VALUE CHAIN FINANCING: How agro-enterprises can serve as alternate aggregation points for delivering financial services to smallholder farmers

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Agro-enterprises within the agricultural value chain\(^1\) can play a crucial role as aggregation points for the delivery of financial services to smallholder farmers, often in partnership with financial institutions. Such value chain financing models require agro-enterprises and financial institutions to work together and balance their respective capabilities to serve smallholder farmers effectively.

In designing value chain financing models, a series of “enablers” support financing for smallholder farmers. These include in-kind provision of inputs or vouchers, asset-based collateral, bundling, receipt-based collateral, field force networks, offtake agreements, farmer groups, technical assistance, digital solutions, and data consolidation or analysis. Successful models group several enablers together to create collaborative and effective value chain financing models for smallholders.

Value chain financing models greatly increase what is possible in terms of lending to smallholder farmers by embedding relationships and processes within value chains. The advantage of these models is their ability to overcome constraints that make traditional lending models difficult. The disadvantage of these models is they can be complex and localized. However, the rich landscape of models being used suggests that value chain financing models are a key part of unlocking credit in difficult market environments. With this in mind the international community should become much more intentional around defining and supporting different value chain models. We would suggest the following roles for key actors:

**Donors:**

1. Fund the design and project management of collaborative value chain financing models
2. Provide start-up capital for specialized financial intermediaries (e.g., dedicated asset financing or leasing companies)
3. Support public good resources such as data aggregation platforms
4. Support emerging models that are experimenting with useful enablers (e.g., digital platforms)

**Investors:**

1. Participate in the design stage of collaborative value chain financing models to jointly develop appropriate financial solutions
2. Provide capital to grow or scale specialized financial services intermediary models

**Agro-enterprises:**

1. Involve financial institutions early to jointly develop value chain financing solutions with agro-enterprises; identify roles and responsibilities for each partner across the financial services value chain and incorporate enablers to reduce risk and maximize success
2. Establish pre-competitive alliances with other agro-enterprises in the industry to better develop joint solutions
ABOUT THIS BRIEFING

This briefing is the tenth in a series about financing for smallholder farmers. It builds on a 2012 report titled Catalyzing Smallholder Agricultural Finance, in which we presented a series of pathways for financing, including lending to farmers aggregated into producer groups, financing through integrated multi-national buyer supply chains, and building direct-to-farmer financing models.

This briefing elaborates on the concept of “alternate aggregation” to explore value chain financing models that serve non-aggregated farmers (i.e., farmers not organized into producer groups) through the agro-enterprises that interact with those farmers (e.g., input providers, agro-dealers, traders, processors, warehouses, etc.)

The FAO broadly defines agricultural value chain financing as any financial services flowing to or through a value chain to address the needs and constraints of those involved in that chain. Common examples include input-supplier finance, accounts receivable financing, and warehouse receipts. For financial institutions, value chain finance creates the impetus to look beyond the direct recipient of finance (the farmer) to better understand the competitiveness and risks in the sector as a whole and to craft products that best fit the needs of the businesses in the chain. These custom products can reduce the cost and risk of financing smallholder farmers – a group that traditional financial services providers are wary of serving. In many markets, value chain financing is a primary source of productive credit for smallholder farmers and may be more readily available than commercial or informal lending.

The various agro-enterprises along the agricultural value chain that buy from, sell to, and provide services to smallholder farmers can be the vehicle for financing. Agro-enterprises include input providers, agro-dealers, equipment vendors, traders, processors, warehouses, extension networks, and commodity exchanges. By building on existing business relationships between agro-enterprises and farmers, loans can be originated, distributed, and recollected throughout the seasonal crop cycle. Each type of agro-enterprise has distinctive advantages and challenges with respect to smallholder financing, as outlined in Figure 1.

Many value chain agro-enterprises struggle with their own capital needs and thus find it difficult to finance farmers. In light of this challenge, value chain financing models can often be more effective when they include a local financial institution, foreign investor, or large food and agriculture company with access to sufficient financial liquidity.

