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SMALL AND MEDIUM ENTERPRISES IN AGRICULTURE VALUE CHAIN

Opportunities and Recommendations

ALISON ESKESEN
DIRECTOR, SHUJOG

RASHI AGRAWAL
MANAGER, SHUJOG

NOOPUR DESAI
SENIOR ANALYST, SHUJOG

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Executive Summary

This report was commissioned by Oxfam to analyze the effectiveness of development programs in addressing challenges faced by Small and Medium Enterprises (SMEs) in the agriculture sector in Asia, and to dissect whether these interventions would be relevant for Social Enterprises (SEs) in the agriculture sector. The purpose of this report is to inform the decision-making of development programs that aim to catalyze the growth of SEs in agriculture and attract impact investment capital to fuel the growth of the food and agriculture sector in Asia.

Access to timely, affordable, and appropriate type of finance, and consistent access to stable and high-value markets remain the most daunting challenges faced by SMEs in agriculture. Development organizations have taken various approaches to solving these challenges. Shujog found that most of the development interventions were relevant and effective when they were tailored for the specific geography and market conditions they targeted. Development Finance Institution financing initiatives for SME development have been more successful in catalyzing domestic financing for SMEs in some countries, and were less successful in changing risk behavior of domestic financial institutions in others. This could be because of the fiscal policy and resource constraints faced by such financial institutions.

Social Enterprises in agriculture face unique challenges in addition to those faced by SMEs in agriculture. They often integrate poor, marginalized or disadvantaged populations as suppliers, work with innovative products and approaches, serve markets with latent demand, or work in difficult, rural or remote areas. The social impact achieved by SEs is even greater than that of SMEs, because not only do they help create jobs and increase farm incomes, but also help achieve better health, education, and environmental outcomes. Shujog believes that development programs and DFI initiatives need to tailor their approach to the specific challenges of agriculture SEs to catalyze their growth. The following are implications for existing and new interventions:

- Development programs, particularly those that offer technical assistance (TA), should broaden focus to include SEs in agriculture value chains.
- Scaling social impact of SEs in addition to ensuring financial growth should be a key design feature of programs.
- Program approach should include working with individual firms to strengthen and scale them, and build markets for SEs through a bottom-up approach.
- Funds and financing instruments should meet unique needs of SEs, such as the need for patient or hybrid (grant and investment) capital.
- Invest in programs and tools that unlock domestic capital because some developing markets have capital and liquidity but are unable to take or absorb financial risk.
- Establish standalone funds in risk-averse markets that have proven their inability to change risk behavior due to fiscal policy or resource constraints.

Shujog believes that development programs can leverage the experience and capital of impact investors in incorporating these recommendations and achieving growth and scale for SEs in the agriculture sector in Asia. Our view on specific interventions can be found in the **Recommendations** section.

Background

Research Rationale and Scope

Small and Medium Enterprises (SMEs) are considered essential for economic progress in most developing countries. SMEs have made significant contributions in developing Asian countries in terms of employment and GDP growth. The importance of SMEs to developing countries has been well documented and studied. Testament to the relevance of SMEs, particularly in the rural economy, is their study by numerous researchers. Research[1] suggests that SMEs make up for 80-90% of all enterprises and generate about 50-80% of total employment in developing Asia.

Within the category of SMEs, there is a growing sub-set of enterprises that uniquely prioritize the achievement of financial as well as social and/or environmental returns. These enterprises are called Social Enterprises (SEs), and while a nascent form of business, SEs are increasingly being recognized as potential game changers in the development space. Because SEs have the intentional purpose to produce measurable social and/or environmental results as well as financial returns, they hold the promise of scalability beyond donor funding. SEs have the potential to catalyze greater private sector investment in the development space. As a result, many governments – including the G8, foundations, and international NGOs are now focusing their efforts to stimulate the deepening of the SE ecosystem. This study, commissioned by Oxfam looks at the challenges facing SMEs across Asia and then dissects whether the same development interventions to address these challenges would be relevant for SEs. It also explores whether it is sufficient to encapsulate SEs as a sub-set of SMEs or if SEs warrant targeted interventions.

The rationale behind this report is to understand the challenges SMEs face, especially in relation to agriculture, how the development community has creatively addressed these challenges, and analyze whether these approaches have relevance to the burgeoning SE industry throughout Asia. The ultimate objective of this report is to form recommendations for new and existing development interventions to accelerate the growth and broaden the pathways to scale for both SMEs and SEs, particularly those working in agriculture value chains. The report will also provide insights on the contextual and implementation factors that shaped the success or shortcomings of case study interventions.

The findings of this report will be used as the basis for further discussion on how to support SMEs and SEs, respectively. Additionally, it will make recommendations for these programs to work along with/for impact investors and other ecosystem enablers to ensure sustained SME growth.

Research Methodology

The research methodology for this report is a combination of desk-based research and primary research through interviews with representatives of agricultural SMEs and organizations involved in the SME support ecosystem such as NGOs, government organizations and private sector trade bodies. Drawing on the findings of previously published work such as academic research papers, intervention case studies, development project update and evaluation reports,

[1] Development of SME in ASEAN, ERAI, 2007-2008

(see **List of Sources** reviewed in Appendix), Shujog formed the analytical framework for understanding the challenges SMEs face and the variety of development interventions. These sources were supplemented by the insights gained from interviewees, who provided timely, on-the-ground and first-hand accounts of the successes and shortcomings of specific interventions.

Defining SMEs

Most governments have unique national definitions for SME; however, they are relatively similar and frequently based on the World Bank's definition, where an enterprise qualifies with two of the three following indicators:

Indicator	Micro Enterprise	Small Enterprise	Medium Enterprise
Employees	<10	10<50	50<300
Total Assets	<$100,000	$100,000<$3 million	$3 million<$15 million
Total Annual Sales	<$100,000	$100,000<$3 million	$3 million<$15 million

Because agriculture is such an important sector in many countries in Asia, Shujog defines agriculture-related SMEs as those businesses operating within the agriculture value chain[2]. These can include individual farmers and producers, as long as they are producing at a scale where they need capital and support services to grow.

