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WOCCU'S VALUE CHAIN FINANCE METHODOLOGY

INNOVATIONS IN FINANCING VALUE CHAINS

microREPORT #

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I. INTRODUCTION

In an effort to capture and disseminate innovative practices in the field of value chain finance, ACDI/VOCA, under the Accelerated Microenterprise Advancement Project Business Development Services (AMAP BDS) Knowledge and Practice II task order, solicited submissions for a competition from practitioners implementing value chain finance programs. Value chain finance is defined as financial products and services that flow *to or through a value chain* to increase returns on investment and growth and competitiveness of that value chain. The "Innovations in Financing Value Chains" competition was held in December 2008, and two selected winners were honored at an awards ceremony in February 2009. This case study details the methodology and experience of one of the winners, the World Council of Credit Union's project in Peru.[1]

This case study comprises the following sections: Section II describes the Peruvian context and rationale for the intervention; Section III outlines WOCCU's methodology; Section IV describes how the approach was implemented in the coffee value chain in the Peruvian department of San Martin; Section V demonstrates project results in the coffee value chain; and Section VI provides lessons learned and concluding remarks. An annex of the value chain scorecard (mentioned later) is attached for reference.

II. BACKGROUND

Peru's economy, once riddled by the effects of decades of violence and terrorism, has stabilized and begun to grow over the last several years. Yet the country still faces high levels of income inequality and rural poverty. The centralization of financial and commercial activity around the capital, Lima, isolates producers in the remoter Amazon and Andean regions and severely limits their access to markets and financial services. In addition, although Peru has a relatively well-developed financial sector, about 95 percent of financial institutions are commercial banks that view rural producers as a risky client group. The perceived high risk of lending to farmers, history of small loan defaults, and lack of appropriate financial products for agricultural producers have all deterred commercial banks from bringing financial services to the rural poor.

The microfinance sector in Peru has developed to address some of the gaps left by commercial banks, lending small amounts to micro and small businesses with minimal collateral requirements. Rural producers, however, still have limited access to financial services for a variety of reasons, including low provincial outreach and high interest rates.

Credit unions have been an exception in Peru, with a historically strong presence in remote regions. Credit unions have been active for more than five decades in serving poor rural communities, reaching areas that banks do not serve and often occupying a leadership role in the community. Peru's national federation of credit unions, FENACREP, comprises 168 cooperatives with a total of 700,000 members throughout 21 of Peru's 25 departments.

One limitation of Peruvian credit unions is a lack of appropriate lending products for smallholder farmers. Credit unions that have lent to farmers offer products that are ill-suited to a farmer's cash-flow requirements, with loans often falling into default.

The World Council of Credit Unions (WOCCU) works with credit unions in Peru to expand their outreach to serve the marginalized poor in new ways. The USAID-funded Credit Union Market Integration Program (CUMIP) was designed to work with organized producers in value chains that have significant market potential. The program component described here was designed to address the financial constraints faced by smallholders through a value chain finance methodology.

[1] A separate case study is available on the second winning project from Bolivia on purchase order financing arrangements.

III. INTERVENTION DESCRIPTION

CUMIP, implemented by WOCCU from 2006-2009, works to raise the incomes and assets of households in poverty corridors of Peru through increased access to finance and markets. CUMIP works with nine credit unions in low-income areas to improve their financial performance and the client-responsiveness of their savings and credit products, facilitate market linkages to increase value chain competitiveness, and create a national shared branching network to lower transaction costs. Through the project, WOCCU has developed and pilot-tested an innovative methodology for creating more appropriate financial products by conducting a systematic analysis of the needs and constraints of a given value chain.

WOCCU's program objectives include the following:

- Increase income and assets of poor households by improving access to financial services and facilitating greater market access for their products.
- Provide credit unions appropriate evaluation tools to measure the market potential and risk of lending to various value chains.
- Develop financial products that fit the needs of producers while reducing risks and increasing profitability for the credit unions.
- Expand the depth and outreach of financial services provided by credit unions.

WOCCU's methodology includes four phases, as follows:

1. Identify and evaluate value chain finance opportunities.
2. Facilitate and leverage market linkages.
3. Determine financial feasibility and design the product.
4. Grant, monitor and recuperate the loans.

