.

Source for both:
World Bank Enterprise Surveys 2013

CREATING FINANCE IN THE MISSING MIDDLE

This market analysis reveals that there is a need for an innovative platform to bring tailor-made financial products to agricultural SMEs. In particular need are those SMEs that do not receive assistance from development actors and are also not able to access loans from banks and other financial institutions – the missing middle.

By supporting these SMEs to enhance their access to finance, such schemes would enable SMEs to engage better with smallholder farmers to improve their production systems and increase incomes. That would further the development goals for rural areas in particular in these East African nations.

The MAEF Model

The Maendeleo Agricultural Enterprise Fund (MAEF) is modelled along the 'venture philanthropy' approach. It is a 'non-returnable investment' mechanism directed at smallholder farmers via SMEs.

Alongside the financial instruments at its core, the MAEF includes a component for systematic business training of SME owners, based on existing knowledge and experience in the region.

It works in partnership with other organisations such as banks, business service providers and accounting firms to outsource training where specialist expertise is needed. Examples of external support include: new product development, standards certification, financial planning, business plan preparation, bookkeeping and accounting, and specialised studies and analyses.

It is clear such training and knowledge sharing not only improves the growth potential of the agricultural SMEs themselves, but also tackles some of the issues of poor management and technical ability that are currently restricting lending to them by commercial financial institutions.

Philanthropy

Giving money or time to improve the welfare of others

+

Venture capital

Financial capital provided to early-stage, high-potential, growth startup companies

=

Venture philanthropy

Building stronger social purpose organisations by providing them with both financial and non-financial support to increase their societal impact



Agricultural small and medium-sized enterprises often act as wholesalers for smallholders' crops.

The Challenge



Micro businesses
Supported by NGOs



Small to Medium SMEs
The 'missing middle'



Large businesses
Supported by commercial loans

How MAEF helps



Capital



Agronomy



Business



Marketing

The results



SMEs grow



They become part of a functioning market that smallholder farmers can engage with



Smallholders increase their productivity and profitability

The objective of MAEF is to support agribusiness SMEs to develop the capacity to serve farmers in a competitive market. It works on three pillars:

Pillar 1: Strengthening capacity.

To improve access to finance, agricultural SME capacity needs strengthening, especially their managerial and financial control. MAEF funds activities to provide technical support and training to SMEs to improve their internal organisational capabilities.

Pillar 2: Financing the bridge to growth.

While undergoing capacity building, the SMEs must continue serving farmers. MAEF structures non-recoverable grants that will enable SMEs to continue to provide services for farmers. It is also developing plans to provide recoverable finance to SMEs to provide operational capital. To qualify, SME grantees will have to cede some degree of managerial and supervisory control to MAEF managers.

Pillar 3: Unlocking further financial services.

We find in this report that financial institutions consider agricultural SMEs high-risk and unviable businesses that are not worth lending to. The MAEF proposes to work with financial institutions to correct this perception. It also plans to provide guarantees to financial institutions on behalf of SMEs, to increase the availability of financial resources available to them and lower the risk of lending for the financial institutions.

In the long term we hope MAEF will create a sustainable marketing relationship between farmers and SMEs, enhancing farmers' capacity to interact with market players directly. In many cases, operations are also partly self-financed from the outset by the partner SMEs or beneficiaries.

Experience from Farm Africa projects tells us that we can estimate that for every \$1 invested, on average, nearly \$3 of income will be generated, not including what the SME makes.

The initial structure of MAEF in East Africa

We anticipate that average 'investment' will range from \$120,000 to \$200,000. These figures are around the size of loans that SME agribusinesses have found it hard to obtain in the commercial sector.

We envisage initial allocation as follows:

- 40-45% agronomic and marketing support (farmer and SME capacity) - in the form of a grant
- 15-20% revolving fund and/or bank guarantee
- 35-40% capacity building, management and other support to the SME

In all cases, the principle will be to provide sufficient technical and development assistance in other forms to build the capacity of the SMEs to access commercial finance over the long-term. We will support farmers to engage in commercial marketing relationships, without creating dependency.

Table 5:
Calculation of return on investment on a typical agricultural product

| | |
|---|--------------------------|
| Average investment in the form of a grant to the SME | \$120,000 |
| Number of farmers engaged | 2,000 |
| Product volume | 2MT/farmer ¹ |
| Farm gate price | 33 cents/kg ² |
| Total sales | \$1.32 million |
| Net income for farmers (25%³) | \$330,000 |
| Income per farmer | \$165/annum |
| Income generated per \$ invested | \$2.75 |

¹This will vary depending on the crop/product and it is calculated per annum.

²Based on average farm-gate prices and Farm Africa knowledge and experience.

³Calculated based on average gains from total sales, minus production costs, by farmers. Although most smallholder farmers use family labour on farm, the percentage used in this calculation assumes hired labour. Under most circumstances, the gross margin, and therefore household returns will be significantly higher.



Strengthening 'first mile' rural agriculture businesses in turn enables smallholder farmers to lift themselves out of poverty.



STRENGTHENING THE FIRST MILE

Assisting smallholders and subsistence farmers is not enough to bring about widespread development in rural eastern Africa. Support is also needed for the 'first mile' rural agriculture businesses that connect small-scale farming to wider markets by buying their produce or supplying goods to them.

The first mile market is failing due to a lack of appropriate financial products for agricultural small and medium-sized enterprises, who tend to be too big for small-scale loans offered by NGOs and others, but too small to be able to borrow money from commercial lenders affordably and viably.

Maendeleo Agricultural Enterprise Fund (MAEF) is a venture philanthropy programme managed by Farm Africa that supports the first mile market by providing working capital and support in agronomy, business and marketing to rural enterprises that in turn enable African smallholders to lift themselves out of poverty.



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