



# *Value Chain Finance and Nepal: Perspectives and Insights*

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## Preamble

Value chain finance refers to financial products and services that flow to or through any point in a value chain in order to increase returns on investment, growth, or competitiveness. Whereas value chain finance transactions are not new (production finance could be considered “value chain finance”) the emphasis on improving financial access at one or several points in the value chain to increase the competitiveness of the entire value chain is a relatively recent development. In Nepal, value chain finance is often referred to, and understood as, formal access to financial services by value chain actors via financial institutions and intermediaries. This differs somewhat from value chain finance as it is discussed in formal value chain finance research papers, and practiced in various other countries, which focuses more on intra-finance (lending) between actors in a given value chain.

This paper looks at gaps in value chain financing in Nepal from a practitioner’s point of view, with a focus on agricultural value chains. It explores how identifying relationships along the value chain, mitigating constraints, exploiting opportunities for value chain finance, and exploring how formal financial institutions can enter the equation can improve the overall effectiveness and efficiency of the value chain. The paper compares value chain finance as it is currently practiced in Nepal with global good practices in an effort to identify areas for improvement in Nepal.

This paper is the culmination of two and a half years of ‘agricultural livelihoods’ work in Nepal by Mercy Corps in partnership with farmers, farmer groups, cooperatives, traders, exporters, trade associations, non-governmental organizations, micro finance institutions and government agencies using a value chain methodology. The paper also builds upon Mercy Corps’ work in financial services and agriculture globally, and on documented global good practices.

The paper is divided into five sections. The introduction discusses the concepts of value chains and value chain finance in the context of the agricultural sectors of developing economies such as Nepal; the second section explains the rationale for value chain financing; the third section discusses various methodologies of value chain finance in Nepal and includes successful approaches undertaken by Mercy Corps and other development agencies in Nepal; the fourth section illustrates global innovative practices in value chain finance; and, the fifth section summarizes the paper’s conclusions.

# 1. Introduction

## *1.1 Value Chain*

The term “value chain” describes the full range of activities that are required to bring a product or service from conception, through the different phases of production (involving a combination of physical transformation and the input of various producer services), delivery to final consumers, and final disposal after use<sup>1</sup>.

While approaches and applications vary, most value chain approaches have several common characteristics, including: a market system perspective; a focus on end markets; an emphasis on value chain governance; a recognition of the importance of relationships; a focus on changing firms’ behavior and transforming value chain relationships; targeting leverage points; and, empowering the private sector. In the international development field, projects utilizing the value chain approach generally tend to shift the balance of power within value chains through the formation of associations; branding; alternative financing; support for market systems; market or supply diversification; and, changing the basis of competition (generally from price-based to quality-based).

In Nepal, most value chain projects implemented to date have focused on agricultural commodities or products, which is logical given that 77% of the country’s population depends on the agricultural sector, and given that the country’s two poorest occupational categories (agricultural wage laborers; and, smallholder farmers) draw income from the sector.

## *1.2 Value Chain Finance – Agricultural Value Chains*

Value chain finance refers to financial products and services that flow to or through any point in a value chain in order to increase returns on investment, growth, or competitiveness for that value chain.

The concept of “agricultural value chain” covers the full range of activities and participants involved in moving agricultural products from farmers’ fields to consumers’ tables. Participants in this chain need money to carry out their activities. Although they often turn to traditional rural credit sources, rural producers, processors and retailers are receiving increasingly large injections of resources from other entities or actors with whom they trade. These flows of credit and financing among value chain actors comprise what is known as “value chain finance.” Although value chain finance is conceptually simple, it is more complicated in practice: financial linkages between different players within a given value chain are often difficult due to factors such as longstanding familial and trading relationships; informal, culturally embedded factors; the presence of feudal landlords and their dominance in the value chain; a lack of formalized trade relations between different levels of the value chain; and, finally,

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<sup>1</sup> A handbook for Value Chain Research – Raphael Kaplinsky and Mike Morris.

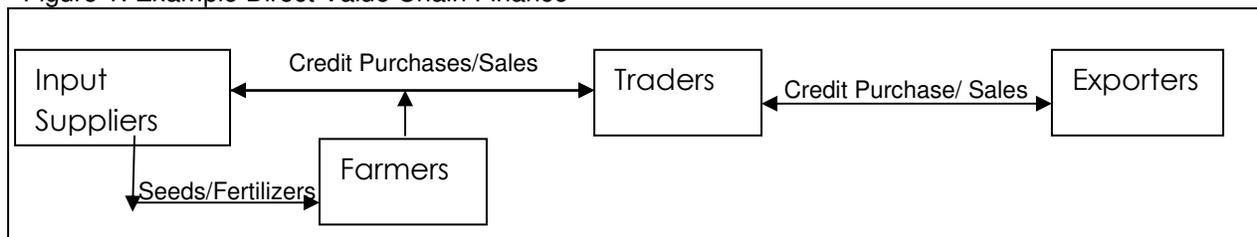
knowledge and information asymmetries between different actors in the value chain. The concept of agriculture and value chain finance is therefore still relatively new for most developing countries, including Nepal.

### 1.3 Broad Categories of Value Chain Finance

In general, the majority of agricultural finance in developing countries and underdeveloped economies is provided from within the value chain, with no direct involvement from financial institutions. The future challenge lies in creating more and stronger bridges between value chain actors and financial institutions (that is, indirect value chain finance)<sup>2</sup>, while recognizing and formalizing lending arrangements between value chain actors (that is, direct value chain finance).

*Direct value chain finance:* In cases where banks are inactive, actors within a value chain cater to financial shortages by entering into non-cash transactions and negotiations to better manage and coordinate the effective functioning of the value chain. In the case of direct value chain finance, examples might include a buyer of the product advancing credit to small producers; producer or farmer groups providing inputs on credit to their members; agro-businesses advancing credit to his or her clients; and, input suppliers providing inputs on credit in return for in-kind repayment post-harvest. In these relationships, there is generally no transfer of money, but the needs of various actors are met ‘in kind’ through the provision of goods and services. In informal direct value chain finance mechanisms as they are currently practiced in many developing countries, no cash changes hands. Figure 1 depicts a direct value chain finance approach.