An important caveat to the success of this methodology is that producers must have access to technical assistance—along with access to financial services—to upgrade production levels (both quality and quantity) to meet buyer requirements. Working together with other donors and technical assistance providers, WOCCU has supported interventions to assist farmers to increase the quality of their production that can meet end market demands.

PHASE I: IDENTIFY AND EVALUATE VALUE CHAIN FINANCE OPPORTUNITIES

The first step is to assess the viability of various value chains using a scoring sheet that quantifies the following set of criteria: 1) market demand for the product; 2) producers' ability to meet market requirements; 3) the producer group's level of organization; 4) the socioeconomic characteristics of the producer group; 5) the strength of the relationships within the chain; and 6) historical record of access to credit.[2]

In addition, the credit union evaluates the strengths, weaknesses, opportunities and threats affecting the value chain and potential points along the chain where financing can benefit small producers and the credit union. Scoring is done by credit union staff during field visits that include interviews with key value chain actors. Weighting of scores is determined by credit union priorities, e.g., job creation and geographic location.

PHASE II. FACILITATE AND LEVERAGE MARKET LINKAGES

The second phase involves bringing together all the value chain stakeholders—producers, producer associations, technical assistance providers, input suppliers, buyers and other actors—in a workshop to accomplish the following:

[2] See annex A for examples of some of the key indicators used in the scorecard.

- Finalize and correct value chain map prepared during phase one
- Assess key constraints along the chain
- Seek commitments from value chain actors regarding appropriate interventions
- Determine real needs of credit and
- Gather critical data on production costs and product pricing

PHASE III - DETERMINE FINANCIAL FEASIBILITY AND DESIGN THE PRODUCT

In the third phase, the credit union uses the financial and production data gathered to analyze the financial requirements and repayment capacity of potential clients. As such, each credit union program designs a tailored set of financial products for its client base, varying with respect to terms, repayment structures, interest rates, grace periods and collateral.

In agricultural value chains, the loan disbursement and payment schedules are often tied to production cycles. Basing a financial product on the specific needs of the borrower reduces the risk of offering loans with unrealistic terms and/or inadequate amounts that do not permit the kinds of investments that increase productivity and enable the borrower to repay the loan. The credit unions determine a fair interest rate to cover all costs and remain competitive in the local financial market. The financial product can also be tied to a client's commitment to undertake certain actions to improve their competitiveness or ensure product sales; for example, upgrading equipment or applying a new technical method. The credit union can disburse the loan in cash or in voucher form (to be used for inputs or equipment).

PHASE IV. GRANT, MONITOR AND RECUPERATE THE LOANS

This final phase of the methodology establishes the processes and policies needed by the credit unions to address the risks associated with value chain loans, including geographic distance from the borrower and the use of balloon payments at the end of the production cycle. The credit unions work with farmer associations and technical assistance providers to monitor production and establish repayment and delinquency policies. A common arrangement that has worked well in Peru is for buyers to pay for orders through the credit union; when the credit union receives its repayments, the loan is paid and profits are deposited into the producer's savings account.

IV. IMPLEMENTATION IN THE COFFEE VALUE CHAIN OF RIOJA, SAN MARTIN

In August 2007, WOCCU began to work with the Santo Cristo de Bagazan Savings and Credit Cooperative in the Alto Mayo Zone in the Department of San Martin. There is a long history of coffee cultivation in this region, and many small farmers depend on coffee for the majority of their income. WOCCU recognized that Peruvian specialty coffee offers a range of opportunities to expand production through export sales if growers can meet buyer's quality and quantity requirements. Based on interest from the Santo Cristo de Bagazan Credit Union, WOCCU launched its value chain methodology in San Martin with the goal of extending financial services to coffee value chain actors.

A. PHASE I: EVALUATE THE VALUE CHAIN FINANCE OPPORTUNITIES

As Santo Cristo de Bagazan was one of the first credit unions to use the methodology in Peru, WOCCU worked closely with the credit union staff to carry out the evaluation of the value chain and its finance opportunities. The evaluation revealed that Selva Andina, a local coffee association in Rioja with about 300 members, had an established relationship with a buyer but lacked sufficient capital to pay the producers upon delivery of their coffee. Producers that sold to the association had to wait to receive payment until accounts were settled with the final buyer, creating a cash flow problem for the producers. Other options for producers included selling to intermediaries or directly to the local market, both of which resulted in a lower price for the farmer and left the association with insufficient quantities of high-quality coffee to satisfy buyers. The evaluation also found that the region had the advantage of good climatic and soil conditions for growing coffee and several organized associations, including Selva Andina.

