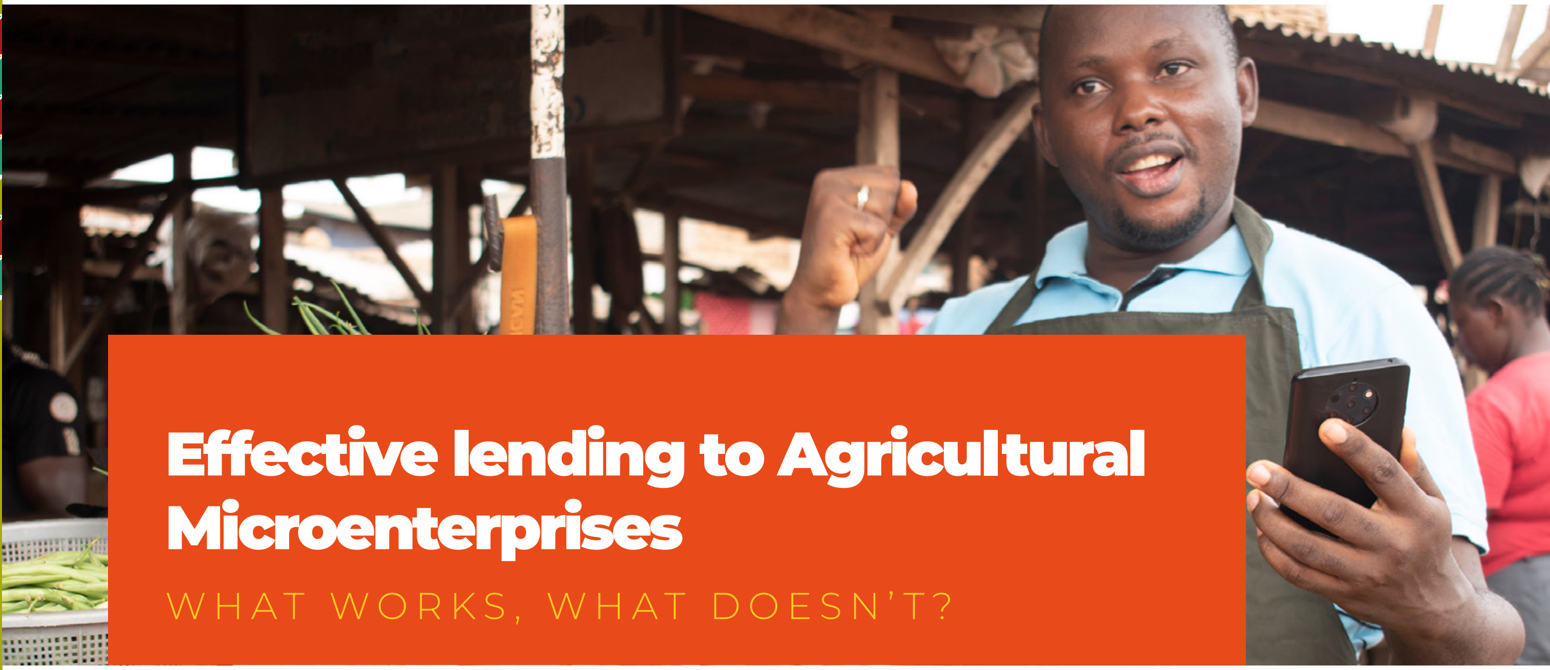

Effective lending to Agricultural Microenterprises

WHAT WORKS, WHAT DOESN'T?

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Introduction

Agricultural Micro, Small, and Medium-sized Enterprises (MSMEs), which include Farmer Based Organizations, play a significant role in AGRA's agricultural transformation agenda. As the key intermediaries for selling improved technologies to smallholder farmers ('agro-dealers') and for buying back, storing and processing the increased yields from smallholder farmers ('traders and aggregators'), agricultural MSMEs in Africa enhance the competitiveness of agricultural input and output systems, and act as the lever for improved agricultural productivity.

Many MSMEs have difficulties accessing the finance they require to run and grow their businesses. These challenges are related to bottlenecks in the supply and the demand side of MSME finance: on the one hand, financial institutions struggle with the high cost and risk of financing agricultural MSMEs, while on the other hand, the entrepreneurs are often ill-prepared to comply with the requirements as defined by the financial institutions (including collateral, documentation, financial records).

In February 2021, AGRA with support from Center for Financial Inclusion and SCOPEinsight, developed bankability metrics that makes the SME screening process faster and cheaper.

These metrics; however, are not suitable for **micro-enterprises** (MEs) with annual turnovers of below USD 100,000, where the cost of lending is high because loan amounts are small and financial institutions do not have the systems to do rapid, automated assessments on the bankability of these enterprises, which could lower their cost of lending.