Figure 1: Example Direct Value Chain Finance

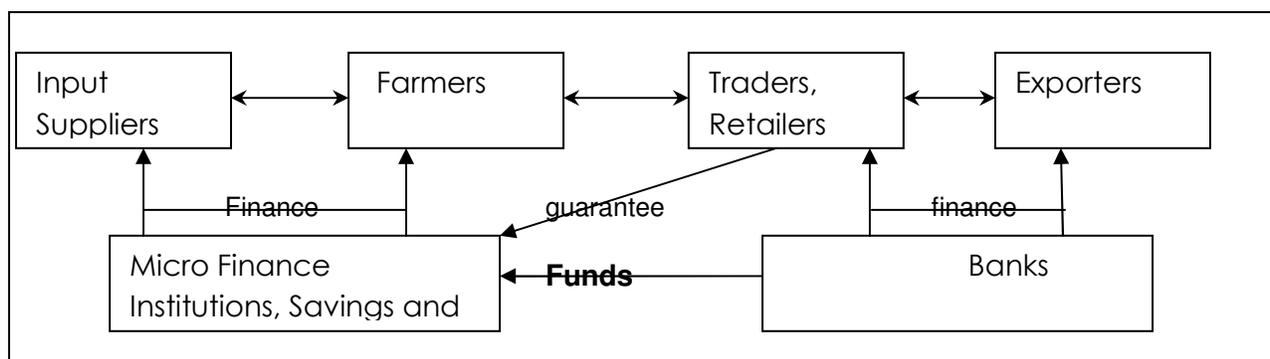


*Indirect value chain finance:* In more developed economies, financial institutions play a key role in financing actors in the value chain. Several financial institutions strategically position themselves to cater to viable and potential value chains. Linking a financial institution to the value chain can be an effective way of taking “direct financing” a step further and improving the likelihood of establishing viable, long-term financing relationships. Strengthening indirect financing can also be a way to provide value chain actors greater freedom of choice in carrying out their value chain transactions, since it has the ability to free them from lending obligations to other actors in the value chain. Examples of effective direct value chain finance might include warehouse receipts

<sup>2</sup> RAFI Notes: Value Chain Finance, USAID

lending; bank lending to a producer based on that producer's relationship with a well-established buyer; or, a trade association operating a savings and credit cooperative and lending to its members (traders, producers). When a buyer with a sufficiently strong reputation as a reliable purchaser is willing to guarantee what it buys from its suppliers (farmers), even smallholders become potential customers for formal financial institutions. Figure 2 depicts an indirect value chain finance approach.

Figure 2: Indirect Value Chain Finance



*Direct value chain finance* builds on established relationships between value-chain actors that facilitate credit screening, monitoring and enforcement, resulting in faster service and fewer obstacles to credit provision. This is practiced in developing economies like Nepal where financial institutions are still clustered around cities and district headquarters. However, this is not considered complete direct value chain financing as it does not build financial linkages among all the value chain actors and instead limits itself to rural actors at the lower levels of a given value chain – that is, between farmers, immediate buyers at the village level, and input suppliers - and ignores more powerful players in the value chain such as regional traders and exporters, who are considered to have a stronger financial base. A more coordinated effort to channel funds from higher level actors with a stronger financial base to lower level actors with poor access to formal financial services could constitute a more sustainable direct value chain finance mechanism. In order for this to happen, however, there needs to be a neutral facilitator who oversees the governance of such an arrangement (such as development actors, trade associations, or chambers of commerce).

*Indirect value-chain finance* from financial institutions is a longer-term process that complements and builds off the strength of value-chain relationships. The benefits of these relationships – secure markets, improved skills – make potential borrowers more creditworthy (attractive) to financial institutions. Lending by financial institutions is more explicit than direct value chain lending because it is not embedded into another commercial transaction – financial institutions know how profitable their lending is, whereas value chain actors generally look only at their overall profitability. Ultimately, lending by financial institutions may well be more sustainable, as it taps into a larger potential pool of funds and transfers responsibility for the actual lending to a specialized entity that sees lending as their core line of business, rather than as a necessary but

secondary activity. Finally, because of the involvement of regulated financial institutions, clients may have access to a greater range of financial services, including savings, insurance, transfers and investment credit. The key to success in this type of mechanism is to facilitate linkages between savings and credit cooperatives, micro finance institutions (MFIs), and commercial banks, and to help these institutions cater to the needs of various actors in the value chain. For example, commercial banks could cater to regional traders and exporters who require a higher volume of financial services, while MFIs and SCCs could cater to smaller-scale traders, producers, and local input suppliers.

## **2. The Rationale for Value Chain Finance in the Nepali agricultural context:**

Agriculture in developing countries, all over the world, is experiencing profound, fast-moving changes. South Asia, where on average 60% of the population is dependent on agriculture,<sup>3</sup> is no exception. Globalization, although advancing more rapidly in some countries than in others, has hastened the transition from traditional, low-productivity agriculture toward a modern, high-productivity agricultural sector. The resulting processes of structural change entail profound consequences for employment, income generation, risk management, poverty alleviation, and the well-being of rural households in these countries.

Given the continual process improvements required to meet global standards and market demand, many value chain actors are left in a “cash-crunch” during production or trade cycles; this is where appropriate financial service mechanisms are most helpful. Faced with this situation, many actors in a value chain resort to informal financial institutions (money lenders, feudal landlords) and trade brackets for financing. This situation is also common Nepal, where limited financing options and outreach of formal financial institutions and mechanisms continue to affect rural input suppliers, producers, and traders.

The subsistence nature of production, and the corresponding low level of savings, has resulted in inadequate funding for farming operations in Nepal. In addition, high interest rates and transactions costs prevent most smallholder farmers from accessing formal financial services. Although cooperatives and savings and credit groups run by rural communities, organized farmers groups, and some NGOs are providing credit to farmers and rural entrepreneurs, these institutions generally lack sufficient capital to cater even to the needs of their members, and therefore have very limited potential to expand their scope or services in a financially sustainable manner. On the other hand, many MFIs provide loans to clients who rely primarily on agriculture as a livelihood strategy: however, since these loans are rarely tailored to the agricultural sector and are not accompanied by embedded technical services, and since the MFIs are rarely interested in the type or potential of the crop being grown by the client, they have limited

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<sup>3</sup> Agri Revolution Seminar: Mumbai India: March 2007

potential to bolster commercial agricultural value chains, although they will remain an important resource for low-income rural families.

