

Bridging the Financing Gap: Unlocking the Impact Potential of Agricultural SMEs in Africa

Summary Report

Full report available for download at www.aceliafrica.org



Dear Stakeholder,

At a sector convening in December 2017, lending practitioners discussed barriers to growing the finance market for agricultural SMEs: namely, the mismatch between the risk-return hurdle of capital providers and the addressable demand among businesses. Stakeholders in attendance pushed lenders to put hard evidence behind their anecdotal experiences. This report synthesizes our journey over the past two and half years: first to distill the economics of agri-SME lending across a diverse set of lenders and then to design solutions to bridge the gap - estimated at \$65 billion a year across Sub-Saharan Africa - between capital supply and demand for agri-SMEs. **Our ultimate goal is to mobilize capital flows at scale and unlock the substantial impact potential of agricultural SMEs for: economic growth, farmer and worker livelihoods, regional food security, opportunities for women and youth, and climate resilience across the continent.**

In partnership with Dalberg Advisors and with funding from 12 donors, we reviewed data from 31 lenders on 9,104 transactions totaling \$3.7 billion and also conducted in-depth interviews with lenders, technical assistance providers, and many other ecosystem actors. This report has the dual purposes of:

- 1. Sharing our conclusions: in short, lending to agricultural SMEs, particularly loans in the \$25k-\$500k range, tends to be unprofitable.** Previous debates have focused on real vs. perceived risk despite a lack of data on loan performance and even less on the composite lending economics at loan- and portfolio-levels. More data is still needed, particularly in other regions, but we believe that the evidence presented here is sufficient to conclude that i) the returns in agri-SME lending in East Africa are well below market rate and ii) solutions that go beyond the current offer are needed.
- 2. Presenting Aceli Africa's data-driven, marketplace approach to align capital supply and demand.** We also put forward a set of specific solutions, informed by this new data and stakeholder insights. Some of these solutions differ in important ways from approaches that have been tried in the past while others build on successful models. We believe that a range of solutions are needed to solve the enormity of the problem and will be testing and honing Aceli's offering to contribute to sector practice and learning for how to optimize the growth and impact of the agricultural SME finance market.

This report focuses on our data findings in partnership with Dalberg Advisors. To learn more about Aceli's product offerings, please download the [full report](#) and a [programmatic overview](#). Our data collection and the design of Aceli Africa would not have been possible without the donors on the next page and many collaborators listed in the appendix - thank you. We invite your continued engagement and welcome new partners as we embark on this next phase of implementation.

Sincerely,

A handwritten signature in black ink, appearing to read 'B Milder', is positioned above the printed name.

Brian Milder
CEO, Aceli Africa

We thank the following donors for supporting the data analysis and design of Aceli Africa:



See appendix for a full list of stakeholders that contributed to Aceli's data analysis and design process.

Investing in African agriculture is critical to achieving the Sustainable Development Goals. Yet while 60-70% of the population in East Africa works in agriculture, it receives less than 10% of commercial bank lending in most countries and as little as 2% in Rwanda. Small- and medium-enterprises (SMEs), which have the potential to facilitate pathways out of poverty for smallholder farmers and low-skill workers, are especially affected. An estimated three in four agricultural SMEs lack sufficient access to finance and the capacity to manage it, leaving an annual financing gap of \$65 billion across Sub-Saharan Africa.

In the past, limited data on the economics of financing agri-SMEs has made it difficult to identify where donor or government interventions are required and how they should be designed. Aceli Africa partnered with Dalberg Advisors to analyze data from 31 lenders on 9,104 loans to agri-SMEs totaling \$3.7 billion. The key findings explain the persistent financing gap for agri-SMEs in Africa:

- **Risk in agri-SME lending is at least twice as high** as risk in other sectors served by the same lenders in Africa; it is also twice as high for lending to agri-SMEs in Africa as in Latin America.
- **Returns in agri-SME lending are on average 4-5% lower** than returns in other sectors in East Africa.
- High operating costs and low returns of serving agri-SMEs are as significant a driver of sub-par lending economics as risk (i.e., **credit guarantees that only address risk are not sufficient**).

Informed by this data, Aceli Africa is designed as a “market incentive facility” to mobilize \$700M in lending to agricultural SMEs by aligning capital supply and demand.

On the capital supply side, Aceli will offer:

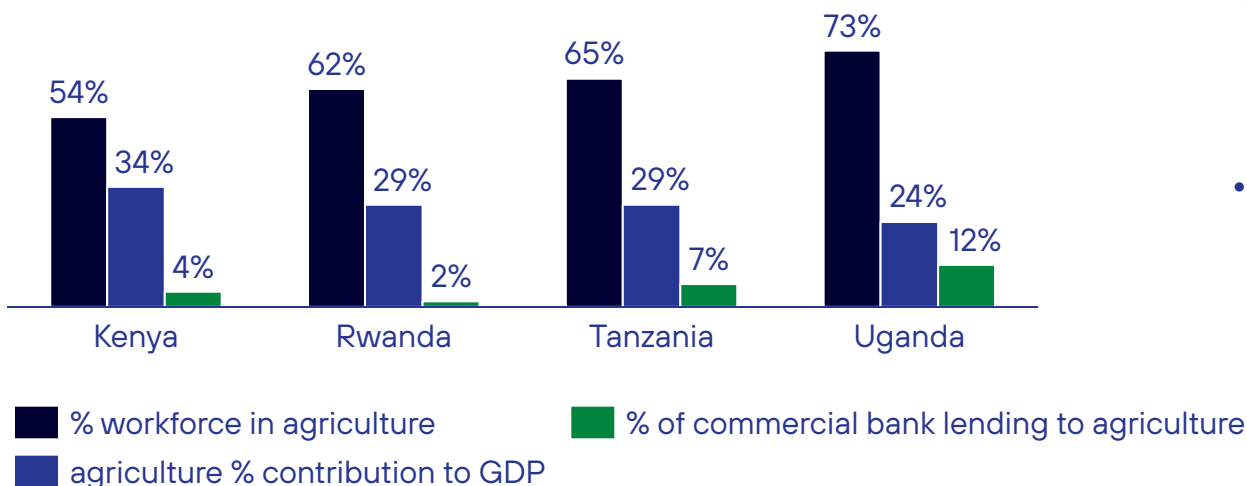
- **Portfolio first-loss coverage** incentivizing lenders to serve new SMEs by absorbing the incremental risk from increased lending.
- **Origination incentives** to compensate lenders for the lower revenues and higher operating costs of making smaller loans and serving new borrowers.
- **Impact bonuses** to reward lenders for serving SMEs that are gender inclusive, improve food security, and/or practice climate-smart agriculture.

In parallel, Aceli Africa will:

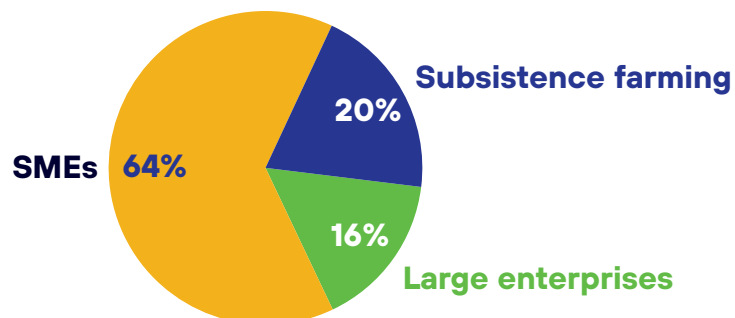
- **Increase addressable demand** through technical assistance so more SMEs have the capacity to qualify for and manage financing.
- **Build lenders’ capacity** to tailor their product offerings, enhance staff expertise, and adapt loan processes for the agri-SME market.
- **Invest in innovative** technologies and business models that drive down the costs of agri-SME lending across the market.
- **Evaluate impact**, in partnership with the [International Growth Centre \(IGC\)](#), to identify cost-effective and scalable approaches for catalyzing a thriving market for agricultural SME finance that advances social inclusion and environmental sustainability.

Agriculture & agri-SMEs are particularly important in East African economies, but the sector remains chronically under-financed

Agriculture as a share of selected East African countries' employment, GDP and bank lending (% , 2019)¹