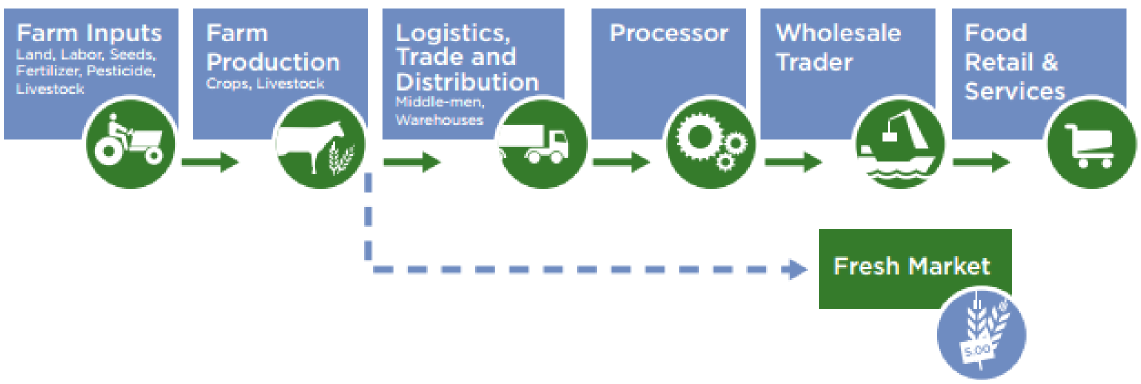

Illustration: Agriculture Value Chain
Source: IFC, Scaling Up Access to Finance for Agricultural SMEs Policy Review and Recommendations, 2011

Types of SMEs in Agriculture

The needs of SMEs in agriculture may vary by the function they serve in the value chain in which they work. For example, an SME that focuses on production may need financing for purchase of inputs at the beginning of a harvest cycle, whereas an SME in processing may need this capital at the end of harvest, to purchase produce for processing. The type of assistance they need may vary too. For example, SMEs in agricultural inputs and technology may need laboratory testing facilities to test and validate their products, whereas those in processing or trading may need access to high-value markets. **Table 1: Types of Agriculture SMEs** in the appendix summarizes the different types of SMEs in agriculture.

[2] The agriculture value chain refers to the series of processes and transformations that are required to produce an agricultural product and bring it to market. At each stage of the value chain, the product undergoes certain processes which could range from biological transformation to value-add processing to transportation or storage.

Agriculture SMEs may exist in a number of different legal forms that vary in definition by country. The legal form an agricultural enterprise takes may determine or affect the governance structure, sources of finance available, and attractiveness in potential investors. **Table 2: Prevalent Legal Structures of Agriculture SMEs** summarizes the various legal forms taken by agriculture SMEs in Asia, and implications for finance and investment associated with each. Table 2 provides only a generalized summary. The specific laws governing each legal structure vary by country, and must be consulted before making program decisions.

Social Enterprises: a Subset of SMEs

Included within the SME umbrella are SEs which can be for-profit or not-for profit but must have a business-oriented operating model, i.e. self-sustaining model, while serving a clear social or environmental purpose. Social enterprises encompass a broad range of different business types, from self-employed individuals to firms with multiple divisions of employees. Those within the rural areas tend to be made up of informal smallholders, family-operated businesses and household agricultural output processors.

SEs in agriculture face unique challenges in addition to those faced by SMEs. They often integrate poor, marginalized or disadvantaged populations as suppliers, work with innovative products and approaches, serve markets with latent demand, or work in difficult, rural or remote areas. Because SEs are currently at a nascent stage, they may require additional support to propel them to growth and scale. Development interventions that invest in their growth have the potential to lay foundations for sustainable social and environmental impact in poor and vulnerable communities that goes beyond economic success.

The following are ways in which social enterprises in agriculture create social and environmental impact in the communities in which they work:

Social

- Increase incomes or assets of poor or marginalized communities by providing them employment, increasing yields of their produce, getting better prices for their produce, helping them access high value markets, generating savings through lower cost inputs, ensuring steady/predictable income streams.
- Increase knowledge/awareness of the communities and stakeholders they work with through training, capacity building, and awareness campaigns.
- Improve health outcomes for farmers through safer/healthier inputs and equipment or production of safer/healthier/more nutritional food
- Contribute to food security in communities at risk of starvation and malnutrition

Environmental

- Ensure efficient use of resources such as water, energy, and land
- Help stakeholders adapt to or build resilience against climate change through awareness building, and innovative services, and products
- Reduce pollution of water, soil, and air through better inputs (e.g. pesticides, fertilizers)

Strengthening agriculture SEs and bringing them to investor-readiness could help attract the widening pool of impact investment capital to the food and agriculture sector while generating a healthy pipeline of investable enterprises for impact investors. Effectively, for each dollar they invest in developing SEs, donor organizations could leverage multiple dollars from the impact investment community to achieve social and environmental outcomes in addition to vibrant economic growth.

Challenges of Achieving SME Growth

There are a variety of obstacles encountered by SMEs during the course of their operations. Fragile internal control systems, poor management culture, corruption, security risks, regulation, lack of skilled workers, and lack of reliable infrastructure are just some of the barriers encountered by SMEs. Although these barriers can be extremely disabling to SME operations, they tend to be localized to specific geographies or crop value chains. Based on Shujog's review of existing research and interviews with experts, Shujog finds that the most significant barriers common across all types of agriculture-focused SMEs are lack of access to financing and to markets.

Addressing the lack of access to financing and to markets is instrumental to unlocking the potential of SMEs as engines of domestic growth. These two key challenges are true for all types of SMEs, and arguably are even more critical for agriculture-focused SMEs because of the influences of weather and perishability. Without working capital and capital investment, SMEs struggle with both day-to-day operations and implementing expansion plans. Crop planting and harvesting are time-delineated, and therefore, the availability and predictability of financing is essential for successful operations. Similarly, lack of access to markets – domestic, regional, and international – constrains SMEs' ability to increase their market share and deepen their value-add. Reliable access to markets is critical to a healthy agriculture ecosystem.