In Nepal, out of a total population of 26 million people, 13 million people lack access to even the most basic formal financial services, a figure thought to be steadily declining.<sup>4</sup> Microfinance Institution (MFI) out-reach, through both government and international donor efforts, is inadequate and heavily concentrated in more easily accessible areas, reaching only 23% of rural people.<sup>5</sup> The coverage of financial institutions in the hilly region is thought to be around 11%.<sup>6</sup>

Over the past two decades, Nepal's financial sector has expanded and the number and type of financial intermediaries have grown rapidly. Still, access to sustainable financial services remains limited for many people in Nepal, especially in the rural hills and mountains. Access to diverse financial products and services is an indispensable component for successful participation in a market economy and the effective development of value chains. In order to expand access to sustainable financial services along the value chains in rural areas of Nepal, financial institutions need outreach support and technical assistance to develop wider client networks, appropriate products, and procedures for profitable lending. Increased coordination and cooperation among value chain actors to address financial gaps for the smooth flow of products from farm to markets is also important, as is the need for coordination and cooperation between formal and informal financial institutions.<sup>7</sup> In short, the growth of commercial agriculture in Nepal is linked, to a certain extent, to the growth of appropriate rural finance mechanisms, including improved direct and indirect value chain finance.

### **3. Value Chain Finance in Nepal as Practiced in Nepal**

The concept of value chain finance as explained in not new to Nepal. Although the concept of value chains has grown more popular among development actors in the past decade, the farmers, collectors, traders, and input suppliers of rural Nepal have been entering into informal contracts<sup>8</sup> for many years, ranging from sales commitments to long-term financial commitments. Most value chain finance evident in Nepal is more direct in nature, including financial relationship between farmers, local money lenders and merchants. Various value chain finance approaches as currently practiced in Nepal are discussed in this section.

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<sup>4</sup> World Bank. "Access to Financial Services." Finance and Private Sector Development Unit. 2006.

<sup>5</sup> ADB. "Technical Assistance to the Kingdom of Nepal for Strengthening Selected Rural Financial Institutions." December 2003.

<sup>6</sup> Presentation MF Summit Nepal, G.B. Thapa, Chairperson, CMF

<sup>7</sup> In the paper the formal financial institutions are referred to A-D types of institutions categorized by Central Bank of Nepal; informal financial institutions are money lenders, savings and credit cooperatives and any other that do not fall under A-D categories

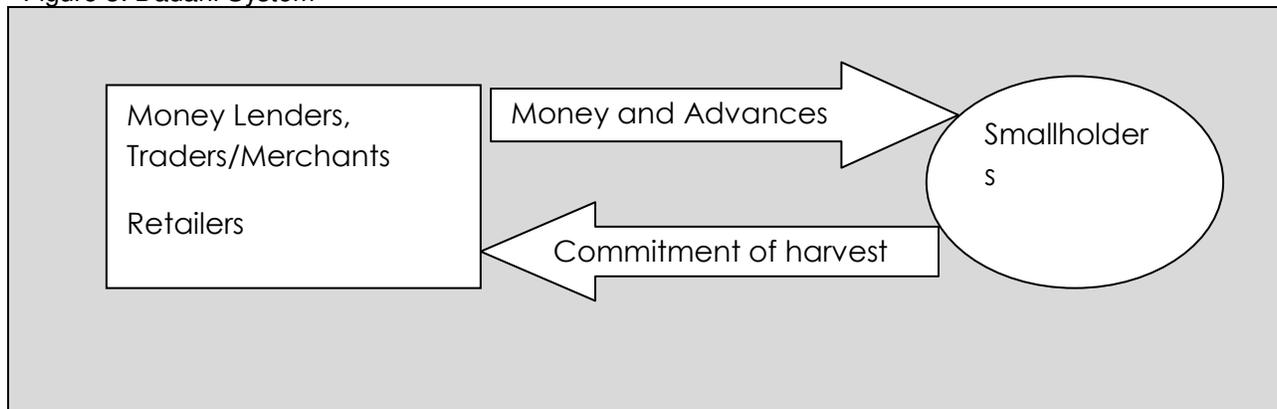
<sup>8</sup> Contracts that do not have any legal consequences and or recourse

### *3.1 Informal Mechanisms: Money Lenders, Local Merchants, and the Dadani System:*

Local merchants and other traditional moneylenders are the most available source of agricultural lending in rural Nepal. These sources are informally organized and are known to transact with farmers on unfavorable terms owing to the absence of other formal financial service providers in the area. Interest rates for these informal loan products can range as high as 120% per annum, although lower interest rates (30% - 60% per annum) are also found.

The presence, even today, of the 'dadani system' reflects informal non-financial and financial agreements prevalent between agricultural producers and traders in many areas of Nepal. Under the dadani system, farmers access loans from the traders or merchants to whom they normally sell their produce in return for a certain amount of their harvest at a pre-determined rate, irrespective of market prices at the time of harvest. These loans are generally taken more for consumption and social purposes than for productive purposes, since the funds are rarely invested into agricultural improvements but are rather used to purchase goods, or celebrate festivals, during the lean season. In some cases traders supply agriculture inputs in credit during cultivation season and collect the credit during harvesting season in cash or kind. The practice is depicted in figure 3 below:

Figure 3: Dadani System



The dadani system, although useful for consumption loans for small farmers during lean seasons, is not considered a sustainable way to address the cash-crunch faced by farmers in production and trade cycles. This is because use of the dadani system minimizes the farmer's post-harvest income by preventing the farmer from selling produce at prevailing market prices. As a result, the cycle of debt continues, and loan capital is not used to improve value chain return on investment, growth or competitiveness. Nonetheless, the dadani system is still widely practiced in rural Nepal where formal financial service providers are absent, and in many cases farmers depend on the dadani system to sustain household livelihood strategies through production and trade cycles.

### ***3.2 Value Chain finance through Agriculture Development Bank***

With the main objective of providing institutional credit for enhancing the production and productivity of the agricultural sector in the country, the Agricultural Development Bank, Nepal was established in 1968 under the ADBN Act 1967, as the successor to the Cooperative Bank. The Land Reform Savings Corporation was merged with ADBN in 1973. Subsequent amendments to the Act empowered the bank to extend credit to small farmers under group liability and expand the scope of financing to promote cottage industries. The amendments also permitted the bank to engage in commercial banking activities for the mobilization of domestic resources<sup>9</sup>.

Agricultural Development Bank Limited (ADBL) is an autonomous organization largely owned by Government of Nepal. The bank has been working as a premier rural credit institution since the last three decades, contributing a more than 67 percent of institutional credit supply in the country. Hence, rural finance is the principal operational area of ADBL. It has also been executing the Small Farmer Development Program (SFDP), a major poverty alleviation program launched in the country. Furthermore, the bank has been involved in commercial banking operations since 1984. The structure and its network enabled ADBL to cater to value chain actors at different levels.