As part of AGRA's Access to Finance agenda, a study and data mining exercise were undertaken by Wellspring Consultants to learn from two practitioners in Tanzania (Equity for Tanzania (EFTA) and the SME Impact Fund (SIF) that both serve micro enterprises:

- What information determines the 'bankability' of their potential clientele.
- How they can capture the requisite information faster, and in a cost-effective manner; and
- How their business development services should be targeted to ensure that the support leads to a financial transaction.

The study aimed to answer five overarching questions:

1. How do we increase the efficiency in the deal screening process to improve the conversion rate of the MEs we engage with to become clients of SIF or EFTA?
2. What (embedded) BDS activity improves the conversion rate?
3. What are the main reasons for MEs dropping out or being dropped during the deal screening process?
4. Which indicators predict the eligibility of MEs for finance so that financial institutions only invest in deal screening when the likelihood of accessing finance (becoming a deal) is high?
5. What can predict the continued interest of MEs to demand access to finance?

If a financier knows what type of BDS makes an ME a probable candidate for financing, they can spend their business development funds on those MEs that eventually become borrowing clients (thus contributing to the income of the financier).

Summary

To identify high potential micro-businesses, investors need access to information with observable and unobservable characteristics:

- 'Observable' characteristics, such as business revenue; the number of employees, etc. is information that is costly to obtain and difficult to verify in most African contexts. This is partly because first-time applicants in particular, do not have/know the information required of them and do not interact with banks and purchase orders for all their transactions. This can lead investors to spend too much time on early-stage MSMEs that do not have a realistic chance of receiving investment.
- 'Unobservable' characteristics, such as the entrepreneurs' character, commitment to agriculture, desire to grow, can in practice only be learned over time by working with the ME.

As both types of information require time and effort to obtain, an effective pre-screening tool applied to a large number of MEs ('cast the net wide') needs to be developed so that the non-qualifying and non-financeable MEs drop out of the 'funnel' in the early stage.

The study and data mining found:

- Current conversion rates (where the applicant turns into a borrower) are 8% for SIF, 60% for EFTA (this is after pre-screening), and 3% to 20% for other investment funds. Improving this rate would enable the economics for provision of smaller loans.
- Agricultural events, radio adverts, visits from staff, and training/ seminars are the most effective ways for investors to market themselves to investable micro-businesses.
- Most investors currently use a list of direct questions to get information on observable characteristics ('What is your annual turnover?'). Some entrepreneurs don't know/ tend to overstate the information when asked in this way; instead, investors could focus on getting information indirectly ('Who are your 3 biggest clients?' What volumes are they buying from you?), getting entrepreneurs to describe their businesses and then using this information to estimate the performance metrics might be more informative.
- Most micro businesses do not appreciate the benefits of Business Development Services until after they have received it, and so can attach limited value to investors offering technical support. Instead, they place a higher value on being able to access specialized agri-financial products, particularly seasonal repayments, to improve their demand for finance.
- From the investors' perspective, there is a need for more incubation and graduation facilities that help improve the pipeline (quality and quantity) of investable MSMEs.

Key findings

How to identify high-potential Micro enterprises

Identifying high-potential MEs requires information on observable and unobservable characteristics and investments by using:

1. The right marketing channels so that potential borrowers enter the pipeline.
2. The right indicators to measure the borrowers' readiness for financial access.

The in-depth study in the records of EFTA and SME Impact funds helped to get an understanding of a workflow that makes the deal process more effective as illustrated in the figure below.

Unobservable characteristics

Character, level of drive, people management and organizational skills

Observable characteristics

Revenue, no. of employees, business activities, sub-sector

The problem: How can investors get this information efficiently?

Can investors get this information without meeting the SMEs and getting to know them over time?

Are these characteristics really observable in Tanzanian/ SSA setting?

Based on the evidence that we have seen, it isn't clear that any credible alternatives currently exist at the moment.

We need to ensure that **marketing/ networking channels** gets good quality SMEs & **minimum time should be spent on SMEs that won't qualify for investment, by making effective use of the observable characteristics.**

SMEs don't know this information/cant' be relied on to provide it accurately. It's costly/takes time to get the 'observable' information. Investors currently rely on asking SMEs for this information directly, filling out checklists and long forms. Not clear that these approaches work particularly well. Instead, could we have SMEs reveal information, using questions that they can reveal more reliable info e.g.

1. Instead how many bags of rice do you sell a month (you know price, estimate a range)
2. Approx. how many smallholders do you purchase from/ sell too?

The key to effectiveness is trying to market yourself to most relevant SMEs and getting the data to narrow down potential investees as efficiently as possible.