Supply channels for food consumption in Sub-Saharan Africa (% , 2018)²



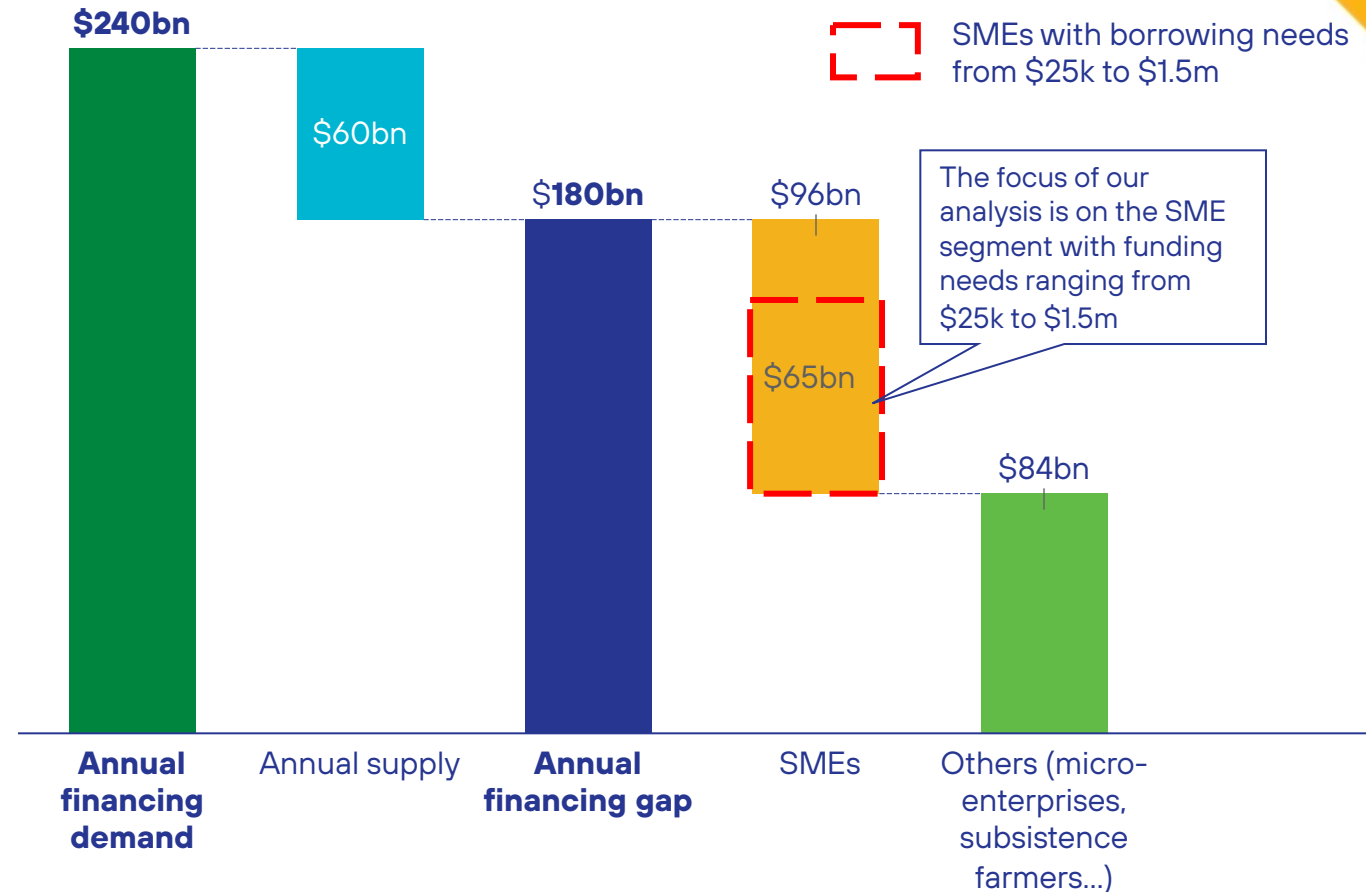
- **Agriculture is one of the most important sectors in East Africa**, representing **on average more than 60% of total formal employment** and more if the informal sector is included
- Despite its prime role in the economy, **agriculture remains heavily under-invested** by both governments and the private sector
 - Loans to agriculture represent on average less than 6% of total lending by commercial banks
 - Despite committing in 2003 under the CAADP framework to spend 10% of their budgets on agriculture, most African countries continue to spend less than 5% of their budget in the sector
- SMEs in Africa represent **~90% of total businesses** across sectors
- In Sub-Saharan Africa, SMEs constitute nearly **2/3rds of the supply channels for food consumption** and **create 70% of formal employment**³

Note. The data uses the World Bank. SME categorization from yearly "Global Financial Development Reports," i.e. businesses employing between 5 and 99 employees.

1. World Bank ILOSTAT database and national accounts data, 2019 and Dalberg Analysis. 2. Alliance for a Green Revolution in Africa, "Africa Agriculture Status Report," 2019. 3. Proparco, "SME Finance in Africa: What's New?" 2019.

Annual financing gap of ~\$65bn for African agri-SMEs with financing needs of \$25k to \$1.5m

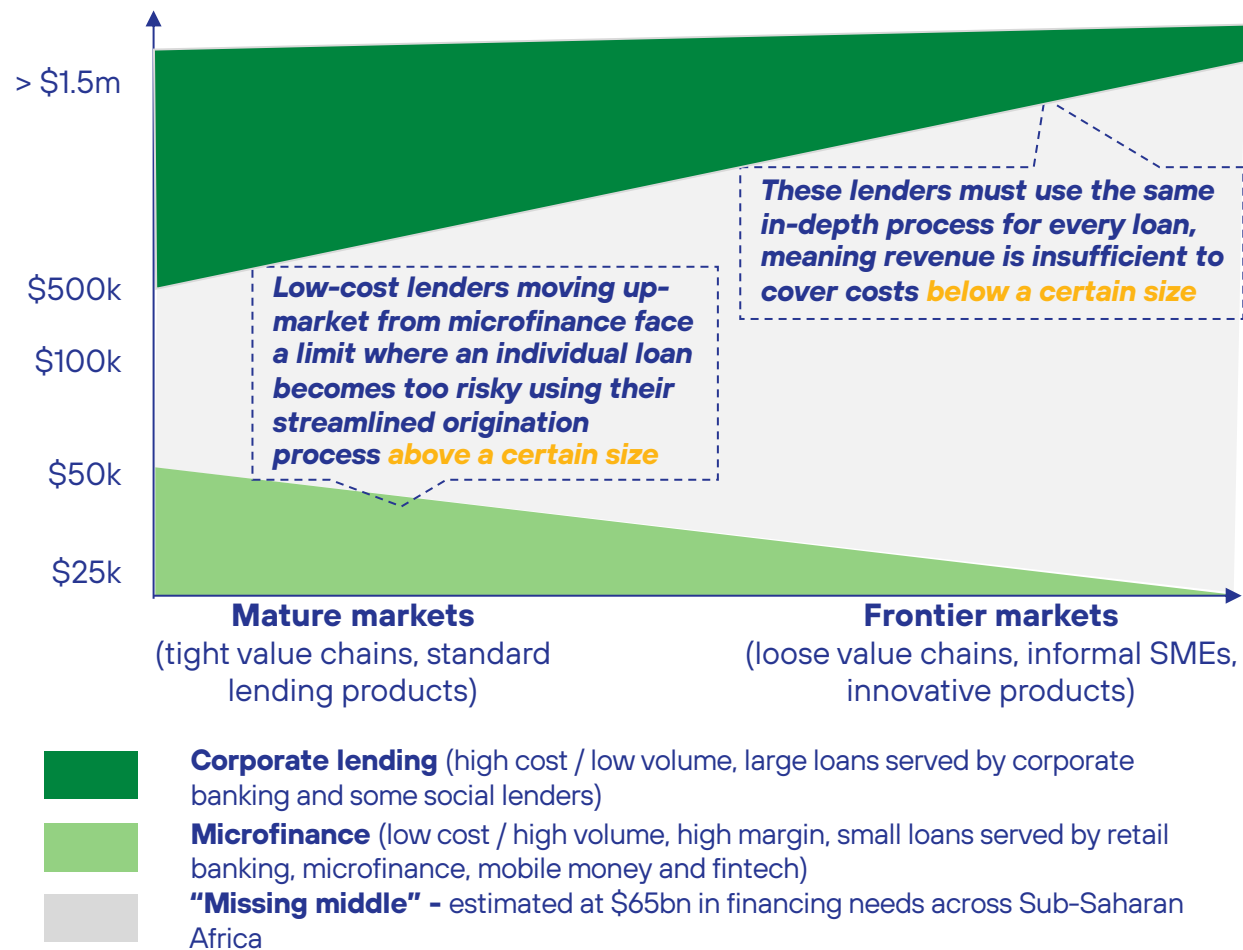
Estimated annual gap in agricultural finance, Sub-Saharan Africa (2018)¹



