Public Disclosure Authorized

Public Disclosure Authorized

49252

MAY 2009

International Finance Corporation
World Bank Group

IFC SmartLessons
real experiences, real development

ABOUT THE AUTHOR

PAOLO SPAGNOLETTO
is an investment officer who has worked for several years with the Small Direct Investment Unit of the Global Manufacturing and Services (GMS) Cluster in Washington, D.C.

APPROVING MANAGER
Richard Rutherford, chief investment officer, GMS, and head of the Small Direct Investment Unit of the GMS Cluster.

Financial Innovation Drives Small Businesses

IFC makes selective investments in small businesses that are in frontier countries and have a strong developmental role. Since 2002, the corporation has made 25 or so small direct investments (SDI), most of which turned out to be success stories. Over the years, SDI developed a specific methodology that works well with small companies. But the most successful stories arise from innovative financial solutions tailored to help small businesses as they incubate and eventually graduate into fully bankable companies.

IFC's Global Manufacturing and Services Department (GMS) works each year on average with at least two small companies that require creative financing. This has resulted in far-reaching developmental impact and replicable financial models that build IFC's competitive edge and goodwill in emerging markets. We discovered that innovation really is the key to making small businesses successful. GMS has an unbroken record when using financial innovation for small businesses. One good example is the creation of a cooperative business, using innovative financing from both IFC and donors, to help alleviate poverty among cotton farmers in Tajikistan.

Lessons Learned

1) Partnerships help innovation.

Tailored partnerships are key for financial innovation with small businesses. In 2002, with funding assistance from Switzerland's State Secretariat for Economic Affairs (SECO), IFC formed a partnership among SECO and IFC's Private Enterprise Partnership (PEP), and GMS's investment arm. Through this partnership, GMS helped set up the first joint-stock company in Tajikistan, SugdAgroinvest (SAS), wholly owned by Tajik farmers. SAS was established in the northern town of Khojand to provide financing and services directly to farmers, bypassing unnecessary middlemen and brokerage fees that kept farmers below the poverty line.

In this case, the innovation is SAS itself, an IFC pilot project to set up the first private cooperative farm in a joint venture with farmers and donor funds. This could only have happened with SECO's backing. On the one hand, SECO funded PEP's advisory services to help manage SAS, notably with lending criteria and loan portfolio management. On the other hand, and more importantly, SECO provided the necessary capital to establish SAS, which neither IFC nor the farmers could do because IFC was restricted by its project exposure limits, and the farmers had inadequate resources.

IFC was able to match SECO's $1.25 million contribution in two repeat investments with a $500,000 loan in 2002 and $750,000 in 2004. Today, SAS has 1,035 farmers as shareholders, all meeting constitutional criteria for incorporation set by IFC. While IFC's investment arm focused on setting up a financial structure that was viable, PEP laid the ground work with the farmers, training them with best practices on cotton growing and corporate governance. In 2008, IFC-PEP helped SAS establish a microfinance subsidiary focusing on onlending to farmers in compliance with the National Bank of Tajikistan's regulations for financial institutions. SAS, the parent company, remains in the business of marketing ginned cotton and procuring fertilizer and brings economies of scale and wider distribution when done on a wholesale basis.

Capitalize on donor-partner funds as part of innovative financing. IFC arranged for SECO to invest funds in SAS first with a capital reserve contribution in 2002 and then through a share subscription to a capital increase in 2004. As an open joint stock company, SAS can

IFC-PEP and investment teams in SAS cotton farms.

increase its capital through an open subscription. However, it cannot by law control the purchase or transfer of shares and hence would be vulnerable to unfriendly takeovers—a high risk in a tightly controlled cotton regime. One option would have been to change SAS into a limited partnership, which restricts transfers of shares. However, to keep the structure simple and facilitate PEP's management of the expansion, GMS recommended a capital increase in 2004 of the existing SAS with SECO becoming a substantial, though temporary, shareholder. This would not totally prevent unwanted parties from entering into SAS, but the likelihood of an unfriendly takeover was greatly diminished. SECO had the ability to block decisions relating to amendments to the SAS charter, reorganization, or liquidation. SECO, however, waived its right to dividend payments, allowing a redistribution of dividend payouts among farmer shareholders.