When partnering on finance for smallholders, financial institutions and agro-enterprises have different core competencies and should structure their participation accordingly. For instance, while financial institutions may excel at credit assessments, agro-enterprises have a deep knowledge of the value chain and should focus their efforts on identifying clients and developing distribution channels. Figure 2 shows typical core competencies of financial institutions versus agro-enterprises across the financial services delivery value chain.

Three Channels to Make Value Chain Financing More Feasible

Value chain financing models are often complicated and require alignment of roles, responsibilities, and incentives across multiple partners. In practice, these models are more readily delivered through one of three channels: 1) a specialized financial service intermediary,
2) a multi-stakeholder partnership, or 3) an integrated supply chain manager.

A specialized financial service intermediary tackles a niche area in smallholder financing, such as agro-dealer financing or equipment leasing, that the mainstream financial sector is not servicing. A multi-stakeholder partnership organizes collaborative partnerships among multiple enterprises in the agricultural value chain to design value chain financing models and assign roles and responsibilities. An integrated supply chain manager works across the value chain to provide inputs, extension, and marketing for farmers while acting as a platform for financial service provision. Additional detail and examples of each are included below.

Specialized financial service intermediaries

Specialized financial service intermediaries are suitable when the local banking sector is overlooking an area of smallholder financing (e.g., asset financing for tractors, irrigation, or processing equipment). In this case, a specialized intermediary can be supported or launched by an agro-enterprise (or coalition of enterprises) that is seeking financing for smallholders in the same supply chain (see case study on Sustainable Agro-Commercial Finance Ltd. below).

Multi-stakeholder partnerships

Multi-stakeholder partnerships are collaborative partnerships among multiple enterprises in the agricultural value chain intended to design value chain financing models and assign roles and responsibilities upfront rather than trying to incorporate financing on an ad hoc basis. They are suitable when multiple enterprises across the agricultural value chain, such as input suppliers, offtakers, or processors, have aligned interests within the same market. These partnerships typically require a project manager to coordinate initially, but will ideally be able to stand on their own once the partnership is set up and running (see case study on FoodTrade ESA below).

Integrated supply chain managers

Integrated supply chain managers are trading or service companies that provide inputs, extension, and marketing for farmers and can serve as a platform for delivery of financing. A model involving an integrated supply chain manager tends to be most suitable for loose, unstructured, or unregulated commodity markets with few established agro-enterprises. Managing an integrated supply chain company requires extensive operational and management experience, which is challenging to execute and scale (see case study on the Joseph Initiative below).
CASE STUDY: SUSTAINABLE AGRO-COMMERCIAL FINANCE LTD. (SAFL)

A model of a private company spinning out and partnering with a financial institution.

SAFL is a non-bank financial institution that offers commercial term loans for agriculture-related assets in India. SAFL began by originating 100% of their business from Jain Irrigation, a well-known irrigation systems manufacturer, but has diversified over time. It has developed a sustainable model to finance smallholder assets by capitalizing on Jain’s sales network to identify and assess customers, using equipment as collateral for loans, employing a robust IT platform to increase operational efficiency, and setting up a dedicated recovery team.

CASE STUDY: FOODTRADE ESA

Warehouses as an anchor to integrate agro-dealers and banks and enable access to inputs and higher sales prices

FoodTrade ESA’s warehouse program combines enablers in digital technology, warehouse receipts, in-kind inputs, and payments to enable farmers to obtain credit by using their stored crops as collateral for loans. Once a farmer has deposited their crop in the warehouse, it is logged in a central system that can be accessed in real-time to confirm that crops meet standards and are in fact stored at the warehouse. Banks use this information to lend to farmers directly. Alternatively, farmers can purchase inputs in-kind from agro-dealers who can also access the system and get repaid by banks.