How to reach MSMEs

To understand the most effective deal origination channels for agricultural micro-enterprises, applicants to EFTA and SIF were interviewed. The most effective marketing activities identified were:

1. **Referrals** from existing MSME clients and repeat customers.
2. Tanzania's National **Farmers' Day** (8th August): information stands and marketing materials.
3. **Radio** programs, which should be then followed up with visits from the investment team.
4. Training and investment **seminars** for micro-enterprises.
5. **Visits** by investment managers or referrals from business development services providers.

The lack of information on opportunities presents a huge challenge for many rural-based micro-enterprises. This is one of the reasons for the prevalence of *'grant-preneurs'* (the phenomena where the same MSMEs benefit from support programs). Deliberate efforts to reach 'new', previously unsupported MSMEs, is key if we seek to increase the number of growing and performing MSMEs that can competitively service more farmers.

What predicts a Micro enterprise's probability of being investable?

The analysis of the deal screening process from intake to deal closing led to the identification of indicators that positively relate to the eligibility of micro-enterprises for loan facilities:

1. A minimum **annual revenue,** substantiated with purchase orders or contracts, depending on the financial institution and country, this number could be anything between USD 5,000 and USD 250,000. The number needs to be supported by evidence or be verified before engaging further as it is often reported wrongly.
2. An **official registration** as a business (as opposed to a sole proprietorship). A license means that some level of documentation is already in existence.
3. Willingness and ability to make a **down payment** for inclusion in the pipeline. Some form of payment ensures the commitment of the entrepreneurs towards improving their performance.
4. Having at least two **formally employed** people (that are not relatives of the entrepreneur). Contracted personnel indicates that the business is out of the 'mom and pop store' category and is seeking professionalization and growth.
5. Having at least some **fixed assets** (e.g. > USD 250 depending on the loan size) in the companies' name (shop, vehicle, machine...) financed by the owner's equity. Assets mean that entrepreneurs have been able to set aside funds for their business which can be pledged against a loan.
6. A **good understanding** of the eligibility criteria and application process. It is worth the investment to brief each potential applicant on the process and criteria to manage the mutual expectations. These briefings significantly improve the conversion rates.

Both institutions have pre-screening forms. The standardized nature of the information required for the deal screening process would seem to suggest that the sector is a good potential area for applying fintech; however, the investors that we consulted currently make limited use of these services.

What role do BDS play in qualifying MSMEs for finance?

The interviews conducted with both successful and unsuccessful applicants yielded interesting insights into the need for and willingness to pay for business development services (BDS).

The companies that secured funding were all positive about the impact of BDS on the performance of the business, but only 20% of them would be willing to pay for such services.

On the contrary, most of the unsuccessful applicants did not see value in accessing BDS and said they were only in need of affordable capital to grow their business. None of these interviewees was willing to pay for BDS.

Of those that identified the need for BDS, they mentioned that they would benefit both from support to improve their marketing activities and how to manage the growth of their business.

This is problematic, especially if on the one hand MSMEs are unwilling to pay for BDS and many of them do not even recognize the value/ need for BDS, while on the other hand, all financiers state that they lack 'quality' deal flow, and there is no potential market for BDS since the demand does not exist.

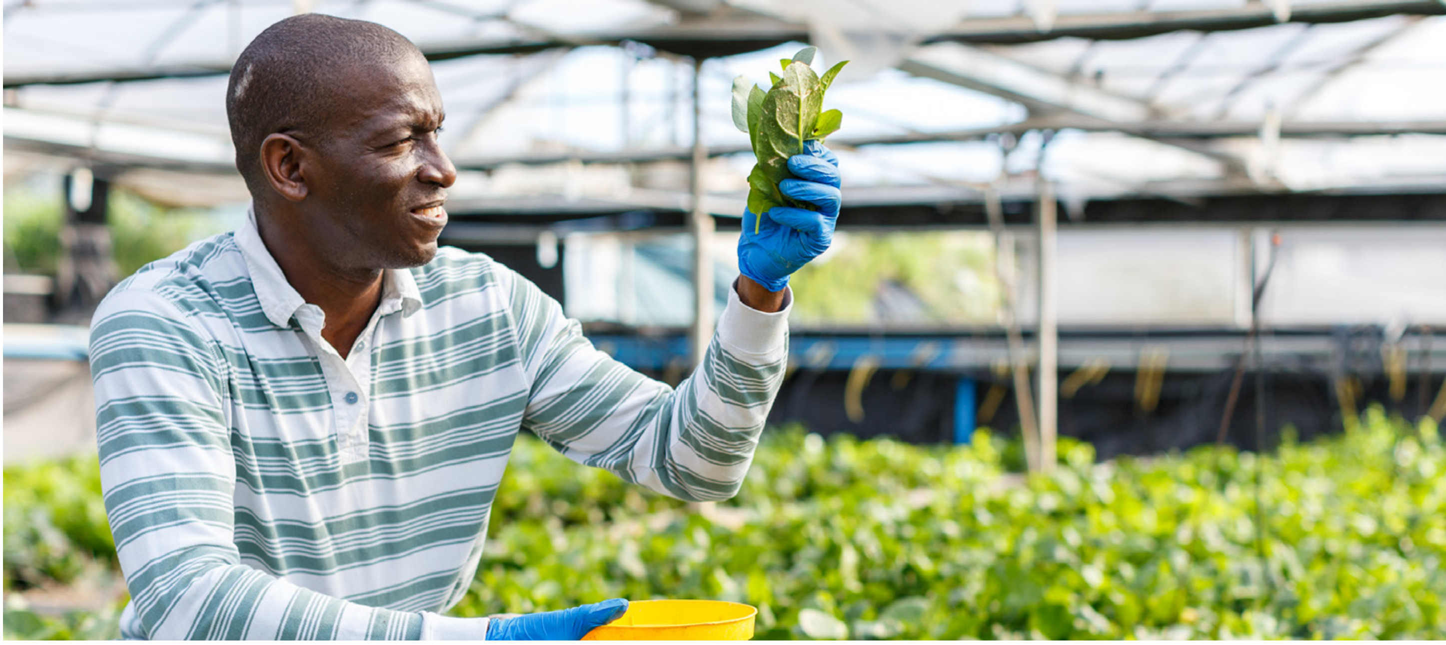
The above scenario would call for some sort of mandatory BDS which could be provided as part of a loan, and for which pricing is bundled with the interest rates for the financial product. From other past studies we have conducted, it became clear that the close interaction between financial and business development services providers is key to ensure that BDS enhances access to finance for MSMEs.