The following sections will analyze the main contributors to both lack of access to finance and to markets. Through a review of the various development approaches that have been implemented, Shujog conducts a gaps analysis to understand what more can be done to enable the growth of agriculture SMEs. Analysis will also draw implications for SEs in agriculture value chains and understand the effectiveness of existing program approaches in addressing targeted challenges. A review of SME funds and financing instruments will reveal the key success factors and provide insight on whether such funds and financing instruments can address the needs of SEs in agriculture.

Lack of Access to Finance

Limited access to finance is one of the biggest challenges for SMEs across Asia, particularly for rural enterprises and those operating within the agriculture sector. A majority of the current funding gap is estimated to be for debt. The gap in formal SME credit in East Asia in 2010 was estimated at US$250-310bn[3], and the gap in South Asia was estimated at US$30-40 billion[4]. It is estimated that, between 45-55%[5] of formal SMEs do not have access to loans from formal financial institutions in developing countries, and this figure increases to 72%[6] when informal SMEs[7] and micro-enterprises are included. The demand for credit by smallholder farmers globally was estimated at US$450billion[8] in 2012. A large percentage of this demand comes from South and South East Asia, where a majority of the world's smallholders reside. Agricultural producers require capital for the financing of farm equipment, expansion projects,

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[3] Two trillion and counting. Assessing the credit gap for micro, small, and medium-size enterprises in the developing world, McKinsey & Company and IFC, 2010
[4] Ibid
[5] Ibid
[6] Ibid
[7] Formal SMEs can be defined as those that are registered with government ministries or other registration bodies. These enterprise are liable to pay taxes and social security measures to its employees. Informal SMEs on the other hand are not registered and hence do not pay taxes and other essentials.
[8] International Finance Corporation. "Innovative Agricultural SME Finance Models." November 2012.

and working capital for the purchase of inputs like seeds and fertilizer. While equity funding channels are growing as impact equity investors enter developing markets, in most countries, agriculture SMEs do not have adequate access to equity. Furthermore, such funds may not meet all the capital needs of agriculture SMEs, which typically need working capital for financing purchase of inputs.

There are four major contributors to the current gaps in funding for agriculture SMEs. Two are challenges that financial institutions face, and two are challenges that SMEs need to address.

- **Access to rural areas is costly**: Existing sources of debt financing include local and national banks, microcredit institutions, value chain financing, and informal sources such as lending by friends and family. However, financial institutions find it both difficult and costly to penetrate into the rural agriculture sectors due to distance from brick and mortar branch offices. This creates a significant gap between the demand and supply for loans. Increasingly, there is interest in exploring mobile technology to facilitate lending in rural areas, but in most countries the policy infrastructure is not yet in place to enable rapid adoption of mobile banking technology.

- **Inability to assess risk**: Financial institutions have capacity deficiencies among their loan officers with limited experience or knowledge about how to assess the risk associated with agriculture SMEs. There are several factors that make risk assessment more complex for the agriculture sector: dependence on weather, geographical context, myriad crop varieties and yield patterns, volatile pricing trends, uncertainty around land ownership and titles, and socio-economic context in which the SMEs work.

- **Informal status and poor corporate and governance structures**: A majority of SMEs in the agriculture sector are informal, making it difficult for banks to gather the information to appropriately evaluate and lend to these groups. Informal, unregistered SMEs can also be risky for banks because their ability to enforce any protection against default is limited. In addition to this, those SMEs that are formalized may lack the corporate or governance structures needed to assure financial institutions that they are bankable.

- **Lack of business or financial credentials**: Agriculture SMEs are often unable to provide the appropriate business and financial management documents to demonstrate to financial institutions that their capital is safe with them. Similarly, SMEs frequently lack the acceptable collateral required by lenders.

Lack of Access to Markets

While financing is typically a major challenge for producer and processor SMEs at the beginning of harvest and production cycles, it is poor access to stable and high-value markets that most affects their ability to sustain businesses and livelihoods in the long-term. In order to protect the income streams for SMEs, establishing stable and consistent market access is crucial. However, access to markets is a major challenge for SMEs and small producers in the agriculture sector. This affects both SMEs in processing and other upstream functions, and farmers who are producers. Farmers are often both willing and able to produce more than their current production levels, but due to lack of market access and the perishable nature of agriculture produce they are only able to sell limited quantities. Exacerbating this challenge is that farmers are frequently forced to sell at the peak of harvest when prices are lowest due to an over-supply of the specific crop on the local market at that time.

In addition to this, local processing and value add-focused SMEs have limited access to international markets because of inconsistent quality standards, lack of transport systems, and unpredictable cross-border mobility. Therefore, value add-focused SMEs tend to process limited quantities that are below their production capacity but are within the market demand of local or domestic markets.

To scale, SMEs need access greater market access, including:

- **Infrastructure**: Poor physical infrastructure is a major deterrent for small producers trying to access high value markets. In most emerging economies, the shortage of critical agriculture infrastructure such as for storage, transportation and warehousing of agriculture produce constrains small producers from reaching market.

- **Information about markets**: SMEs often do not have access to relevant information about the demand and pricing for their products in national and international markets, limiting their reach to low margin and low volume local and regional markets.

- **Consistent quality standards**: Agriculture SMEs often do not have the production, processing, and packing technologies to meet the standards of international markets. Similarly, agriculture SMEs struggle with consistent quality and reliable, timely distribution.