- In Sub-Saharan Africa, the agriculture **financing gap amounts to \$180bn** annually
- **~\$65bn**, or more than 35% of the total gap, is among **SMEs with borrowing needs of \$25k to \$1.5m**

Agri-SMEs in this \$25k-\$1.5m segment are under-financed in part because they fall between two lending business models

Illustrative representation of the African agri-SME finance market by loan size, lender type, and market segment



- The agricultural **"missing middle"** ranging from ~\$25k to \$1.5m is underserved because the loan sizes and borrower profiles are too large and too risky for microfinance and retail banking, but too small and costly to serve for corporate banking
- While there is some lending activity in the "missing middle" the unattractive economics of serving this segment (which are detailed in this report) indicate why **there still are not successful business models for serving it at scale**
- Apart from loan size, other parameters influence the agri-SME "missing middle":
 - **Informal or "loose" value chains** (e.g., many food crops) **tend to have less access to finance than formal or "tight" value chains** (e.g., coffee, cocoa, tea)
 - **Working capital facilities** made on the basis of a borrower's cash flows rather than hard collateral are **deemed too risky by commercial banks**, which are best positioned by virtue of their reach and access to local currency to serve the "frontier" end of this market

Aceli Africa and Dalberg Advisors analyzed data from 31 lenders to assess the economics and low volumes of agri-SME lending

Ingoing hypothesis

- While some are willing to finance this market segment, **lenders find agri-SME lending unprofitable relative to other market segments in agriculture and especially to other sectors in the economy**. However, prior to this analysis there was **no comprehensive data to prove it**.
- We assumed that **lenders are not adequately rewarded for the risk or cost associated with agriculture and SME lending**, two segments with higher risk profiles compared to non-agriculture retail or corporate lending.

Analysis of social lenders

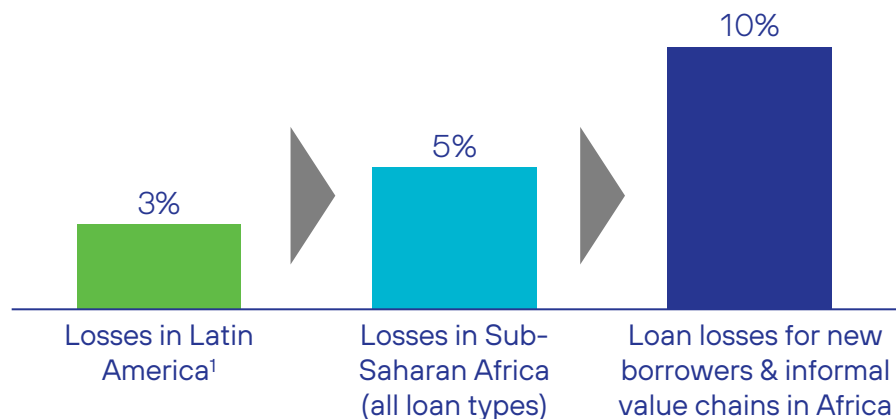
- In collaboration with the [Council on Smallholder Agricultural Finance](#) (CSAF), we reached out to 11 **global social lenders** and gathered loan-level and entity-level profitability data of agri-SME loans in Sub-Saharan Africa and Latin America.
- The analysis highlighted that profitability was indeed an issue as only half of those loans had positive net operating returns, and even less after considering costs of funds. Regionally, **lending risks were 2x higher and operating costs 22% higher for social lenders in Africa than in their more mature portfolios in Latin America**.