However as evidenced by different studies as well as an ‘access to finance’ study conducted by the World Bank in 2006, the Agricultural Development Bank’s financial performance revealed serious concerns about its financial health and outreach. Nonperforming loans were alarmingly high, reaching 40 percent in the Small Farmers Development Program. Accordingly, it was recommended that the program be turned over to independent cooperatives as soon as possible. In addition, the ADBL has not capitalized upon strategic investment areas in agriculture, which is a major bottleneck in structuring agricultural loans and embedding mitigation strategies to reduce non-performing loans and defaults. Finally, the bank’s outreach network was necessarily reduced during the conflict period, and has not yet returned to pre-conflict levels. Despite the uneven financial performance of this bank, their extensive branch networks—which account for 61 percent of Nepal’s bank branches—offer enormous potential for expanding access to financial services and to cater to the needs of specific value chains.

### ***3.3 Value Chain financing through savings and credit cooperatives***

Savings and credit cooperatives (SCCs) provide a variety of microfinance services to households in three of Nepal’s distinct regions—the Hills, Terai, and Kathmandu Valley. Nearly all Nepali SCCs are self-funded using member savings and equity. Most Nepali SCCs are also profitable, including those located in poor, remote areas of the Hills

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<sup>9</sup> [www.adbl.gov.np](http://www.adbl.gov.np)

region. Key reasons for the SCCs' strong financial performance include reliance on member savings and control of administration costs.

The majority of the SCCs in Nepal are also multipurpose cooperatives, and specifically focus on agriculture commodities. Most of their members are smallholder farmers, who use loans from the SCCs to invest in high quality seeds, fertilizers and marketing. High-profit SCCs also show superior interest earnings on loans as compared to low-profit SCCs. Nepali SCCs generally do not need concessionary funds, because they are already profitable and able to mobilize member savings. While savings-led microfinance in Nepali SCCs is a slow process, there is significant long-term outreach potential in local communities

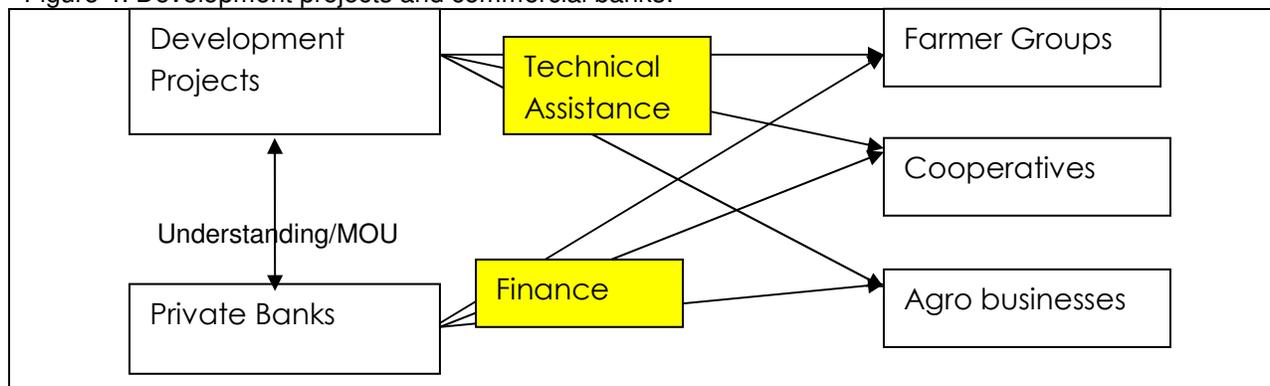
There is much debate regarding the financial sustainability of microfinance institutions (MFIs) and commercial banks engaged in rural finance. Critics argue that most MFIs and banks can only cover operating costs under the most optimistic conditions when providing microfinance services in remote areas. Sustainability is especially challenging in Nepal's Hills. Poor communication and transportation infrastructure increase administration costs and complicate routine tasks such as savings and loan collection. Consequently, the conventional wisdom among Nepal's microfinance community is that MFIs in the Terai and Kathmandu Valley find it comparatively easier to achieve sustainability than MFIs in the Hills. However, there is no available evidence that either supports or refutes this claim.

What is clear, however, is that there is much to be gained from improved coordination and cooperation between SCCs and MFIs (or commercial banks providing microfinance services) in rural areas. A more coordinated approach of linking SCCs to more structured financial institutions, such as MFIs and Commercial Banks, is important in contexts where larger financial institutions are hesitant to expand due to remoteness and high operating costs.

### ***3.4 Value Chain Finance through Private Commercial Banks***

Increasing numbers of commercial banks in Nepal are strategizing to expand into rural areas and "down-scale" their operations to meet the needs of the poor. The banks see these segments of the population as a growing customer base; are seeking to serve the poor as per Nepal Rastra Bank deprived sector lending policies; and, see opportunities to address current gaps in rural finance through new technology platforms. However, while the capital and technologies available to these banks are assets, the knowledge and practices of these banks to work with remote and rural clientele is inadequate. For this reason, many banks are working with development projects to gain an understanding of the context before opening branches or expanding operations. In most cases, these development projects give non-financial guarantees by way of assurances, technical assistance, and guarantees to the clients in order to provide banks with a psychological impetus to expand into non-familiar environments. Figure 4 below, and the following case study (case 1), exemplify this practice in Nepal.

Figure 4: Development projects and commercial banks:



The case below outlines a successful partnership between a commercial bank and a development project to finance value chain actors effectively.

*Case 1: Value Chain financing efforts by commercial bank in rural Nepal: Courtesy Deepak Khadka: Formerly Deputy Team Leader, BDS MaPS project, currently with Practical Action*

During the implementation of a USAID-funded Non-Timber Forest Products (NTFP) value chain development project in Mid-Western Nepal, the Bank of Katmandu partnered with the project to finance a distillation plant to benefit the NTFP value chain in the Surkhet district.

In the process of implementing activities in the NTFP sub-sector in the Dailekh-Surkhet-Banke economic corridor, the project team recognized the need for a small scale secondary processing plant (distillation plant) as a way to add value to NTFPs while supporting product diversification. In conducting the feasibility study for this distillation plant, the cost was determined to be NPR 1,100,000 (USD 14,000). The project team had meetings with Micro Finance Institutions (MFIs) and Financial Intermediary NGOs, but both of these actors were unwilling to finance or co-finance the plant. The project then organized NTFP farmers into a formal association (Gwansi Manakamana Group) to facilitate the creation of a for-profit distillation entity (Gwansi Manakamana Jadibuti Prasodha Uddhyog); however, it still proved difficult to source appropriate financial services. As these events were taking place, the Nepal Rastra Bank's deprived sector lending policies were introduced, providing incentives for commercial banks to extend rural financial services. This provided an enabling environment for the project to begin discussions with the Bank of Kathmandu (BOK).