During this assessment phase, the WOCCU team noted that the only access to finance came from intermediary buyers (traders and brokers) who required all production to be sold to them. This arrangement gave the intermediaries a great deal of control over pricing and limited the grower's flexibility to adapt new approaches to their coffee farming. The team also identified technical assistance that was already being provided by donor organizations in the region and that, once fully applied, would enable coffee growers to meet buyer requirements for export and gain a better price.

Another complication to this value chain was the fact that many producers had obtained organic certification for the land used to grow specialty coffee. However, due to the association's cash flow difficulties, the producers often did not have enough cash to invest in purchasing organic inputs and therefore did not obtain the potentially higher prices for their coffee. This, in combination with selling to local intermediaries who did not value organic products, resulted in a lost opportunity for higher returns.

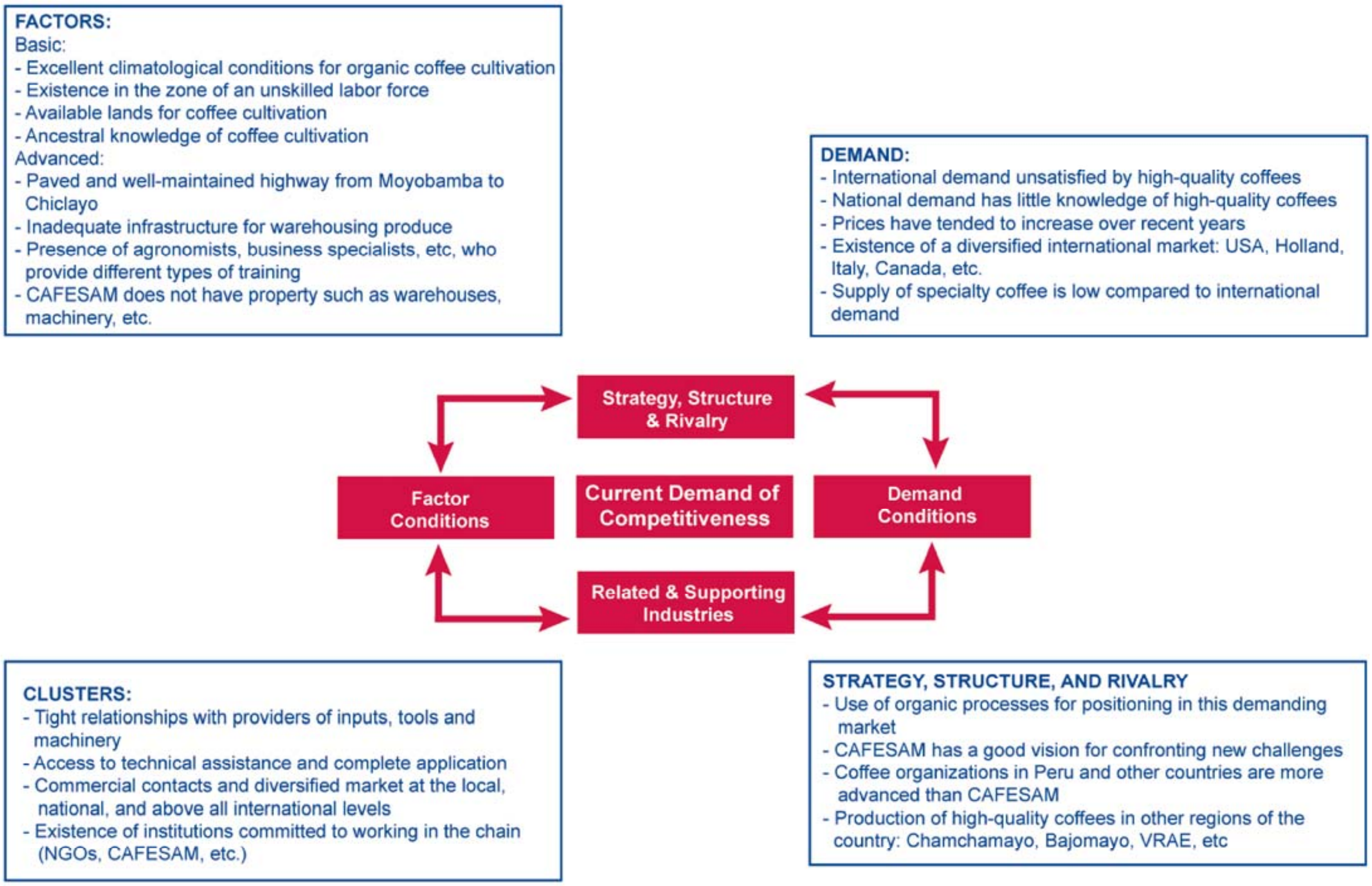
The scorecard used to evaluate value chains measures two types of indicators: market and risk. The credit union/WOCCU team gave the coffee value chain in Rioja a weighted score of 7.75 and was deemed eligible for the next phase of the value chain finance methodology. Annex A lists some of the key indicators from the scorecard.