Eventually, SECO will sell its shares to farmers who meet the eligibility criteria for qualifying as creditworthy borrowers of SAS. Depending on the timing, SECO's sale of shares to new shareholders will be priced at either book or market value as advised by SAS' supervisory board and to the satisfaction of IFC. SECO will then reinvest the proceeds from the secondary sale of shares into the capital reserves on a grant basis. Thus, SAS operates independently with farmer shareholders in charge of the business while reporting to IFC and SECO through specific covenants.

2) Seek Innovation that lasts.

Focus on the lasting effects of innovative financing for small businesses. Although SAS itself is the innovation, IFC focused on creating a corporate culture and incentive system that would keep farmers constantly engaged and interested in the long-term well-being of their company. Thanks to the commitment of the farmers, SAS averages revenues of approximately $200,000 each year on an outstanding loan portfolio of approximately $600,000. Revenues comprise mostly interest income on loans to farmers and, to a lesser extent, commission income on procurement of fertilizers and marketing of ginned cotton. Its net profit margin ranges between 7 and 11 percent, and its return on equity is 5 percent, in line with other lending institutions. SAS continues to remain a viable model, charging farmers competitive market rates of 18 to 24 percent against IFC's fixed rate of 8 percent on average. SAS has no bad debts at present and does not have to increase its impairment reserves. The model is cautiously proving to be sustainable with monetary benefits to farmers.

On the advisory side, IFC-PEP trained the farmers to act as shareholders that together share the profits and risks of their collectively owned company. This is not a popular concept for entrepreneurs who normally thrive on their individual success. The buy-in process takes time but has a lasting effect. Farmers can now pay themselves dividends, limit their indebtedness, and afford better fertilizers and equipment that yield higher productivity rates. This is the result of stronger cooperation among them under the guidance of PEP.

3) It takes a village to innovate.

Create the ideal mind-set for financial innovation. Bringing farmers together with a common goal of success is indeed a process that takes time—in this case, three years of preparatory work and another three to create the right mind-set. Before SAS was established, IFC visited numerous times with the farmers, discussing the concept of a cooperative business. IFC was in reality encouraging the farmers to break ranks with the status quo and with the tight farming regime, which in fact accounted for most of the poverty in a predominantly agrarian country. IFC inevitably encountered strong resistance from farmers who were afraid to lose their only asset, which was their inherited land, as collateral to IFC's borrowing. There was also a lot of resistance from ginners, town mayors, and local banks which bartered discounted cotton prices in exchange for loan refinancing that kept farmers in perpetual debt.

IFC cannot expect to change the culture of an entire industry, particularly one that is of such importance to a country. In this case, IFC focused on first changing the mind-set of the ultimate beneficiaries, the farmers. Second, IFC gave comfort to the converted farmers by providing them with a secure platform on which to conduct their business. SAS was, in fact, the insurance that farmers needed to break away from middlemen and the cycle of debt. When IFC showed up in 2002 with a PEP advisory team and an investment and legal team that literally covered all aspects of their lifeline business, the farmers were greatly encouraged and agreed to become shareholders of SAS. They defied generations of a cultural mind-set and put everything they owned at risk. This was quite an accomplishment as farmers are generally not keen to modernize and innovate. Ginners started yielding higher inputs on the farmers' cotton, and farmers used the extra profits to start paying down debts.

Measure financial innovation by the momentum it creates. SAS created a furor. Farmers were actually walking around town preaching to others about the benefits of becoming a shareholder of SAS. In addition to the 1,035 farmer shareholders that joined SAS, another 11,500 have indirectly benefited from SAS. These are largely family members of the shareholder farmers. On average, each shareholder farmer represents 10 other family members with about five to six of them having their own land and borrowing through the shareholder farmer. Many new farmers are expressing a desire to become full participants of SAS and not only be able to access the financing, input materials, and training it provides, but also actively participate as shareholders, along with corresponding rights and duties.

Farmers signing up to become shareholders of SAS.

IFC is measuring the financial performance of SAS, its productivity rates, and the breadth of impact across the population of farmers in its region. The traditional financial ratios of profit margins, debt-service coverage, and capitalization help track the performance of SAS. In this case, as part of the innovative aspect of this initiative, IFC set in place both real and financial-sector ratios. The company is to maintain a capital adequacy ratio and an open-loan exposure ratio, in addition to debt-service coverage and dividend-payout ratios just as banks do. To date, SAS is maintaining a 13 percent capital adequacy ratio (minimum of 10 percent) and an open-loan exposure ratio (past-due loans to equity) of just 1 percent (maximum of 25 percent) while the debt-service coverage remains close to1.0x. (versus a minimum of 1.3x).