The project and the bank entered into an agreement under which the BOK extended a loan for slightly over 50% of the project costs, with the remaining amount to be covered by the association as shareholder's equity, in return for support from the project to facilitate site visits,

organize rural agro-enterprise assessment workshops, and help the association develop a business plan to BOK standards. BOK also agreed to extend the loan without collateral, and to adjust to a repayment frequency more appropriate for small agro-enterprises (quarterly installments, with a loan tenure of four years at a 7% interest rate per annum), in return for the project's efforts to monitor performance and facilitate repayment. Based on the successful deployment of this model in Surket, BOK agreed to finance two additional distillation plants in banke (Bridaban Jadabuti Uddhyog and Chipanai Jadabuti Prasodhan Uddhyog).

### ***3.5 Facilitating Expanded MFI Outreach as a Key Input in Agricultural Value Chains: A Case Study of Mercy Corps' partnership with Nirdhan Utthan Bank, Ltd.***

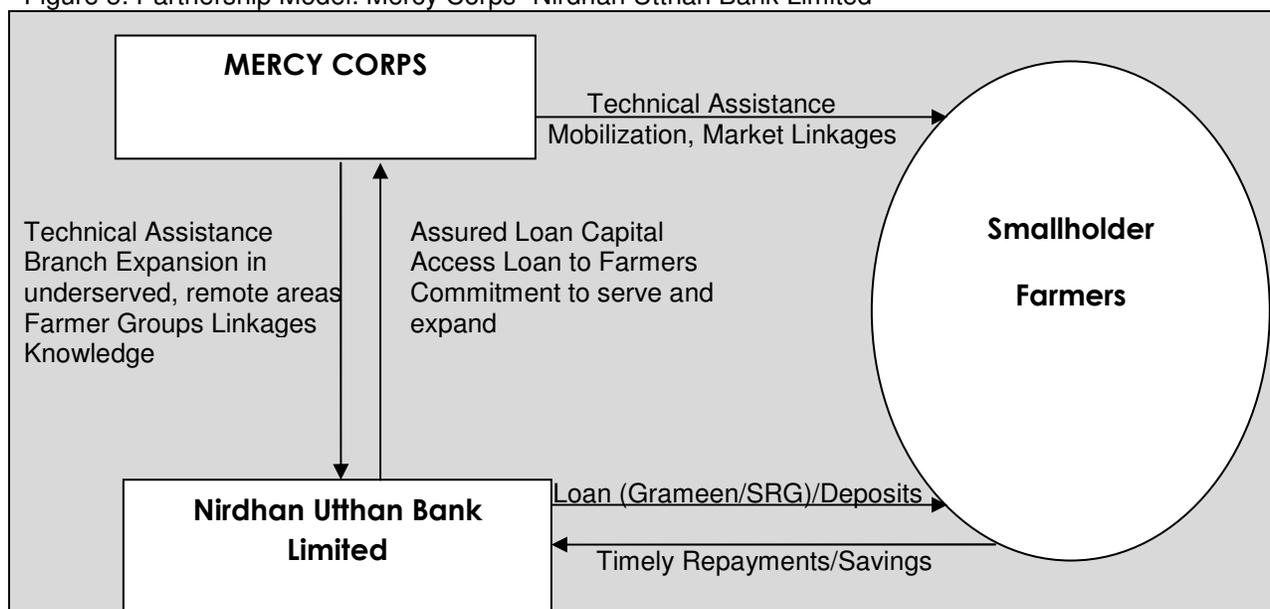
Mercy Corps' work in Nepal with Nirdhan Utthan Bank, Ltd. (NUBL) provides another example of the facilitation of indirect value chain finance by formal financial service providers, this time in partnership with a MFI in Eastern and Far Western Nepal. After working with spice crop farmers in Eastern Nepal for a year, Mercy Corps realized that a lack of access to formal financial services was a key constraint for commercial agriculture. In particular, lack of formal financial services and reliance on the dadani system were barriers to collective marketing, and also restricted productive investments at the household and farmers group level.

As a result, Mercy Corps entered into an agreement with NUBL that temporarily subsidized the MFI's geographic expansion along several value chains supported by the Mercy Corps (that is, covered operational losses for a three year period) in return for a guarantee of financial service provision to a certain percentage of farmers supported by Mercy Corps (\$3.7 million in loans in the expansion districts, of which at least 10% went to farmers supported under Mercy Corps projects). Outside of this agreement, NUBL was free to select and mobilize its own clients so as to maintain a profitable operating platform. The decision to facilitate the entry of a new firm was made after an analysis of existing financial service providers in the target districts, which concluded that existing MFIs and SCCs in the project area provided insufficient outreach to and support for client groups, and that there was a general lack of professional-quality financial services in the project areas.

This partnership agreement created a situation in which technical support to farmers, and efforts to improve overall value chain governance by Mercy Corps, were complemented by financial services from NUBL. While both organizations worked independently, NUBL's work reduced farmer loan costs while strengthening farmers' group mobilization, while Mercy Corps' work made farmers more creditworthy through improved technical practices. As a result, NUBL was able to lend to over 480 farmers in 26 groups in the first year of the partnership, and this number continues to increase with time.

The partnership modality as described has been depicted in Figure 5 below:

Figure 5: Partnership Model: Mercy Corps- Nirdhan Utthan Bank Limited



## 4. Global Innovative practices in Value Chain Finance

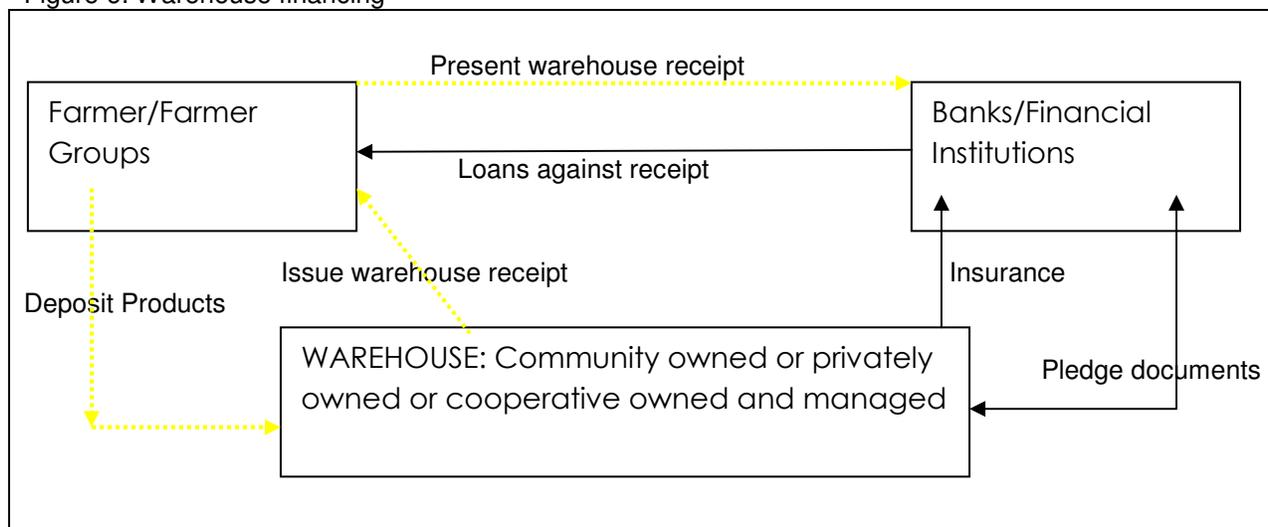
There are many global approaches in value chain finance that have been successful and others that have failed. This section of the paper highlights the latest trends in value chain finance that can potentially be replicated in developing agricultural economies such as Nepal.

### *4.1 Warehouse Receipts as a Source of Financing the Value Chain*

This approach, which is a common practice in many developed countries, is increasingly being practiced by financial institutions in developing countries. The approach facilitates a partnership between a warehouse (private or cooperative-managed), a financial institution, and the farmers in a network to finance the working capital needs of the latter. Farmers deposit produce in a designated warehouse, and in exchange receive an instrument called the 'warehouse receipt'. The farmer then presents the warehouse receipt to the financial institution, which accepts the receipt as a supporting document for a loan application and issues a loan, generally at 65% of the value of the receipt. The bank requires the warehouse to cover the insurance for the amount of produce pledged with the bank through the farmer's warehouse receipt; the

bank then retains title to the produce until the farmer repays the loan principal and interest<sup>10</sup>. The approach is depicted by Figure 6 below:

Figure 6: Warehouse financing



The practice is usually beneficial for commodities that are durable and can be stored for three to six months. In the majority of cases, farmers replenish fresh stock of equal value and sell the old stock. This is usually a secure practice for both the bank and the farmers, and also stabilizes operations for the participating warehouse. This approach has yet to be practiced in agricultural settings in Nepal, but manufacturing companies in Nepal pledge stock to avail short-term working capital loans.

#### ***4.2 Loans with Purchase Order as Collateral: the Factoring Approach***

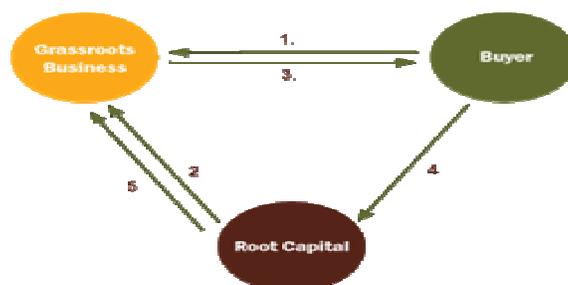
There is an increasing trend globally in which financial intermediaries extend loans against secure sales contracts or purchase orders. Under this approach, the financial institution receives a confirmed purchase contract from the producer, and then enters into a tripartite agreement with the producer and buyer that commits the buyer to pay the entire amount of sales due to the producer to the financial institution. After payment, the financial institution deducts the interest and principal against the producer's loan, and remits the remaining funds to the producer.

The case below illustrates a similar approach, as practiced by Root Capital<sup>11</sup>.

<sup>10</sup> RAFI Notes Issue 2, June 2006: Value Chain Finance, USAID

<sup>11</sup> Root Capital is a nonprofit social investment fund that is pioneering finance for grassroots businesses in rural areas of developing countries. Root Capital provides capital, financial education, and market connections to small and growing businesses that build sustainable livelihoods and transform rural communities in poor, environmentally vulnerable places.

**Root Capital approach<sup>12</sup>:** For many of its loans, Root Capital as the investor enters into sales contracts with companies like Green Mountain Coffee Roasters, Marks & Spencer, Starbucks, and Whole Foods as a form of collateral. When natural products are shipped, the buyer pays Root Capital directly for interest and principal payments. Because of this factoring model, Root Capital is assured that a loan will be repaid (the repayment rate exceeds 99 %). By moving beyond traditional approaches to collateral, Root Capital is proving the business case for lending to the rural “unbankable”.



Root Capital's Model

1. Order goods;
2. Make loan with purchase order as collateral;
3. Ship goods;
4. Pay for goods;
5. Remit payment, net of loan principal and interest.

In countries like India, the factoring approach is practiced by commodity exchanges that act and broker the deal between the buyers and the farmers. The commodities are hedged with future options and contracts based on sophisticated forecasting techniques. In an environment like Nepal where commodity exchanges are relatively underdeveloped, and where the agriculture sector standards are inconsistent, it may be difficult to find investors willing to enter into a tripartite agreement that requires financial and long term contractual commitments. Nonetheless, this approach may be applicable in contexts where proven contract farming arrangements exist.