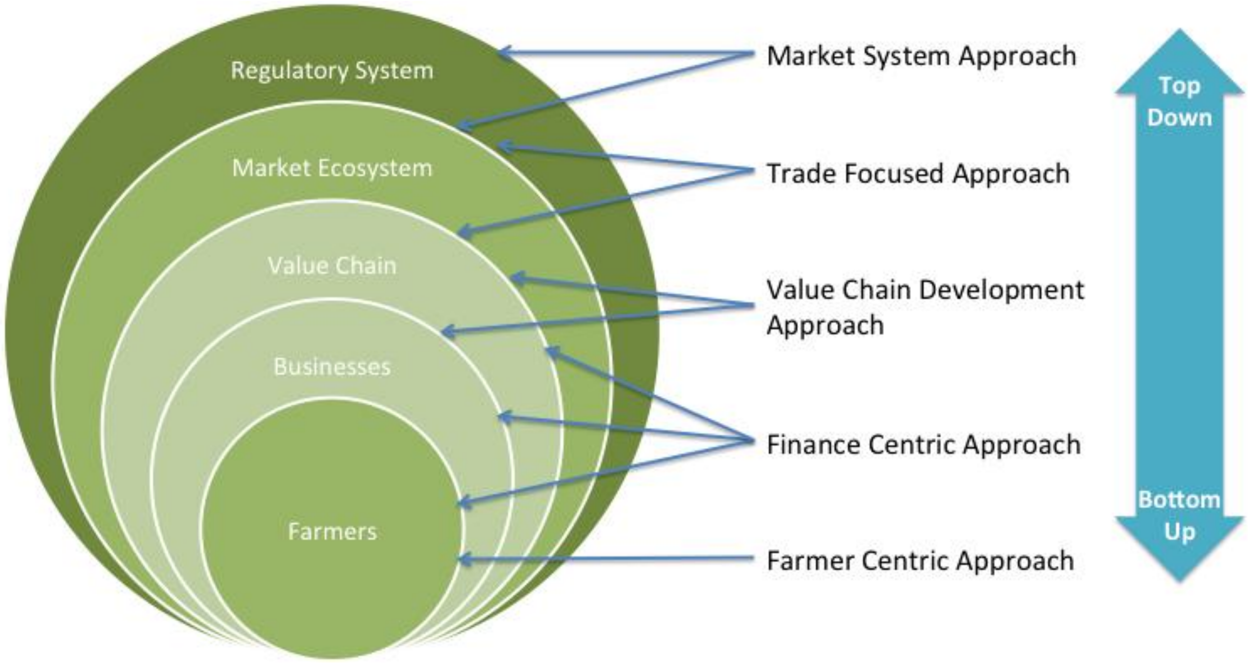
- **Marketing capability and skills**: SMEs in agriculture sometimes do not have the skills, networks, or resources to market their products in high value international markets.

Development Interventions

Access to finance and access to markets have been identified and acknowledged by most major development interventions as the key challenges for scaling SMEs in agriculture. Recognizing that SMEs are the engines of growth in many developing country economies, development professionals have redoubled their support of relevant interventions to address these challenges. Not since the green revolution, has the global development community been as unified in its support of agriculture and food security. Of all the development aid by the largest multilateral and bilateral donors as well as international non-governmental organizations (INGOs), on average about 9.8% percent was explicitly spent on supporting agriculture and rural development in year 2010-2011[9] - about 34% in South, Central, and East Asia.

Most of the development interventions/programs work with the ultimate goal of poverty alleviation, employment generation, and economic development. They aim to do so by addressing the challenges faced by SMEs and the ecosystem they work in. Donors and their development programs take tailored approaches to addressing the access to finance and markets challenges. The following schematic summarizes some such approaches taken by development stakeholders:

[9] OECD. “Aid to agriculture and rural development.” October 2013; Donor Agencies include: AusAid, USAID, DFID, GiZ, SIDA, AFD, FINNIDA, ADA (Austria), Belgium, CIDA, DANIDA, Irish Aid, Italian Development Cooperation Programme, JICA, Korea International Cooperation Agency, Lux-Development, NZAid, Netherlands Ministry of Development Cooperation, NORAD, Instituto Português de Apoio ao Desenvolvimento (Portugal), Spanish Agency for International Development Cooperation (AECID), Swiss Agency for Development and Cooperation (SDC), Turkish International Cooperation and Development Agency (TİKA) and Kuwait Fund for Arab Economic Development.



Summary: Development program approaches

While some of these interventions take a top-down approach by addressing regulatory and market ecosystem level challenges, others take a bottom-up approach by strengthening the production capacity of farmers. Shujog's analysis below explains each approach and the market conditions they are most effective in.

Market System Approach

This approach focuses on improving the market system of a particular country or region. Programs that take this approach aim to address market failures associated with one or more product chains in a market. These programs typically work on various levels with multiple stakeholders to improve market conditions for a particular product chain. This includes: working at the policy level to ensure that the trade and economic policies are conducive to market-led growth and development of the value chain; improving the ecosystem supporting a particular market; and working to improve linkages among various stakeholders in the product chain. Making Markets Work for Poor (M4P) and Participatory Market Systems Development (PSMD) are two variations of this approach developed by Practical Action, an international development consultancy that has been adopted by various development programs. USAID programs in many developing countries have taken this approach, particularly for agriculture value chains where development impact is significant. While SMEs or SEs are not the only target beneficiaries of such programs they benefit greatly from an improved market system.

The market systems approach can be most effective in relatively more established or mature markets. It assumes the existence of basic market infrastructure and key stakeholders in the product chain. Because the market systems approach identifies and resolves critical market failures that inhibit the growth of the market, its success frequently relies on key public and private sector champions to help drive an agenda of systemic change. These champions frequently have a long-term vision as well as the political/social capital to sustain incremental changes that when aggregated would facilitate a stronger functioning marketplace. New or dynamic markets may make strategic design and implementation of such an approach difficult because the market systems approach is typically a long-term program. A dynamic market may systemically change during the period of implementation of such an approach, rendering initial strategy ineffective.

Trade-Focused Approach

A trade-focused approach to SME development ensures that the target SME sector is able to access the international markets. This approach is often designed to address the challenges associated with market access for SMEs. According to an assessment of The Organisation doe Economic Co-operation and Development[10] of such programs this approach is motivated by the objective to achieve growth in the SME sector, develop knowledge assets, develop better supply links or social ties, and address any domestic or regional challenges facing the sector. Implementation of these programs can take various forms – such as trade, asset and working capital financing earmarked for export oriented SMEs, trade credit guarantees and insurance, and financial assistance for marketing costs.

This approach is most effective in countries where there is high potential for trade and investment or in markets that are transitional. Also, the trade-focused approach depends on high value crops with sufficient margin and volume to support the higher transaction costs associated with intra-continental and global trade. This approach provides incentives and support systems to encourage existing SMEs to engage in international trade. Product value chains that find it difficult to meet international demand and quality standards may not benefit from this approach.