Access to finance unlocks awareness at the MSME level, and BDS might be beneficial to the growth of the company.

What is AGRA's conclusion?

The above findings point to how deal screening and BDS provision can be more effective to reduce the cost and risk of micro enterprise financing. In combination with the experiences gained from AGRA's contracted BDS providers, here are some of the key challenges that agricultural micro-enterprises face:

Challenge	Gaps in support system	Why does market failure persist?
Informal businesses	Cumbersome registration process, lack of property titles and complicated processes.	There are no scalable and attractive solutions that help formalize microenterprises. Entrepreneurs fear the tax-man and prefer 'under the radar' businesses.
Lack of asset base	Few funding options for start-up capital exists in rural areas. Family and friends might be short of resources.	There are many competing priorities in rural areas; starters find it difficult to mobilize initial capital from saving and credit groups.
Access to finance	Limited financing options for rural microenterprises beyond family and friends.	Informal rural financial institutions lack modern lending instruments and are often inefficient and undercapitalized.



To address these gaps in the micro enterprise support systems, AGRA proposes to focus its capacity-building investments for micro-enterprises (MEs) in the following areas:

Possible AGRA Investments	Implementing Partners	Outcome
Innovation fund that accelerates solutions that can offer formalization of MEs at scale.	Government, ICT companies, local BDS providers/NGOs working with MEs.	More visible and trustworthy MEs, tax income from ME sector for Government.
Matching grant fund for investments in fixed assets (shop, equipment, software).	BDS providers that train and support VBAs; suppliers of relevant assets; financial institutions to share funding.	MEs (youth and women) have assets to pledge to access finance and become more visible and trusted partners.
Acceleration funding for BDS providers that improve MEs' record keeping and biz mgt. at scale and linkages to larger SMEs.	Local BDS providers like TAPBDS, Miruki, ADEM etc. Selected providers in each of AGRA's geography.	Thousands of MEs meet min. performance criteria: records, permits, contracts, HR — that make them better business partners.
Acceleration funding for innovations in rural financial institutions (digital). Can be part of blended finance vehicle.	Rural financial institutions, digital solution providers; TA providers; Agriterra/Rabobank/ ABC Fund; National DFIs.	Rural FIs capable of offering appropriate and affordable services to Ag. MEs using digital technology.

The fact that each of the AGRA countries count thousands of rural micro-enterprises that directly deliver products and services to small-scale producers, calls for solutions that address the gaps in the support system. Those solutions need to be:

1. Scalable and transferable to many different financial institutions and BDS providers.
2. Building a market for financial and business development services.

It should be noted that building a market for support services calls for initial cost-sharing and subsidy mechanisms to ensure the emergence of willing buyers and sellers of support services. In the current context, MSMEs do not see the need for and are unwilling to pay for BDS, yet the business advisors and financial institutions do not see the market opportunity for their loans and business advisory services that rural micro-enterprises present.

Hence, AGRA's proposal to invest in (grant funded) facilities capable of investing and accelerating the innovative solutions that are required to build the market and ecosystems for support services targeting micro-enterprises.