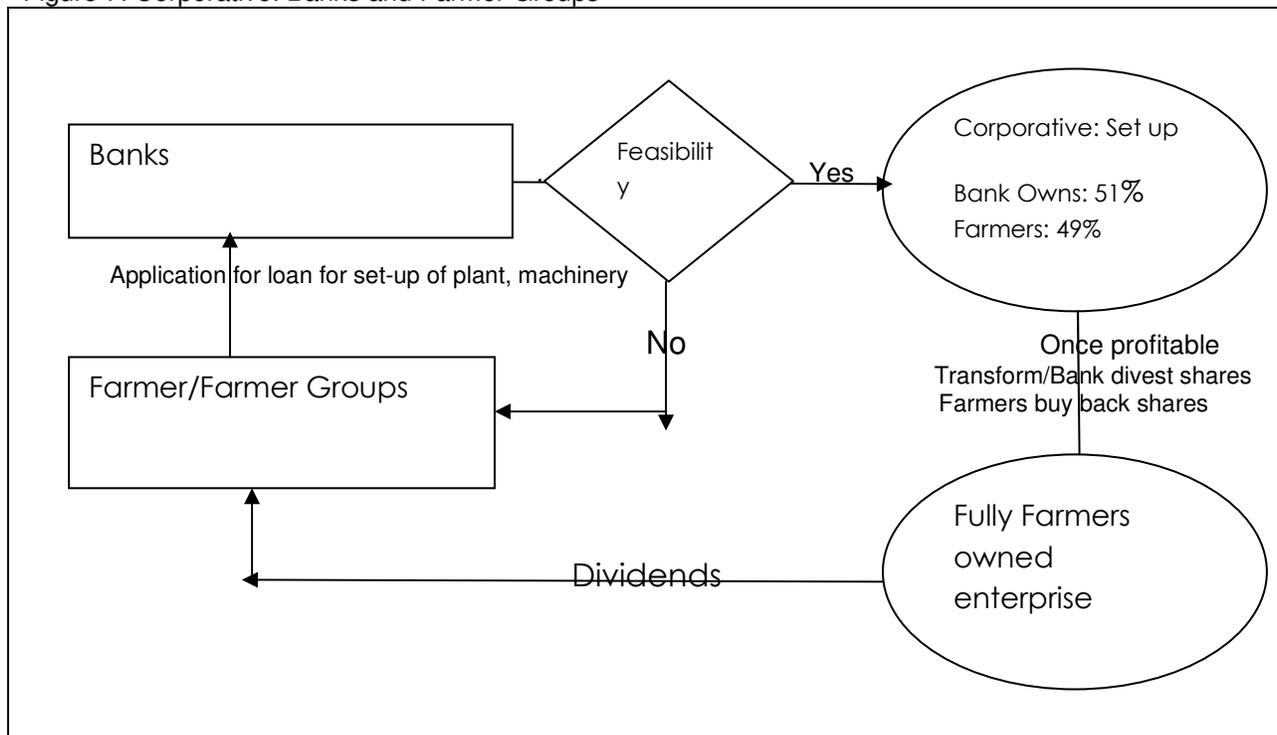
### ***4.3 Corporate Approach: Bringing Together Value Chain Actors***

The corporative approach is defined as a modality wherein all actors involved in the production, sale and financing of a product self-organize into a collectively-owned private enterprise. The banks, along with the farmers/ farmers' network, then buy shares in this company and become partners. In the majority of cases, the bank owns 51% and

<sup>12</sup> www.rootcapital.org

the farmers group buy the remainder (49%) of the shares<sup>13</sup>. Once the enterprise starts making revenue through the sale of produce, part of the revenue is used to buy back the share of the bank and transfer it into the name of the farmers' group. The amount of investment by the bank is usually used to set-up plants, processing units and related infrastructure. Under this model, both the bank and the farmers benefit from the set-up of the corporative; however, this approach is more suitable in cases where processing and value addition units need to be set-up to add value in the respective value chain. Figure 7 below depicts this corporative model:

Figure 7: Corporative: Banks and Farmer Groups



The risk inherent in the corporative model is that the set-up phase of the enterprise must be successful. This means that the bank must understand the nature of the business; the effectiveness of existing relationships between the farmers and other actors in the value chain; and, whether key value chain actors are supportive of the enterprise. There are instances wherein farmers establish enterprises without understanding the needs of the market, putting the entire venture and partnership in risk.

<sup>13</sup> The SEEP Network (<http://edexchange.seepnetwork.org>)

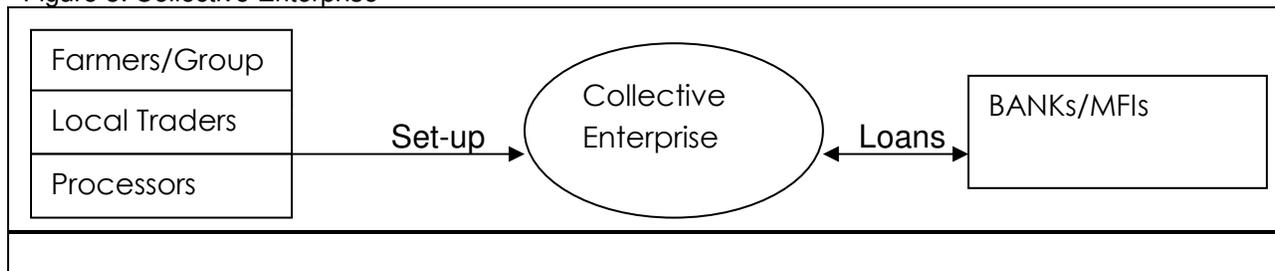
#### 4.4 Collective Enterprise

The collective enterprise model is a variation of the corporative approach. Under the collective enterprise model, actors in the value chain come together to form a jointly-managed entity (for example, traders, farmers and processors come together to form a warehouse, trading center, or processing center). The collective enterprise is usually established to assist the entire value chain. In some instances, most value chain form a collective enterprise to meet certain international standards and requirements for export. In Arusha, Tanzania, jatropha collectors, local processers, and export companies came together to establish a soap processing plant to meet the demand for soaps in Southern and Eastern Africa. Currently, the collective enterprise is a profitable venture<sup>14</sup>. Once established, the enterprise can access loans via commercial banks for working capital.

In similar economies like Nepal, wherein there are greater disparities in income and distribution of wealth, issues of trust and transparency in ownership and management of such enterprises are major challenges. However, there are cases in Nepal where such enterprises have been successful. One such case is the establishment of Highland Coffee Promotion Company Limited. The company was established with joint investments from farmers, traders, processors and exporters. The company now has linkages to commercial banks, and exports more than 40 tons of coffee each year to Holland Coffee Inc in New York. Similar endeavors have also been seen with the Himalayan Orthodox Tea Producers Association (HOTPA) and the Paper Enterprise in Bajhang<sup>15</sup>.

Figure 8 below depicts this collective enterprise model:

Figure 8: Collective Enterprise



A case study on the effective establishment of a corporative in partnership with a bank, and the process of sustainable transformation into a fully owned farmers' corporative, is presented below.

Example: Corporative: how a bank can empower farmers to move up the value chain:  
 In the majority of value chain cases in the Philippines, the role of farmers is generally limited to supplying the raw commodities. Most value addition is captured by agro-corporates, who do the processing and

<sup>14</sup> MatchMaker Associates, Arusha, Tanzania

<sup>15</sup> Successes and Failures of Collective Enterprises in Nepal: Karki, Sanjay - March 2004

bring the products to the market. However, in one case, a corporative model was successfully used to involve farmers in value addition.

In rural Philippines, a rural bank had successfully experimented with an innovative scheme to finance a rice mill. When analyzing an initial loan request from a farmers' group, the bank recognized that the project made economic sense. However, given the lack of experience of the farmers as plant managers and marketers, the loan would be unduly risky. Rather than turning them down, they made a counter-offer: let's create a "corporative".