B. PHASE II: FACILITATE AND LEVERAGE MARKET LINKAGES THROUGH A STAKEHOLDER WORKSHOP

The goals of the stakeholder workshop were twofold: 1) bring together as many direct and indirect value chain actors as possible to identify and discuss the problems and opportunities in the specialty coffee value chain of Alto Mayo; and 2) identify concrete activities for the stakeholders to improve the functioning of the chain. Results of the analysis were analyzed using Michael Porter's Diamond of Five Forces. (See Figure 1.)

Unfortunately, the major buyer of specialty coffee from the region, Rain Forest, did not attend the workshop. A meeting was held in Lima after the workshop with the general manager of Rain Forest and representatives of CAFESAM and WOCCU. Rain Forest's general manager outlined his understanding of various aspects of the demand, including price, quality, quantity, seasonality and internal and external competition, and these were included in the final analysis.

Figure 1. Competitiveness Diamond of the Specialty Coffee Value Chain in Alto Mayo



The workshop participants attributed the main problem of low production of high-quality coffee to two causes:

1) lack of financial resources to properly apply recommendations of technical assistance providers; and
2) lack of available resources to properly maintain crops organically.

The producer members of Selva Andina determined that they each wanted financing for the cultivation of additional hectares of specialty coffee, which was required during the two-month pre-harvest period when the smallholders did not have other sources of income.[3] The association also needed finance during the immediate post-harvest period to pay farmers upon delivery of their product. Having access to finance for cultivation and post harvest payments would alleviate much of the association's cash flow problems. The association's access to working capital loans would also encourage farmers to produce more specialty coffee with the security of getting paid upon harvest and delivery. Based on this scenario, commitments were made by the producers, the association and credit union to take steps to resolve these financial constraints. Producers signed contracts committing them to apply a specific set of technical recommendations to improve production if they received loans.

[3]Although AGROBANCO is present in the region, its lending process has been very slow and is not client friendly.

C. PHASE III: DETERMINE FINANCIAL FEASIBILITY AND DESIGN THE PRODUCT

Information gathered during the workshop about production cycles, costs, yields and prices was used during the third phase to design and structure the loan characteristics. Two potential products were identified for the coffee value chain:

- production loans for the producers
- commercial loans for the association

Production loans for producers – these were designed as loans disbursed directly to producers to cover up to 70 percent of production costs. Terms were set for 6 to 9 months based on production cycles. Loans were repaid by CAFESAM, a second-tier regional association of which Selva Andina is a part and the buyer of their coffee. Loans were disbursed at a 2 percent monthly interest rate with a 2-3 month grace period. Collateral was taken in the form of forward purchase orders or a title to property.

Commercial loans for Selva Andina - were provided with a one-month term, a monthly interest rate of 2.2 percent and no grace period. Collateral was taken in the form of a guarantee of product delivery. These loans gave Selva Andina the liquidity to purchase more coffee from the producers and pay upon delivery. The interests rates for individuals and for the association are 1-1.5% lower than those of competing institutions.