Value Chain Development Approach

This approach is focused on ensuring better interaction, knowledge transfer, trade, financing, and partnerships among various actors in a product value chain – such as suppliers, producers, processors, traders, and logistics providers. This approach is popular among development programs in the agriculture and labor sectors. Some programs are focused on development of smallholders or SMEs in their target value chains. For example, Netherlands Development Organization (SNV), a Dutch INGO, works in agriculture value chains in developing countries and focuses on formalizing and integrating small farmers in target value chains. Others, like International Labor Organization (ILO)'s Value Chain Development Program, work with a specific development objective, such as youth employment, or increasing competitiveness. Such programs work with all stakeholders in the value chain, including SMEs, to achieve a specific development goal.

This program can be highly effective in new or dynamic value chains or value chains that have a high number of poor, marginalized, at-risk, or disadvantaged populations associated with them. The Value Chain Development approach can be more adaptive to stakeholders' needs than some of the approaches discussed earlier.

Finance-Centric Approach

Recognizing access to finance as one of the key challenges for SMEs in general and in the agriculture sector specifically, many programs build their approach around increasing access to finance. Such programs could help channel development capital into specific sectors through apex and regional banks, create financial products, tools, and mechanisms (such as letters of credit, guarantees, lender liquidity, warehouse receipts, crop insurance, credit rating system, cash flow based lending, equity funds), or offer technical assistance for better access to finance.

[10] OECD (2009), "Top Barriers and Drivers to SME Internationalisation", Report by the OECD Working Party on SMEs and Entrepreneurship, OECD

Most development finance institutions (DFIs) have SME-focused access to finance programs in developing countries.

This approach is most effective in countries that have a relatively developed financial sector. Since most of the programs are implemented in partnership with local financial institutions, it is essential that these institutions have the infrastructure and capability to collect and assess the financial data, and enforce any financial penalties for default and misuse of the program. The success factors that determine effectiveness of SME finance-centric programs are discussed in the "SME Funds and Financing Instruments" section.

Farmer Centric Approach

Many programs take a grassroots level approach by directly empowering farmers and increasing their productivity and incomes. These programs are typically envisioned and implemented by large INGOs in collaboration with local NGOs or local government agencies. Programs take on various functions such as training and capacity building of farmers, providing grants or loans for purchase of farm equipment, building farmer organizations (such as cooperatives and producer companies), creating small-scale market infrastructure, and facilitating linkages with local and regional markets. These programs aid development and growth of SMEs by empowering their supplier or producer base. These programs are often the first steps in a long-term cycle of both social development and enterprise development for post-conflict or disaster affected areas.

This grassroots level approach is most effective in least development countries (LDC), post-conflict regions, or disaster or climate affected areas that rely on farming for income. It is also effective in strengthening under-developed value chains. This approach can also be implemented in combination with another program that is market systems based or trade-focused, to ensure both top-down and bottom up strengthening of a market or a sector.

SME Funds and Financing Instruments

DFIs and development programs that take a finance-centric approach to addressing the challenges of SMEs have set up several funds and financing instruments across Asia. These instruments have been created with the support of various stakeholders ranging from governments, development finance institutions, and regional and national banks. These programs increase access to finance in three major ways: (i) provide direct equity or debt funding to SMEs in developing countries; (ii) provide concessionary capital to financial institutions in developing countries for lending to SMEs; and (iii) provide instruments to reduce the risk associated with investments in frontier markets and sectors. Shujog assessed the effectiveness of such instruments in addressing the challenges for agriculture SMEs.

SME Funds

SME financing initiatives are typically led by multilateral aid agencies or DFIs who provide the funds to capitalize the initiatives. In some cases, the donor country establishes its own team and board to oversee the implementation of the funds. In others concessional debt or equity is issued to national or regional financial institutions in target countries. In the latter case, disbursement of the funds is controlled entirely by national or regional financial institutions.

The success of such funds is predicated on various factors such as strength of the fund management and governance team, macroeconomic trends, and socio-political conditions in the countries where they operate. SME funds set up by the U.S. government in the transitional economies of Eastern Europe in the 1990s are hailed to be widely successful in boosting SME growth in the target countries and setting up strong financial institutions. However, they have faced challenges in achieving similar success in other countries, such as South Africa. The following are what Shujog believes to be the key success factors in making SME funds effective:

Accessibility of funds

Availability of the appropriate type of funds is key for SMEs, who need both debt and equity to fund their growth. The timing and ratio of debt and equity a company needs varies by its stage and business model. SME funds could deliver concessionary debt, provided by DFIs or government, through domestic financial institutions, or they could be structured as equity funds administered by an independent body or an established financial institution.

Concessionary debt often comes with the assumption that financial institutions in developing markets lack the capital to lend to SMEs. While this is true in some countries where the financial sector is highly underdeveloped, in many developing markets today, financial institutions are sufficiently capitalized and liquid. However they remain reluctant or averse to taking on the risk associated with lending to SMEs. Even those financial institutions that have sufficient capital from internal sources, government, or DFIs are unable to meet the financing needs of SMEs because they still must assume the fiduciary risk for such funds. SME debt funds are more effective in countries where financial institutions make funds accessible by sharing some risk.

While in many developing counties liquidity for loans is not a challenge, there is a shortfall of equity capital available for SMEs. This is largely because of three reasons, (i) it is expensive to establish independent institutions to make equity investments; (ii) domestic financial institutions that are largely accustomed to evaluating debt investments may not have the skills and resources to administer equity transactions; and (iii) equity investments require a longer time horizon and can be riskier than debt investments. Success of such equity funds where they do exist depends on the management's ability to assess and take risks. SME equity funds are most effective in countries where independent management teams administer the funds.

Favorable Loan Terms

Keeping the cost of capital relatively low is essential for the success of SME funds in fueling growth because SMEs face tremendous pressure to be financially sustainable. High interest cost can significantly affect their bottom line. In most developing countries despite concessional funding from DFIs, SME loans made by domestic institutions charge between 10 – 30% annualized interest rates – making the transaction prohibitive for SMEs.

Timeliness of access to finance can also be crucial to making a fund effective in addressing SME challenges. Accessing SME loans is a highly bureaucratic process in countries such as Indonesia and India where it involves several middlemen. It can take up to one year from the initiation of the loan application until funds are finally disbursed to the enterprise. This lengthy and often onerous process does not serve the needs of SMEs that require capital to fund their growth. Programs that integrate technology or process mechanisms to reduce the time to loan disbursement are likely to be most effective in addressing SME needs.