Farmer benefits through:
• Taking on very little risk
• Ability to “sell off” a portion of their crops to obtain cash for emergencies
• Access to much higher prices later on
• Access inputs on credit based on arrangement among agro-dealer, bank, and warehouse

The warehouse anchors this arrangement by managing a digital platform that collects and shares real-time data, which increases transparency for all actors:
1. Banks can confirm that crops meet standards, and are in fact in the warehouse
2. Farmers can sell their crops in batches as their cash needs arise
Enablers across the value chain

While the three channels described above are effective for organizing value chain models, the rich landscape of models in the market suggests there are many ways to structure a specific solution. When looking across all these models, our research revealed a series of “enablers” that improve customer acquisition, distribution, administration, and repayment. These enablers include in-kind provision of inputs or vouchers, asset-based collateral, bundling, receipt-based collateral, field force networks, offtake agreements, farmer groups, technical assistance, digital solutions, and data consolidation or analysis. Successful models group several enablers together to create collaborative and effective value chain financing models for smallholders.

Our research groups these enablers into ten categories (see Figure 3):

Enabler 1: In-kind provision of inputs/vouchers

In-kind provision of inputs helps financial institutions better reach and serve smallholder farmers.

In this situation, a financial institution (e.g., a bank) transfers money to an agro-dealer or input provider, thus bearing the risk of providing the upfront capital, while the agro-dealer or input provider gives in-kind products (e.g., seeds and fertilizer) to the smallholder farmer. The agro-dealer and input provider serve as accessible distribution points for farmers, but farmers repay the bank for their loans after harvest and the sale of crops.³

BENEFITS

In-kind provision of inputs ensures farmers use financing for its intended purpose because instead of receiving cash that can be spent on anything, the farmer receives agricultural inputs that can only be used on the farm. It also simplifies distribution for financial institutions, which can use existing agro-dealer networks to deliver financing rather than building new channels. Lastly, in-kind provision lowers risk by limiting the number of cash transactions to farmers, which can be risky and difficult to distribute.

CHALLENGES

Agro-dealers often have a difficult time establishing working partnerships with financial institutions to source upfront capital and agro-dealers may have limited capability to assess and administer new loans on their own. Further, the in-kind inputs process runs the risk of
leading agro-enterprises to promote a certain vendor or type of input at the expense of a farmer’s best interest.

Similar to the in-kind provision of inputs, vouchers can also facilitate smallholder access to agricultural finance and increase the likelihood the lender will be repaid.

Through the voucher system, an agro-enterprise provides a farmer with a voucher that she can then redeem at a participating service provider for productive services, such as plowing. This gives the farmer access to better products that can improve her farm, while the lender lowers risk by ensuring allocated funds are used properly and avoiding cash transactions. Challenges of this model include loopholes that can allow for the misuse of funds, as well as the potential distortion of existing markets that can discourage private sector engagement in agricultural value chains.

**Enabler 2: Asset-based collateral through leasing and asset financing**

Farmers can acquire and use larger and more expensive equipment through leasing or asset financing arrangements.

The asset-based collateral approach includes leasing and asset financing (e.g., for tractors, irrigation equipment, etc.) Through leasing, the lessor owns the asset while the borrower pays “rent” until they own the asset outright or returns it to the lessor. Through asset financing, the farmer is the legal owner of the asset and repays a loan to the lender. In this case, the collateral backing the loan is the asset. This hard collateral provides additional protection against a borrower who doesn’t make payments and goes into default because the asset can be re-possessed and sold by the lender.
Asset-based collateral models are typically implemented in partnership between a financial institution (or dedicated leasing company) and one or more equipment vendors (e.g., tractor distributor or retailer). The financial institution assesses the borrower’s credit risk and provides the upfront capital for purchase of the asset. The equipment vendor acts as an accessible distribution point and leases the asset to the farmer, often along with technical assistance or training. Over time, the farmer repays the financial institution.

**BENEFITS**

In addition to improving farmers’ productivity, hard assets such as agricultural equipment open financial doors for farmers as they serve as collateral that they may not otherwise have. The relationship established between a farmer and an equipment vendor means that the farmer is more likely to receive training on how to operate the equipment, improving his or her ability to use it well.