D. PHASE IV: GRANT, MONITOR AND RECUPERATE THE LOANS

WOCCU supported Santo Cristo de Bagazan to establish new processes and policies to lend to coffee farmers. For example, prior to WOCCU's involvement, Santo Cristo de Bagazan's bylaws prohibited the credit union from making agricultural loans. The new processes established also included monitoring approaches for clients that were working in difficult-to-reach geographic locations. Because their remoteness made it inefficient or impossible for loan officers to visit every member twice during the production cycle (the minimum required), Santo Cristo de Bagazan leveraged relationships with other value chain actors such as local farmer associations, technical assistance providers and the buyer to monitor production and establish repayment and delinquency policies. In some cases, the credit union worked through buyers to directly repay loans upon receipt of final orders; after loans were repaid, the profits were deposited into a farmer's or association's savings account. Working with various actors in the value chain in this way serves the dual purpose of strengthen the value chain linkages and reducing the cost and burden of monitoring for the credit union. To cope with the risks associated with lending in agriculture, the credit union also established policies for refinancing that clearly spelled out the conditions and penalties for refinancing.

Loan type	Location	Disburse ment	Amount (US$)	No. of credits	No. of Beneficiaries	Outstanding loan (US$)	Loan due

Table 1. Total Loans Disbursed by Santo Cristo de Bagazan

Coffee producers	Rioja	January 2008	42,900	97	97	0.00	July 2008
Coffee association	Rioja	March 2008	16,666	1	117	0.00	April 2008
Coffee producers	Rioja	Sept 2008	95,033	114	114	95,033	July 2009
production	[illegible]						
Coffee production	Nuevo Caja-marca	Nov 2008	44,100	56	56	44,100	July 2009
TOTAL			**251,033**	**330**	**446**	**191,466**	

The first loans to producers in Alto Mayo were disbursed in January 2008 for a total of 97 individual loans. The first loan to the coffee association Selva Andina was disbursed in May 2008. Santo Cristo de Bagazan has been pleased with the results to date, with no delinquency and continued strong demand. The credit union plans to continue expanding this and similar products based on these strong, positive results. Table 1 summarizes cumulative results.

V. RESULTS AND IMPACT ON THE VALUE CHAIN

Credit unions working with WOCCU have developed a better understanding of targeted value chains and associated smallholder financing needs. WOCCU's efforts have resulted in five Peruvian credit unions designing and implementing a set of new financial products for producers and farmer associations in 20 different value chains.[4] These new products have deepened the credit unions' outreach while simultaneously lowering their delinquency rates. Benefits have been reaped by producers: They have achieved a 54 percent increase in coffee purchase prices because they are now producing organically, adopting a range of technical recommendations and upgrading activities, and selling to the association rather than intermediaries.

WOCCU's value chain finance methodology benefits all levels of the value chain. By bringing buyers and sellers together—often for the first time—the project's workshops have opened new communication channels for value chain participants. The increase in sharing of information among all stakeholders allows everyone to make better-informed decisions. For example, a producer's exposure to buyer needs can result in their procurement of higher-quality inputs and the production of an improved final product. Additionally, by interacting with key stakeholders, value chain actors are exposed to new perspectives regarding how the value chain works, and producers can begin to increase their bargaining power based on their understanding of the needs of buyers and suppliers.

[4] Value chains have included: coffee, industrial oats, milk, kiwicha, guinea pig, trout, alpaca fiber, purple corn, cacao, potatoes and tropical flowers.

Alpaca Fiber Value Chain

Alpaca fiber or wool from Peru's Andean region is used to make sweaters, scarves and other garments. Historically, producers raised Alpaca high in the Puna region of Peru and traded the fiber to merchants traveling through the region for sugar, rice, clothes and other goods.

Beginning in 2004, the Belgian technical development organization CTB provided technical assistance to upgrade the fiber and organized four producer associations, each of which has a fiber collection center. Using this economy of scale, the association was able to negotiate a contract directly with the buyer. However, the buyer did not comply with the contract terms to pay in full upon receiving the fiber, leaving the association and producers short of cash. The producers lost confidence in the association, and many returned to selling to intermediaries who paid immediately. In this case, the buyer and the intermediaries controlled the sales price to the farmers, based on the quality and weight of the fiber. Because of the remoteness of the region and lack of a traditional guarantee, the financial sector did not serve the Alpaca fiber value chain.