Keeping collateral requirements low can also enable better access to SME funds. Because SMEs are perceived as risky, financial institutions in developing countries often require assets worth 100-150% of the loan value. In addition, some institutions require that these assets be immovable assets – such as land or house. Financial institutions in some developing countries also require personal guarantees from the owners of the enterprise. Relaxing or working around some of these prohibitive conditions can make SME funds effective in serving their target enterprises.

Guarantees

Credit guarantees for financial institutions in developing countries have been used by multilateral and bilateral aid agencies since the 1970s to encourage risk-averse financial institutions to lend to risky sectors such as SMEs, microfinance, and agriculture. Guarantee instruments can leverage development, government, and private capital by de-risking investments in frontier markets.

Credit guarantee schemes (CGS) work in a variety of ways depending on the context in which they are created. The two most common guarantee structures are: guarantee funds and paper-backed guarantees. For guarantee funds, there is an anchor investor/donor that capitalizes the fund. The capital ring fenced for the guarantee fund is then managed as part of the domestic government, a quasi-governmental entity, or a stand-alone fund. The guarantee fund works in partnership with pre-defined lenders – be it public or private financial institutions – to guarantee loans made for specific purposes. In the event of default or realized loss, participating financial institutions submit claims to the guarantee fund, up to the pre-negotiated percentage/amount. Paper-backed guarantees work similar to guarantee funds, with the main exception that there is no capitalization of a fund. Rather claims against the guarantee are paid by a third party, usually an AAA-rate national government or multilateral institution.

CGSs have been successful in unlocking the liquidity already available in the domestic financial sector. As opposed to subsidies and other fiscal policy measures to encourage growth in the SME sector, CGSs enforce market-friendly behavior while de-risking certain assets for financial institutions. CGSs are also effective at persuading risk adverse financial institutions to learn about a new borrower group with the protection of the guarantee.

A major critique of guarantee schemes, however, is that they provide a relatively short-term solution by shifting the risk from financial institutions to the CGS. As standalone development interventions, they do not address some of the underlying causes that make lending to SMEs risky in the first place – lack of information and transparency, and weakness of legal policy and enforcement. For CGS to be effective in changing long-term lending behavior, they need to be coupled with targeted capacity building or technical assistance for the participating financial institutions.

Implications for Social Enterprises

The development interventions and SME financing instruments designed to address access to finance and access to market challenges for SMEs in agriculture have been successful in catalyzing SME growth in many developing countries. However, such interventions have had their challenges and limitations. Often relying on governments and domestic organizations for implementation, they are bound by the values, resources, and constraints of their partners. Furthermore, many such programs, while successful in strengthening SME growth, may not be designed to suit the unique needs of SEs in agriculture value chains. Developing interventions and financing instruments of DFI can pivot their current approach to fit the needs of SEs in the agriculture sector. Promoting the growth of SEs will create a sustainable path to achieving significant development outcomes, and ensure efficient use of donor capital. In addition, each dollar spent by donors and DFIs can be leveraged in multiples from the growing pool of impact investment capital.

The following are implications drawn from current programs and analysis of their effectiveness addressing the needs of SEs in the agriculture sector. These implications will inform Shujog's recommendations for next steps for donors who seek to play a larger role in the growth of SEs in agriculture.

Development programs should broaden focus to include SEs in agriculture value chains

Shujog believes that the strategies currently employed by development programs can be relevant and effective in developing and supporting SMEs in agriculture, with their success depending on the geography and economic conditions for which they are designed. However, SEs in agriculture are different from SMEs in that they typically work with poor, marginalized, or disadvantaged communities, with innovative new technologies, or in latent demand markets that require market awareness and activation. The product value chains that SEs work in are often not fully developed. Because of this, some of the more top-down approaches like market systems based or trade-focused approached may not be timely or effective in addressing the day-to-day challenges that SEs encounter. In addition to this, SEs in agriculture face unique challenges that development programs focused on SMEs may not address. For example, while scaling their operations is challenging for most SMEs, SEs face the added pressure of scaling while remaining true to their social or environmental mission. Assisting such enterprises without appropriate resources to serve social business models can be challenging and/or ineffective.

It is essential to invest in programs that address these needs to ensure growth and scale of SEs in agriculture. Specifically, there is a need for technical assistance programs that leverage organizations and experts who understand the challenges faced by SEs in agriculture. Technical assistance services should be designed such that they help SEs refine their growth – financial and social impact – strategy and bring them to investor-readiness. Support programs need to emphasize measurement and reporting of social and environmental impact of SEs so that they are able to attract capital from impact investors.

Scaling social impact of SEs should be a key design feature of programs

Development programs focused on SMEs in the agriculture sector typically focus on reaching or supporting a target number of SMEs. While programs measure and report various success metrics such as outreach, employment generated, and systemic changes, rarely do they track the social impact of the companies that they support. SEs are different from SMEs because they intently deliver many layers of social impact in their communities. Tracking basic impact metrics such as increased revenue and employment may be optimal for SME development programs; but any program focused on SEs should aim to both help scale an SE's impact on its beneficiaries and track the social and environmental impact it generates. Shujog believes that this is essential for growing the number of impact-oriented SEs, as well as attracting impact investment in the agriculture sector.

Success metrics of existing development programs that work with SMEs or in the agriculture sector typically do not include increasing the social impact of the organizations they work with. Programs that target SEs in agriculture should include improving their social and environmental impact on their beneficiary enterprises as a key program outcome. This requires the expertise of professionals who have experience working with SEs and can advise them on strategies that integrate both business success and social impact. Development programs can leverage the experience of impact investors who have substantial experience evaluating social enterprise strategies.

Program approach should include working with individual firms

The ecosystem and markets in which SEs work are relatively less developed in most developing countries in Asia. Top-down approaches like the market-systems based approach or trade-focused approach may not provide timely interventions that foster the growth of nascent SEs. Programs should, instead, work with individual firms to strengthen and scale them, and develop markets for high social impact products. Programs should identify agricultural value chains that have the potential for high social impact based on the country context, and work with different types of SEs in these value chains.