**CHALLENGES**

Larger equipment can require a longer loan horizon (12-24 months) that is misaligned with farmers’ need to prioritize more immediate needs. Smaller assets (e.g., drip irrigation kits) may prove difficult to produce enough margin on the loan to cover the financial institution’s cost of origination and servicing. Additionally, farmers need to be trained on usage and maintenance of equipment in order to ensure it is used properly and doesn’t break down. Depending on local contract law and the maturity of the re-sale market, repossession and liquidation of an asset can be difficult in practice.

**Enabler 3: Bundling**

Bundling products can enable improved access to financing, potentially reduce distribution costs, and enhance user uptake.

**BENEFITS**

Bundling products increases access to financing by making the size of the loan economically feasible.

For example, when agro-dealers bundle pumps – which have low prices and margins – with other agriculture products, they are able to increase the total price and revenue of the bundle so a loan can be feasible. Bundling also reduces distribution or collection costs per item by sharing or building upon delivery channels or points. An asset financing company, for example, can “piggy-back” on the delivery points, relationships, and financing track record of a major agro-dealer. Most of all, bundling can increase farmers’ yields by giving them more access to a full suite of agricultural products.

**Which products are usually bundled?**

<table>
<thead>
<tr>
<th>Example bundles</th>
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<tbody>
<tr>
<td>A</td>
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<tr>
<td>B</td>
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<tr>
<td>C</td>
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</tbody>
</table>

**CHALLENGES**

Delivery, distribution and collection of bundled products can be highly complex and difficult to coordinate, master, and scale-up. While bundling is logical in principle, it is often challenging in practice to capture the efficiencies and cost reductions from integrated delivery.
Enabler 4: Receipt-based collateral

Receipt-based collateral is an alternative form of collateral that gives farmers access to agricultural financing.

After harvest, farmers often store their crops at a warehouse. Warehouses may also clean, process, and/or certify crops for farmers. Afterwards, a warehouse will issue a farmer a receipt verifying the crop is stored in the warehouse. Using the warehouse receipt as collateral, a farmer can then receive a loan from a financial institution for working capital or other investments that will help grow the farmer’s business.

**BENEFITS**
Provides farmers with alternative collateral to use in loans for working capital and other investments, while also helping banks protect and secure the collateral itself.

**CHALLENGES**
The poorest smallholder farmers are difficult to reach and serve through warehouse receipts, as warehouses often require a minimum deposit size. Warehouse partnerships with banks can be difficult, as banks are not always willing to accept receipts as legitimate collateral and there have been many instances of forged receipts (though most modern warehouses now use digital platforms that are easier to verify). Warehouse receipt systems work more effectively when price discovery mechanisms such as commodity exchanges exist, as they can improve the transparency and predictability of prices.

Enabler 5: Field force networks

Field force networks include the teams of bank loan officers, sales agents, or agro-extension agents that travel to villages to meet farmers in person.

Field force networks enable financing by acting as the front-end customer service agent for rural farmers. However, different types of field forces are better suited to certain elements of the loan origination, distribution, administration, and recollection process. For example, agro-enterprises and public and NGO extension networks are well positioned to identify farmers for financing because they have existing relationships with the farmers and knowledge of their productivity. However, credit assessments and distribution of loans is generally best handled by a financial institution’s own loan officers.

**BENEFITS**
In-person, on-the-ground relationships are very important in local communities, and field force networks led by groups from financial institutions or NGOs can harness the power of those relationships. With the development and expansion of mobile solutions, the process of coordinating and communicating with these networks is becoming more efficient.

**CHALLENGES**
Field force networks are costly and complex to execute as it is often difficult to train and maintain a field force. In practice, it is difficult to integrate the roles of bank officers and agriculture extension agents because they require two different specialized skill sets. Moreover, field agents may lack time, training, compensation, and incentives for additional duties.