Analysis of other lenders

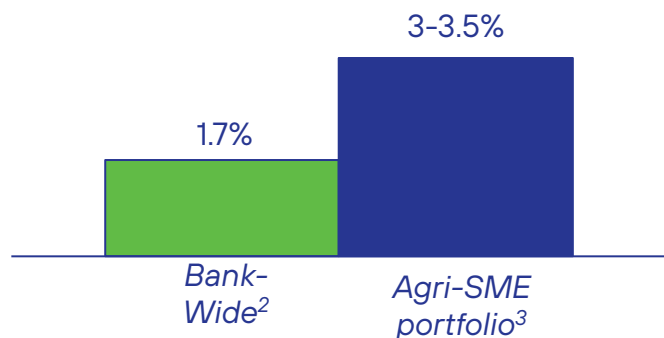
- We enlarged the scope of the analysis to **two additional business models in East Africa: non-bank financial institutions (NBFIs)** that serve the lower-end of the agri-SME segment with a high-frequency and low loan-size model, and **commercial banks** that operate with a low-frequency and large loan-size model and that serve agri-SMEs in-between their retail and corporate banking business.
- This analysis **confirmed that risk is twice as high for bank lending to agri-SMEs relative to other sectors and that operating costs are also higher – the combined effect is returns are 4-5% lower for banks in their agri-SME lending relative to other sectors.**

Data findings: Risk is 2x higher and returns are 4-5% lower for lending to agri-SMEs vs. lending to other sectors in East Africa

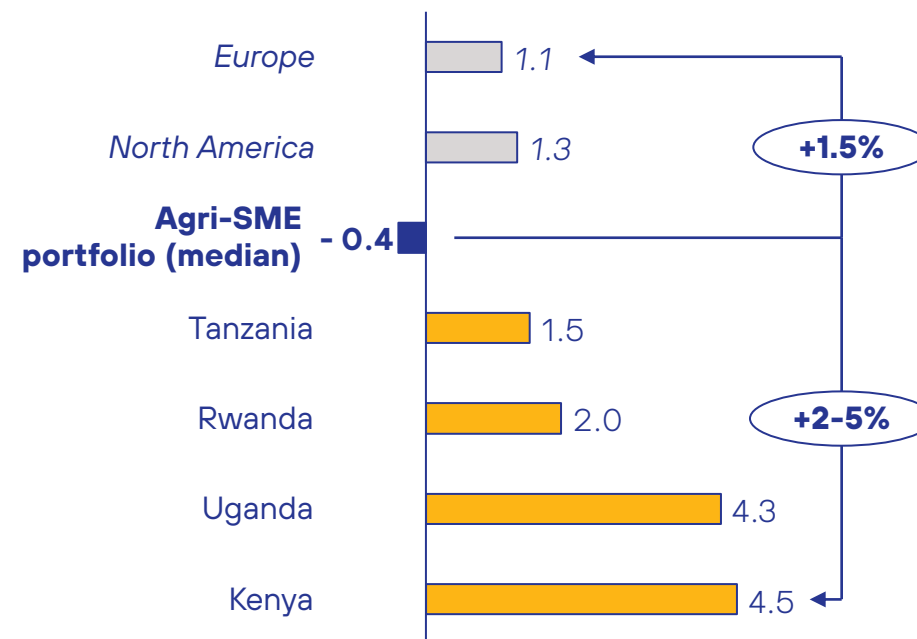
1. Risk of agri-SME lending in Africa vs Latin America for social lenders (write-off %)



2. Risk in agri-SME vs overall lending for commercial banks in East Africa (write-off %)⁴



Bank Return on Assets by region and country compared to agri-SME portfolios in our dataset (in bold) % , 2017 (latest year available)



Due to limited competition, African commercial banks earn some of the highest returns in the world. Therefore, activities that are less profitable such as agri-SME lending, present a high opportunity cost for lenders.

While agri-SME lending is often unprofitable, the economics could shift if the impact generated by these capital flows were included