Capturing these results requires a truly innovative mind-set. Having just one set of sector-based ratios is difficult enough for just about any type of client. Imagine imposing two different sector-type ratios on farmers who know very little about corporations to begin with. This is where the intervention of advisory services through a tailored partnership becomes critical, and corporate governance is especially crucial as this is a new concept for the farmers to ingest. We begin by depicting the individual benefit to farmers versus the collective benefit of SAS.

4) Innovation can lead to divergent paths; but wherever it leads, you must measure it.

IFC needs to regularly monitor monthly or quarterly financial statements. In 2005, SAS incurred a loss by having to write off bad loans that resulted from direct lending to certain shareholders. What is more, the shareholders paid themselves a handsome dividend that came from cash reserves. This was quite embarrassing for IFC, which was spearheading this pilot project and using donor funds from SECO. Fortunately, SAS did have audited reports, which highlighted the problem and prompted IFC to quickly intervene. Under the direction of PEP, SAS changed its board composition, brought an external party on board, and added an IFC staff member as an observer. In addition, no board member could be part of the lending committee that clears loans to farmers. The eligibility criteria for farmers borrowing from SAS was revamped and tightened by external consultants, and by 2007 SAS returned to profitability.

In addition, the right mind-set was created with all farmers and shareholders understanding that the sustainability of SAS is for their ultimate benefit and eventually those of their children. They now appreciate that corporate governance and transparency can lead to additional funding and new investors.

Stay focused on financial performance when innovation opens new doors. Recently, IFC received an e-mail with a summary proposal for SAS by one of its advisors. The advisor proposed a two-step development approach as a way forward for SAS. The e-mail recommended creating a new advisory program parallel to SAS as well as developing a new sister company to take over management of water systems needed for crop irrigation and a campaign to help increase SAS 10-fold over a four-year period. This would be a substantial diversion of effort.

Instead, the SAS board and IFC decided to stay focused on making sure that farmers have good access to loans, that the loans can be repaid, and that farmers can bypass unnecessary middlemen, including those that present themselves as potential investors in an expanded SAS. Changing the mind-set and culture of a key industry does not happen overnight. We are fortunate that it happened over seven years (2002-2009) with Tajik cotton farmers and just in one region of the country. SAS is an excellent example of a small innovative business that has weathered seven years of challenges amid a difficult and complex economic backdrop.

5) Innovation that works is replicable.

Make financial innovation for small businesses replicable. The SAS story comes in handy as IFC promotes general innovation through small businesses. The SAS story is not over yet, and challenges still remain; but the impetus to

make it survive is stronger than ever from both sides: IFC and the farmers. IFC only has a return on investment in interest-income generated over IFC's small loan. But the developmental impact is tremendous if we consider the breakthrough IFC achieved in Tajikistan by empowering entrepreneurship at the Base of the Pyramid.

Conclusion

The story of innovation does not end there. IFC is using the SAS experience to promote innovation through small businesses in other contexts. In 2005, IFC set in place a three-year Recycling Linkages Program (RLP) in the Western Balkans to assist small recycling businesses. As it did with SAS, IFC maintains the retail approach through donor-funded advisory services for each small business, helping them endorse the right mind-set for long-term sustainability, corporate governance, and transparency so that they can become fully bankable and attractive to other investors. Using the SAS model, the wholesale RLP financing initiative will be tracked with specific measures that combine bank performance with the progression of recycling companies and energy and carbon emission savings over the years.

DISCLAIMER
IFC SmartLessons is an awards program to share lessons learned in development-oriented advisory services and investment operations. The findings, interpretations, and conclusions expressed in this paper are those of the author(s) and do not necessarily reflect the views of IFC or its partner organizations, the Executive Directors of The World Bank or the governments they represent. IFC does not assume any responsibility for the completeness or accuracy of the information contained in this document. Please see the terms and conditions at www.ifc.org/smartlessons or contact the program at smartlessons@ifc.org.