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**Field Force Networks**

<table>
<thead>
<tr>
<th>Owner of field force</th>
<th>Customer identification &amp; acquisition</th>
<th>Credit assessment &amp; approval</th>
<th>Distribution of finance</th>
<th>Admin. &amp; Monitoring</th>
<th>Repayment</th>
<th>Collection / workouts / write-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial institution: employ a network of loan officers responsible for activities in the financial services value chain</td>
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<tr>
<td>Agro-enterprise: employ private extension agents who provide technical assistance and training to the agro-enterprise’s clients, i.e., smallholder farmers</td>
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<tr>
<td>Public and NGO: recruit and deploy (as paid workers or volunteers) agricultural extension networks/agents to provide technical assistance to smallholder farmers</td>
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Enabler 6: Offtake agreements

An offtake agreement is an arrangement in which an offtaker (i.e., a commodity trader or buyer) enters into a contract with a farmer agreeing to purchase that farmer’s crop at the end of the season.

The agreement can be used as a form of collateral for bank financing, and in many cases the loan from the bank is distributed through the offtaker to the farmer. After harvest, the farmer sells their crop to that offtaker. After subtracting whatever is due to the financial institution, the offtaker gives the remainder of the cash to the farmer and repays the financial institution, thus ensuring that the farmer’s loan is repaid.

**BENEFITS**
The offtake agreement model allows for improved distribution of smallholder financing by capitalizing on existing relationships, ensuring the bank gets repaid, and reducing the amount of cash that needs to be managed by the farmer.

**CHALLENGES**
The primary challenge to offtake agreements is “side-selling.” In other words, farmers may sell to a different offtaker despite having an agreement with the offtaker that arranged their financing. Thus, offtake agreements are best when relationships between the farmer and offtaker are strong (i.e., in relatively structured value chains). Another risk is that prices can vary between the time of the initial purchase agreement and final sale, which can leave insufficient revenue at harvest to repay the loan.

Enabler 7: Farmer groups

Organizing farmers into formal or informal groups that jointly obtain credit can facilitate the distribution of financing and ensure repayment. This practice is commonly used by microfinance institutions.

**BENEFITS**
The social dynamic of farmer groups can serve as a form of credit assessment because farmers will not want to participate in groups with people they do not trust. Furthermore, a group is an efficient distribution point for loans and repayment because the transactions can be aggregated by a group lead. Finally, repayment is further ensured when group members co-guarantee each other and support one another to repay the loans.

**CHALLENGES**
First, farmer groups are costly to organize, facilitate, and maintain. The best functioning groups are those that form naturally, rather than those in which farmers are artificially assigned to a group in a top-down manner. Second, covariance in the agricultural sector makes it difficult for farmers in the same group – and therefore in the same region and farming the same crops – to co-guarantee each other. If one farmer’s crops fail due to weather or other systemic reasons, other group members are likely to have experienced similar issues. Lastly, formal producer organizations or cooperatives are not always available or feasible. In less organized value chains, for example, informal clusters of neighboring farmers may be more effective than farmer groups.

Enabler 8: Technical assistance and training

Technical assistance (TA) and training is a critical enabler of finance for smallholders. It is important to note that agronomic training alone will not suffice; farmers also need financial literacy, farm enterprise training, and market linkages.4

Agronomic training is typically delivered by public or private extension agents, whereas financial literacy and enterprise training is delivered by financial institutions; some NGOs do both. Agro-enterprises may also provide technical assistance, particularly on how to use inputs or equipment properly.

Technical assistance packages unlock steps in the financial services value chain, but do not need to be delivered simultaneously to each other. Technical assistance spans across the financial services value chain and ideally the cost is built into the business model. When designing the financing model, it is not who provides technical assistance that’s most important, but rather ensuring that all packages of technical assistance are delivered to the farmers and that there is a clearly designated payer for the technical assistance.
Enabler 9: Digital or mobile data collection, information dissemination, and payments

Digital services can overcome various barriers to financial access. User data collection informs credit assessments, information delivery over mobile technology can strengthen the farmer’s enterprise, and mobile payment transactions enable loan and insurance disbursements or repayments. A subsequent ISF Briefing Note will describe trends in digital agriculture finance solutions in more detail.