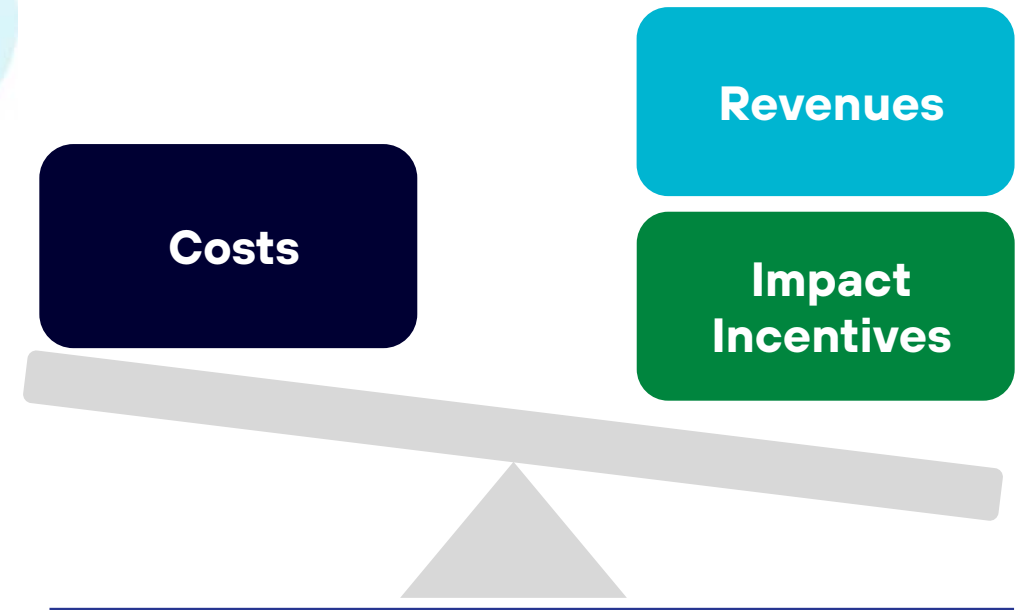
The status quo

Lenders shy away from financing agri-SMEs – and their impact potential goes unrealized – because these loans are unprofitable and lenders do not derive financial value from the positive benefits (e.g., farmer & worker livelihoods, food security) of reaching these underserved borrowers.

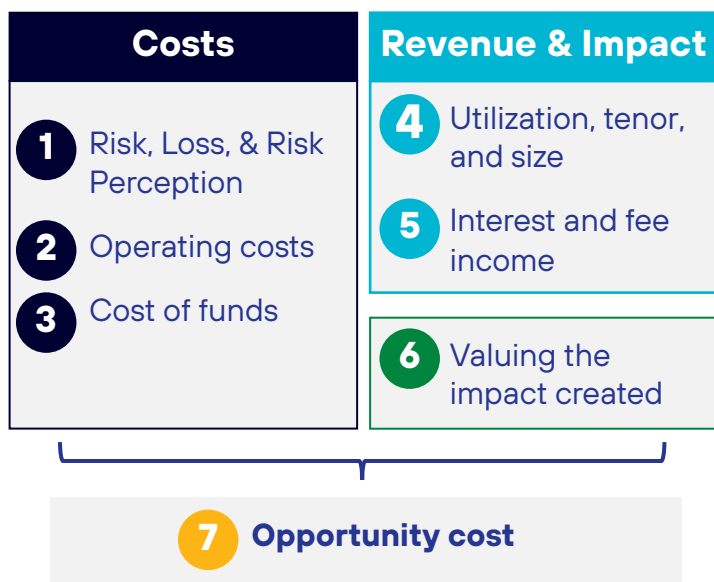


Re-balancing the scale with impact

By valuing the social and environmental impact generated by agri-SMEs lending and compensating lenders for the risks and costs of making these loans, we can increase capital flows and unlock substantial impact on farmer and worker livelihoods, food security, gender inclusion, and climate resilience.



Multiple challenges combine to make the economics of lending to agricultural SMEs unattractive