Funds and financing instruments should meet unique needs of SEs

SEs in agriculture tend to be early-stage SMEs that are typically testing innovative solutions and strategies. These companies may be more risky and difficult to evaluate than typical SMEs because they are often working new markets or supplier bases where a track record does not exist. This could be outside the risk appetite of domestic financial institutions in most developing countries in Asia. In addition to that, the lengthy application process may not be suited to the needs of these dynamic organizations that often need to pivot business plans and strategies based on early market testing and response.

Financing instruments that target these enterprises should be designed for their specific risk profile. In addition, some SEs may need to spend both time and capital on building the ecosystem and creating market linkages. This work is a public service that benefits all SEs and SMEs, but is a cost for the SE leading the efforts because the economic benefits of which may not be realized in the near term. This requires investors and financing instruments that can provide patient capital for the longer time horizons.

SEs may also need hybrid funding through a combination of grants and investments. Grants may be needed either for SE operations such as market activation, or for SEs to receive the technical assistance they need to become investor ready. Funds targeted at agricultural SEs should consider including technical assistance or market activation grants as a component. Development programs can consider establishing hybrid funding mechanisms with impact investors, who could bring in investment capital when donors provide grants for capacity building.

Invest in programs and tools that unlock domestic capital

Inability to assess risk, or low risk appetite is the major reason behind the inability of domestic financial institutions to meet the demand of SMEs in agriculture. This challenge is more pronounced when it comes to financial products for SEs in agriculture. Development programs could help unlock domestic capital by de-risking it through short-term solutions such as credit guarantees while investing in other longer-term solutions that address the inherent challenges. Such programs could also work alongside impact investors to leverage their investment experience in emerging new sectors and to design financial products that meet the needs of SEs. The following are different ways in which programs can help financial institutions to better assess risk:

- Bringing information and transparency: it is challenging to find appropriate data and tools to assess risk in some developing markets. It is especially difficult for financial institutions to assess credit risk of SEs because they often work in unchartered or difficult markets. Establishing transparency in markets by creating credit rating tools for SEs or credit bureaus could reduce both the cost and risk associated with lending to SEs.
- Capacity building of financial institutions: loan officers at domestic financial institutions may not have the skills or experience to evaluate SEs, because they are not equipped to analyze the effect of the social impact goals of SEs on their credit risk. This may be a major deterrent to these institutions designing and offering financial products for the organizations.
- Enabling moveable collateral registry: one of the major challenges to access to credit for agriculture SEs (particularly those in processing and value addition) is that they do not

have sufficient land or buildings they can use as collateral. Enabling entrepreneurs to register movable assets such as machinery, jewelry, gold, livestock, and vehicles, would be one way to address this challenge.

- Reducing agricultural risk: one of the major challenges for financial institutions working with agriculture enterprises is that there are risks associated with climate change and weather patterns that are outside the scope of predictability. For social enterprises, these risks extend to not just the financial health of the company but also its ability to achieve social impact. Creating financial products (such as crop insurance, livestock insurance) to mitigate these risks for SEs, as well as their beneficiaries, could help allay some of the concerns of financial institutions that serve this market.

Establish standalone funds in risk-averse markets

Development programs and DFI funds have created several strategies in the past to de-risk focus sectors and unlock local capital. However, some of these efforts have not been successful in changing behavior of financial institutions that remain risk averse and unwilling to lend to new and emerging sectors like SEs. Development organizations should consider establishing standalone debt and equity funds (independent of established financial institutions) to provide access to capital to promising SEs in agriculture. Such patient funds can be managed by a combination of international and domestic management team who are in agreement with the mission of scaling SEs in agriculture and understand the risks the sector brings. Development programs can also leverage impact investment capital to establish such funds, and the expertise of impact investors in administering them.

Recommendations

Shujog believes that donors and development agencies can both work with existing programs to make them more effective in addressing the needs of SEs in agriculture value chains, as well as invest in developing new programs. The following are specific recommendations for organizations working in the agriculture value chains in Asia.

Require implementation agencies to include Social Enterprises as beneficiaries

Donors can encourage greater developmental impact from existing SME programs by requiring implementers to include a small percentage of SEs as their target program beneficiaries. By creating demand, funders will force contractors who have previously not worked with SEs to begin thinking about how to support SEs within mainstream SME development programs. This may require incremental funding for existing programs to include SE specific services such as social and environment impact assessment of beneficiary SEs, experts to provide TA services on SE growth strategies, and design and implementation of financial instruments that meet SE specific needs.

Shujog believes that this is a unique opportunity for organizations already working with SMEs in agriculture to pilot support strategies for SEs. Such organizations can leverage the existing resources and framework for SME support to test innovative strategies for building a better ecosystem for SEs in agriculture.

Invest in ecosystem building for agriculture SMEs, with focus on SEs

Incubators and Accelerators

Development organizations should invest in building a stronger ecosystem for SMEs in agriculture, with specific focus on sourcing SEs. Agriculture focused incubators and accelerators in countries that have high potential for agriculture SME growth but lack support services could serve as catalysts for creating strong value chains. Incubators and accelerators can provide the necessary technical assistance, resources, and guidance needed to bring agriculture SEs to investor-readiness. They could potentially work in partnerships with impact investors to ensure that successful and high impact SEs get funded for growth.

Shujog believes that donors and development organizations can provide the grant money and strategic guidance needed to establish such incubator and accelerators in countries like Bangladesh, Cambodia, Indonesia, Nepal, and Sri Lanka where such services do not currently exist.

Credit Scoring Mechanisms

Donors and development organizations could work with local credit assessment agencies to develop robust credit scoring mechanisms for agriculture SMEs. In many countries, while banks have the liquidity to lend they perceive agriculture enterprises as risky investments because they lack the data and frameworks to evaluate such enterprises. Specifically, institutions may lack the tools to assess SEs because they often balance mission alignment with profitability. Donors should help develop credit scoring tools that analyze and incorporate the effect of social impact criteria in the credit score of SEs. By building the capacity of local institutions to develop such credit scoring mechanisms, development organizations could help unlock domestic capital for agriculture SMEs.