1. Collection and management of user data

User data collection supports credit assessments, allows the industry to track borrower composition and trends, and enables financial institutions to monitor borrowers.

2. Delivery channel for agricultural extension, market updates, or training refreshers

Information delivery over mobile can strengthen the farmer’s enterprise through information on best practices (e.g., crop and livestock advice, storage solutions, post-harvest processing opportunities), weather information, market data (e.g., crop prices), and financial information. Farmers can use mobile phones to contact call centers for extension advice or product-specific information and training. Sending SMS reminders to farmers can also improve farmer’s repayment rates.

3. Disbursement and repayment platform

Mobile money platforms and mobile wallets support loan disbursement to or repayment from input providers, agro-enterprises, or other smallholder farmers. Additionally, digital payment platforms facilitate insurance premium payment and claim disbursement.

Enabler 10: Data consolidation and analytics

Efforts to gather and consolidate relevant data from various sectors or companies serving smallholders and analyze the data to inform credit decisions can help qualified farmers access financing and allow financial institutions to make more informed and safer credit decisions.

DATA CONSOLIDATION

Compiling and aggregating farmer’s personal data (e.g., ID, loan history, land size), past financial transaction data (e.g., loan history, airtime purchases, mobile money history), and data from other sources (e.g., agriculture sales volumes or contracts) can supplement credit history and allow financial institutions to make a more informed credit decision. Historically, data has often been dispersed across agro-enterprises or sectors, but providers serving smallholders can form bilateral or multilateral partnerships to more effectively identify qualified customers (e.g., mobile network operators can share data with agriculture finance providers, or vice versa).

DATA ANALYTICS

Algorithms can be applied to analyze consolidated smallholder farmer data from both agricultural and non-
agricultural sources to improve accuracy of and decrease costs of credit assessments. A future ISF briefing note will discuss trends in data analytics in more detail.

**Implications for Donors, Investors, and Agro-Enterprises**

Value chain financing models can be an effective way to serve smallholder farmers by building on existing business relationships between agro-enterprises and farmers to originate, distribute, and recollect loans throughout the seasonal crop cycle. Value chain financing models greatly increase what is possible in terms of lending to smallholder farmers by embedding relationships and processes within value chains. The advantage of these models is they are able to overcome constraints that make traditional lending models difficult. The disadvantage of these models is that they can be complex and localized. However, the rich landscape of models being used suggests that value chain financing models are a key part of unlocking credit in difficult market environments. With this in mind, the international community should become much more intentional around defining and supporting different value chain models. We would suggest the following roles for key actors:

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2. Establish pre-competitive alliances with other agro-enterprises in the industry to better develop joint solutions

**NOTES**

1. Note: This study covers “agro-enterprises” that interact directly with smallholder farmers, but does not include farmer organizations (e.g., cooperatives) and integrated supply chains of multinational buyers, which are covered in prior ISF research.

2. IFAD, “Agricultural Marketing Companies as Sources of Smallholder Credit in Eastern and Southern Africa,” 2003

3. There are some variations of the repayment method; e.g., the farmer may repay the bank via the agro-dealer. However, such models are much less common.

4. For additional research by ISF on technical assistance, see “Technical Assistance for Smallholder Farmers: An Anatomy of the Market” and “Rethinking Technical Assistance to Unlock Smallholder Financing.” Source: Dalberg and ISF research and analysis.

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**Manufacturers (of inputs)**

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ABOUT THE INITIATIVE FOR SMALLHOLDER FINANCE

The Initiative for Smallholder Finance is a multi-donor initiative hosted by the Global Development Incubator to build research and development infrastructure in the smallholder finance industry and make progress toward filling the gap in financing through targeted product development, piloting, and partnerships. For the original report that led to the creation of the Initiative for Smallholder Finance, see “Catalyzing Smallholder Agricultural Finance” (2012).

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