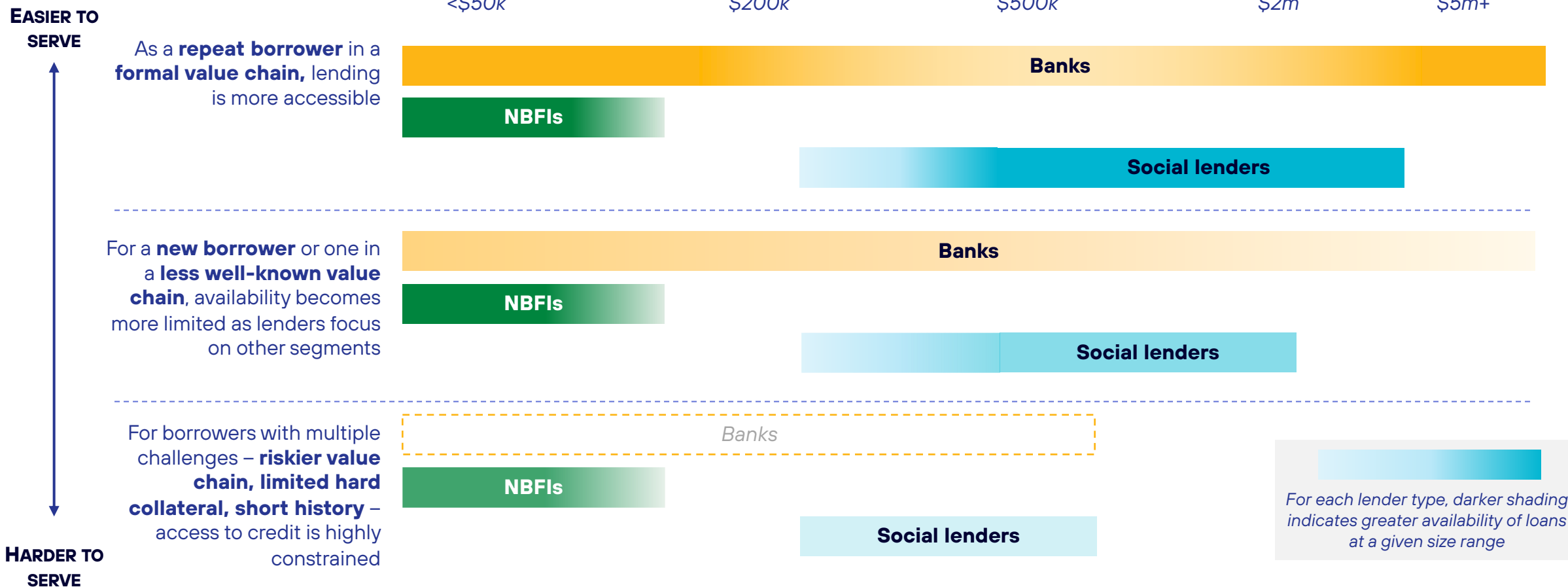


Key findings on profitability drivers from our research into agri-SME lending

- 1** Lending to agri-SMEs compounds the high inherent risks of agriculture with the informality of SMEs. As a result, lenders experience relatively high losses and often face pressure from their leadership and investors to limit exposure to the sector
- 2** Agricultural borrowers are more expensive to reach, especially for lenders with limited local presence; the cost of assessing new value chains or new borrowers is even higher
- 3** Banks and social lenders have access to relatively low-cost funding so capital providers would need to accept returns close to 0% to shift their lending economics; innovative non-bank lenders focused on smaller loans struggle with high funding costs but capital providers would need to be comfortable with additional risk and/or currency exposure
- 4** Due to the nature of loan economics (where there are significant fixed costs and revenues are linked to loan size, term, and price), lending to smaller borrowers or those with only short-term, seasonal needs is especially unprofitable
- 5** Revenues are rarely sufficient to provide a comfortable lending margin, and raising interest rates further would cause difficulties for borrowers
- 6** Many agri-SMEs are at the center of complex webs of interaction; increasing their ability to grow has positive spillover effects on livelihoods and food security, among others – but lenders cannot capture this value today so are not taking these benefits into account in their strategies
- 7** While banks have significant ability to mobilize funding for agriculture, they also face the biggest opportunity costs given the profitability of African banking overall (i.e., non-agriculture lending). Similarly, innovators are attracted to other markets with lower barriers to entry and higher returns, perpetuating the unattractive economics for agri-SME lending

Overall, we find lending limited to lower risk, higher return segments, creating gaps in the agri-SME market

Availability of credit by loan size and borrower / loan characteristics



Limited financing constrains the ability of early stage agri-SMEs to realize their growth and impact potential

The challenges in the agri-SME lending landscape require market-level, targeted interventions

Current state: Key challenges

- The **focus on mitigating risk** pushes lenders towards **strict standards** and **collateral requirements that exclude most SME borrowers** and market segments – but even so, loss and loan impairment experience is still high
- The **challenge of serving agri-SME borrowers in a cost-effective manner**, combined with the size-driven economics of lending, **push lenders away from serving smaller loans** to businesses that have growth potential and need finance
- While business model improvements offer potential for efficiency gains, there are no “quick fixes” and lenders still face **a trade-off between the customization** that agri-SME lending demands and **the ability to lend efficiently at scale**
- The **potential for technology to disrupt** current business models **is constrained** by the **heterogeneity of agri-SMEs** and **dearth of quality data**

Implications

1. A **market-based approach** is necessary to promote a **diverse set of actors** offering a **range of financial products** and serving **different market segments**
2. **Providing risk mitigation**, helping lenders improve underwriting, and building borrower capacity can **reduce the actual and perceived risk** of lending and **increase addressable demand**
3. **Defraying lenders' operating costs in the short-term** will enable them to **expand lending to new borrowers in less formal segments** and spread fixed costs over a larger portfolio to **increase operating efficiency**
4. **Innovative business models** that **leverage technology** are needed to drive down operating costs in the long run **but investments today may take years to bear fruit**

Bridging the gap between capital supply and demand to build a more competitive market for agri-SME finance aligned with impact

THE AGRI-SME FINANCING MARKET IS CHALLENGING

Challenges in agri-SME finance are not new and many blended finance instruments (e.g., partial credit risk guarantees, concessional finance, technical assistance) already exist.

Through extensive data collection and analysis, we found that lenders' profitability challenges persist, even though some already benefit from these blended finance instruments.

When it comes to incentivizing outreach to riskier and remotely located borrowers, current blended finance solutions are not sufficient.

ACELI AFRICA COMPLEMENTS WHAT EXISTS

Aceli Africa ("Aceli") is a market incentive facility, launching in Q3 2020 in East Africa, to align the risk-return expectations of capital supply with the addressable demand among agri-SMEs.

Aceli is designed to cover the incremental risk and costs of lending that is high impact and high additionality. Financial incentives for lenders are paired with capacity building for lenders and technical assistance for agri-SMEs.

Aceli's offerings have been informed by the data summarized in this report and extensive consultation with lenders and other stakeholders.