The principles of the corporative were simple. The bank set up a limited stock company, with 55 per cent of the stock owned by the bank, and the remainder by the farmers. The bank's share was fully paid up, while the farmers paid only a minor sum. The bank's share payment was sufficient to construct the rice mill. The bank appointed professional plant managers. Once the plant was operational, farmers started delivering paddy. Part of the revenue was used to pay the farmers' share capital, and afterwards, for the farmers to gradually buy equity from the bank. After six years, the farmers were majority owners – the mill had developed from a corporative into a well-managed cooperative. After two more years, the bank had been fully paid back.

This was considered a win-win project for all involved. The farmers had become owners of a processing plant, without any financial pain, and captured a much larger part of the consumer price. The bank had carried out a successful long-term loan, at low risk because during the critical period it controlled all key physical assets. The project also made it possible to provide short-term production and consumption credit because reimbursement could be arranged through paddy deliveries to the mill.

**Source: AGRI REVOLUTION: Financing the agriculture value chain conference, Mumbai India**

## 5. Challenges in Value Chain Finance

Value chain finance holds many positive attributes. These include ease of access, flexibility, and risk mitigation, all of which can lead to the increased competitiveness of a sector. However, there are imminent challenges to institutionalize value chain finance in developing economies, such as Nepal, where formal financial institutions are still struggling to develop business models to reach smallholder farmers in remote locations and link these farmers to value chain counterparts in the plains. In addition, value chain actors are faced with limited financial resources to cater to the cash flow needs of other actors.

One major challenge, however, for value chain finance actors in both developed and developing economies is the provision of longer-term loans for capital investment<sup>16</sup>. Most value chain actors supply short-term working capital to clients that require limited monitoring, collateral or paperwork. As with formal financial institutions, value chain actors often struggle with weighing the risks and rewards of offering investment loans.

Value chain finance actors are also faced with challenges of working in a sector they know little about. Since their main driving factor is securing a product and reducing risk, the specifics of the financial transaction can be mismanaged – with risks of non-repayment, lack of equity, and misuse of funds.

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<sup>16</sup> USAID MicroLinks: [www.microlinks.org](http://www.microlinks.org)

One of the major constraints for networks of financial service providers in Nepal, both formal and informal (SACCOs, MFIs, Banks/Money Lenders, Landlords, traders), is their failure to recognize the need for financial services at all levels of a value chain. For instance, SACCOs and MFI's target clientele at the base of a value chain, at the production levels, and consequently consider only the financial needs at that level. While the type of financing needed at higher levels may be beyond the capacity of SACCOs and MFIs to deliver, they fail to coordinate with other financial actors that could cater at the higher end of the value chain. In order to cater to the financial needs of the value chain, the financial service providers targeting the lower end of the value chain should be aware of financial constraints of value chain actors operating at different levels of the value chains in which their clients operate. This understanding will enable financial service providers to establish sustainable linkages, alliances or partnerships with other financial institutions in order to ensure that the value chain is being adequately financed at all levels, and that the products of their clients do not face bottlenecks at higher levels in the value chain. This will create better understanding and minimize credit risks for financial institutions catering to different levels of a value chain.

In summation, determining whether the financial products and services are appropriately designed in terms of risk mitigation and delivery mechanisms is equally important for both the lender and borrower in a given value chain. It is essential in value chain finance to create mechanisms that reinforce mutual benefits for buyers and sellers – for both lenders and borrowers - for sustainable services and relationships. The financial service providers should coordinate and link with different financial institutions based on their capital base and outreach, and at the same time link with service providers such as insurance agencies and technical service providers to design innovative financial-plus products to mitigate credit risks.

## 6. Conclusion

The findings from various literature confirm that value chain finance is the provision of finance throughout the series (or chain) of transactions that result in the product arriving at market.<sup>17</sup> Although this paper discusses various approaches, no single approach stands out as a sole preferred option – rather, each has advantages and disadvantages, and the choice of approach will depend on the context.

Global good practices illustrate that the value chain framework hinges on market orientation, without which the resulting financial services would fail. At its most basic, the value chain finance methodology requires that financial institutions take into account the financial potential of the entire value chain and not just the creditworthiness of a single actor that dominates the dealings within the value chain. With this shift in focus, the financial institution can more accurately measure and mitigate the risk. Once a

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<sup>17</sup> For more information on value chains, visit SEEP (<http://edexchange.seepnetwork.org>) and the USAID microLINKS Enterprise Development and Value Chain Resources, “Value Chain Development Wiki” ([www.microLINKS.org/valuechains](http://www.microLINKS.org/valuechains)).

financial institution establishes the market-oriented logic for an investment, it leverages pre-existing relationships and information between value chain actors to assess risk and more effectively evaluate an individual farmer's ability to service a loan. This in turn will also provide financial institutions with necessary linkages to multiple borrowers over multiple functions (trading, exporting, processing, collecting), achieving economies of scale and reducing overhead costs.

It is also evident from various case studies highlighted in this paper that there are additional benefits to facilitating the entry of formal financial entities to finance value chains. By providing poor and low-income people with access to formal finance, a financial service provider can reduce the liquidity and production constraints that weaken the negotiating power of smaller producers. As a third party, the institution can also facilitate consensus building and align the incentives of different value chain actors, increase value chain competitiveness, and improve end products.

One of the many benefits of value chain finance approaches is that they move people who typically use only informal finance into safer financial institutions. This shift enhances financial literacy and preserves wealth by providing a secure place for savings and access to other financial products. This shift also allows financial inputs to be used for productive, as opposed to consumptive, purposes.

In conclusion, there is no single solution regarding the best value chain finance approach. In some contexts, a more direct value chain financing approach could be used, while in other cases a more indirect value chain financing approach with linkages to financial institutions is practical. In some cases a mixture of both the direct and indirect approach is more feasible. The primary innovation is the creation of a value chain lending methodology that helps financial institutions reluctant to finance rural activities to successfully break into that market.

Finally, the effort should be to design approaches that enable formal financial institutions to mitigate the risks associated with value chain finance by: thoroughly evaluating the viability of financing opportunities; bringing together all value chain actors to forge market linkages; designing custom products based on the producers' needs for finance; and ensuring that the process is mutually beneficial for all value chain actors.

In Nepal, value chain finance generally consists of informal direct approaches, or of the introduction of indirect approaches via MFIs, SCCs, and commercial banks. While the introduction of formal financial intermediaries is a promising development, agricultural economies in Nepal could still benefit both from expanded indirect value chain financing by financial service providers, and from formalized direct value chain financing as practiced successfully in other country contexts.

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