Using its value chain finance methodology, WOCCU worked with two credit unions, Santa María Magdalena and San Cristóbal de Huamanga, to provide loans directly to this local association (for small fixed assets and working capital). Loans had a one-month term and a 2 percent monthly interest rate. These funds enabled the local association to pay producers immediately upon receipt of their fiber and hire women to grade the incoming goods. The loan was also used to purchase a small scale to weigh incoming fiber, which added transparency to the transactions. Loans were guaranteed by the contract with the buyer and the fiber being collected at the association's collection center. These new arrangements have resulted in producers receiving a 180 percent increase in the price per pound of their wool.

VI. CONCLUSION & LESSONS LEARNED

Key challenges for any successful value chain finance project include reducing risks and creating sustainable incentives. Addressing these issues in a manner that does not replace private sector dynamics but creates a catalyst for increased competition is critical. There are several important lessons from the WOCCU model:

- Incentives to lend to smallholder farmers were created through the proven profitability of well-designed financial services.
- Risks of lending were reduced for the credit unions by creating a product that met the cash-flow needs of farmers and farmer associations.
- Incentives to work collaboratively were created among value chain actors after stakeholder workshops linked buyers, sellers and credit unions.

The WOCCU value chain finance methodology offers many useful lessons to the finance community seeking to reach more vulnerable and isolated target groups. Below is a short summary of the key pre-existing conditions that should be present to successfully replicate the model.

- **Market Demand**: The presence of an identified market for the product is necessary to ensure its viability and growth beyond project support.
- **Organized Producers**: A minimal level of organization among the producers in the value chain is required for a number of reasons. The first is to aggregate sufficient volume for larger buyers. Second, associations help ensure the application of the technical assistance packages that enable small producers to meet buyers' quality requirements. The volume and quality increases producers' bargaining power with both buyers and suppliers. In addition, working through an association is more cost-effective for credit unions, for example,

in organizing meetings and monitoring loans. Lastly, associations can provide information on their members, who may have little or no formal credit history, and can also lower lending risks by applying social pressure and cosigning loans (in some cases the association guarantees the farmers, in other cases, farmers guarantee each other). Reduced costs and risks eventually translate into lower interest rates.

- **Data:** Reliable market data is a necessary precondition for replication.
- **Technical Capacity:** A high degree of technical capacity or access to technical assistance is key, as it enables the actors to meet production standards and market demands.
- **Infrastructure:** Basic infrastructure in the location of the value chain is needed, such as adequate roads for farmers to move their products to the markets.
- **Legal Framework:** While legal title to land is not necessary, informal declarations of ownership of land are required for producers to receive loans.

WOCCU's value chain finance methodology provides a road map for institutions seeking alternative financial mechanisms to reach rural and isolated businesses. Its approach has provided the sector with examples of how to reduce risks while serving new target groups through lower-risk interventions. This model serves as an interesting example for possible replication by other institutions seeking to supply rural markets with financial services.

ANNEX A: WOCCU VALUE CHAIN SCORECARD KEY INDICATORS

WOCCU's value chain scorecard is designed as a decision-making tool to complement much of the qualitative information gathered during a value chain analysis. Below is a list of the key indicators used in Peru for the value chain finance analysis.

Credit union loan officers used a weighted scoring system that changed according to the institution's priorities (e.g., job creation, income growth). Quantitative scores from the scorecard were coupled with qualitative information gathered during Phase I to determine the viability of creating financial services for the value chain.

INDICATORS

MARKET DEMAND

- Is the value chain connected to a viable market?
- Is there sufficient demand to incentivize production?
- Can the producers compete with their peer group to successfully meet demand?

PRODUCERS' TECHNICAL ABILITY

- Do the producers have the appropriate level of technical ability to understand and meet demand?
- Will the producers receive technical assistance from strategic partners who can ensure product volume and compliance?
- How will technical assistance services be financed?

PRODUCERS' ORGANIZATION

- Are the producers organized?
- Do the producers need training to strengthen the association?

MARKET ACCESS

- Does the local infrastructure allow basic market access, e.g., public transportation for goods and people, modes of communication, etc.?

EXTERNAL FACTORS

- Does supporting the value chain encourage the employment of underage workers or interfere with the completion of their schooling?
- Does supporting the value chain encourage environmentally friendly practices?
- Does supporting the value chain encourage practices that violate local or national laws?