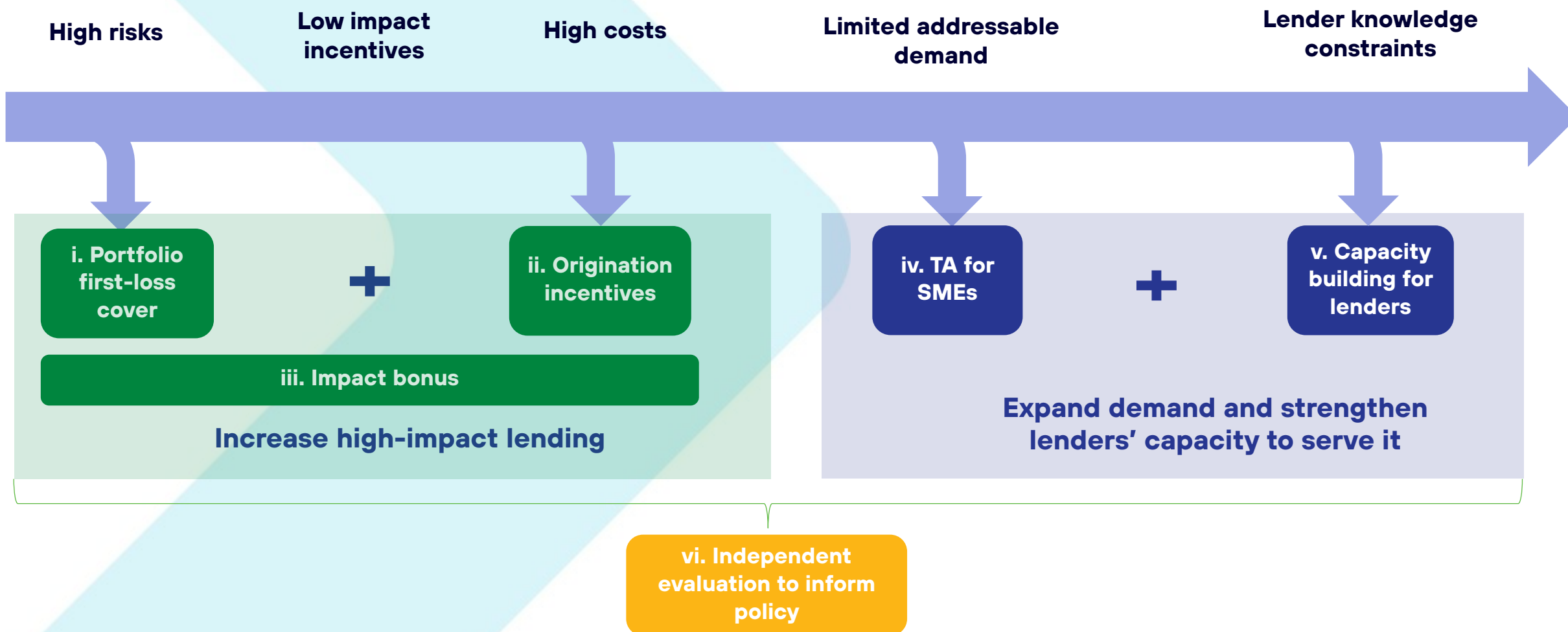
ACELI PROMOTES MARKET GROWTH, EFFICIENCY & IMPACT

By pricing in the risk and cost to serve agri-SMEs and aligning incentives with additionality & impact, Aceli aims to shift the risk-return calculus for lenders and attract more competition in the market.

As lenders gain experience they will improve risk management and achieve cost efficiencies through scale. Targeted investments in technology will lower operating costs and improve infrastructure and formalizing value chains will lower risk.

Aceli will recalibrate incentive levels to offer the minimum subsidy required as markets become more efficient.

Aceli Africa addresses these challenges with solutions tailored to the least served segments of the market



To learn more about Aceli's product offerings, please download the [full report](#) and a [programmatic overview](#) or contact info@aceliafrica.org

In addition to the donors that have supported Aceli Africa, we would like to thank the following institutions for their roles in the data analysis and design process:

Institutional partners

- **Council on Smallholder Agricultural Finance** for initiating dialogue among lending practitioners that led to the development of Aceli Africa
- **Dalberg Advisors** for conducting data analysis and providing inputs to calibrate the financial incentives Aceli will offer
- **Global Development Incubator** for serving as institutional host
- **International Growth Centre** for developing the independent evaluation of Aceli's financial incentives and technical assistance
- **Anjarwalla & Khanna and Ropes & Gray** for offering legal counsel in establishing Aceli's legal entity and program parameters

Lenders that contributed quantitative and qualitative data

Absa Bank (Kenya and Uganda), AgDevCo, Alterfin, Benefactors, Centenary Bank, Credit Bank, Development Bank of Rwanda (BRD), DFCU Bank, Equity Bank, EFTA, Global Partnerships, FACTS (Kenya and Uganda), Kiva, Incofin, Madison, Mango Fund, NCBA, NMB, Oikocredit, Opportunity Bank, Rabo Rural Fund, responsAbility, Root Capital, Shared Interest, SME Impact Fund, Stanbic Kenya, TADB, TPB Bank, Triodos

Ecosystem actors that provided input to the initiative's design

Africa Development Bank, Agriterra, Alliance for a Green Revolution in Africa, BlueInventure, CGAP, Co-Impact, Dutch Ministry of Foreign Affairs, Financial Sector Deepening, Kenyan Bankers Association, Kenya Investment Mechanism, KfW, ISF Advisors, MIX, Mulago Foundation, New Markets Lab, Open Capital Advisors, Partners in Food Solutions, Roots of Impact, Salum Awadh, Smallholder and Agri-SME Finance and Investment Network (SAFIN), Solidaridad, Swiss Development Corporation, TechnoServe, Uganda Agribusiness Alliance, US Africa Development Foundation, US Development Finance Corporation