Shujog's cursory analysis shows that such interventions may be effective in countries like Indonesia and the Philippines where financial institutions have better liquidity. Further research can help identify markets and value chains where such interventions can be most effective.

Establish guarantee funds that favor SEs

Guarantee funds have been effective in unlocking domestic capital for SMEs in many developing countries. Development organizations could build on this success and design a guarantee fund that prioritizes support to SEs. For example, the guarantee fund could provide a higher percentage for SEs vs. regular SMEs to facilitate their access to credit, help establish their creditworthiness, and introduce lenders to the concept of SEs.

A regional guarantee fund that works with financial institutions across two or three focus countries in a target region could be an effective strategy for donors and development agencies. Pooling the demand across multiple small markets could help realize cost synergies associated with setting up and administering such a fund.

Create debt funds and vehicles with specific features designed to serve agriculture SEs

Development organizations can create debt funds with financial product features that cater to the unique needs of agriculture SEs. For example loan moratoriums to allow time for SEs to activate markets with latent demand, and harvest-linked payment cycles could serve financial needs of agriculture SEs better because they are better aligned with their cash flow patterns.

In addition, development organizations could create debt vehicles that are tailored to the unique needs of agricultural SEs. For example, development organizations could help SEs access public funds by helping them issue impact bonds to raise capital. This could be highly beneficial for countries where DFIs are unable to issue debt due to bilateral agreements.

Create SE-focused equity funds

Development organizations can consider partnering with impact investors to launch agriculture SE focused equity funds in markets where financial infrastructure is not fully development. Early-stage agriculture SEs, particularly those that work with innovative technological solutions in agriculture often need access to equity funding, but do not have avenues to access such funding. Traditional equity funds may not be able to serve SEs because they seek sound market conditions[11] – which SEs, that work in new markets or markets with latent demand, may not have.

Shujog believes that equity funds coupled with TA facility to support ecosystem or marketing building activities could be more effective in producing sustainable development outcomes through agriculture SEs. We support the recommendation made by the Stanford Social Innovation Review article that funds aimed at supporting SEs should target lower financial returns, and be designed to seek the highest social return. Based on cursory analysis, we believe that countries like Vietnam, Cambodia, Nepal, and Sri Lanka, where financial markets are underdeveloped, could be ideal for such funds.

Conclusion

Social enterprises in agriculture value chains have the potential to create sustainable social and environmental impact in their communities. However, the market conditions in which they work today makes it difficult for SEs to achieve the scale their need to achieve significant impact. Now more than ever, development organizations need to adapt existing SME programs and initiatives to meet the needs of SEs, and invest in new interventions targeted at SE development. While on one hand global leaders are rallying unprecedented support for ensuring food security and sustainable agricultural practices; on the other hand, there is a widening pool of impact investors looking for opportunities to invest in high-impact solutions. Development organizations can empower SEs in agricultural value chains to ensure agriculture sustainability and food security, by creating strong, investable SEs that can leverage impact investments.

Shujog believes that Oxfam, as a leading organization in the development of agricultural communities should play a vital role in this effort. By improving market conditions for SEs in agriculture, Oxfam can set a precedent for development programs working with impact investors and global DFIs to establish the foundation for strong financial and developmental growth in the agriculture sector.

[11] As recognized by the survey of 84 African investors by Monitor Inclusive Markets Group in the article titled "Closing the Pioneer Gap" in the Stanford Social Innovation Review, Winter 2013

Appendix

Table 1: Types of Agriculture SMEs

Inputs and Technology Providers	Producers (Farmers)	Logistics, Trade, and Distribution
Design, assemble, or manufacture key inputs or equipment for use in agriculture **Key Needs and Challenges:** • Research and development infrastructure • Financing at idea-stage through grants or equity difficult to access • Generally have capital intensive models that require setting up of manufacturing facilities **Example:** DripTech, India – assembles and sells drip-irrigation systems for smallholder farmers	*Sow, farm and harvest crops, raise poultry and livestock, or fish* **Key Needs and Challenges:** • Financing for purchase of inputs and essential equipment (tractors, feeders, fishing boats) • Most affected by weather and climate risks, and pests and crop diseases • Have difficulty accessing reliable and high-value markets **Example:** Blue Impact Capital, Malaysia – eco-friendly mushroom farming company	*Provide logistics, distribution and trade services for agricultural produce* **Key Needs and Challenges:** • Generally have capital intensive models that require setting up of warehouses, cold storages, and purchase of transport vehicles • Must rely heavily on public infrastructure such as roads, highways, and power supply **Example:** Royale Cold Storage, Philippines – provide cold storage facilities to farmers around the Metro Manila area
Processors	**Wholesalers**	**Retailers**
Process or package agricultural products to sale to consumers or traders **Key Needs and Challenges:** • Working capital financing for purchase of raw materials • Generally have capital intensive models that require setting up of manufacturing facilities • Often unable to access high-value international markets **Example:** East Bali Cashews, Indonesia – processes raw cashew into flavored packaged products	*Procure raw or processed products from farmers and processors for export or sale to retailers or processors* **Key Needs and Challenges:** • Working capital financing for purchase of produce during harvest • Capital intensive models that may require setting up of warehouse and logistics • May not to able to access high-value export markets **Example:** StarAgri, India – procures from farmers and *mandis* (wholesale markets) to sell to major agri-processing companies and retailers in India	*Sell agricultural products to consumers through retail markets* **Key Needs and Challenges:** • Working capital financing for purchase of different products, and operations of retail outlets • Capital intensive models that may require setting up of retail outlets **Example:** Kheti Bazaar, Nepal – sells organic farm produce through retail store in Kathmandu

Table 2: Prevalent Legal Structures of Agriculture SMEs

Legal Form	Description	Implications for finance and investment
For Profit Structures		
Sole Proprietorship	One owner personally liable for business – typically small family business	• Can raise debt financing based on personal or business credit history, and assets, but could be difficult because they are unregulated • Cannot raise equity
Partnership	Two or more owners/partners – Unlimited and joint liability	• Can raise debt financing based on partner's personal guarantees • Each partners are personally liable for its debts
Limited Liability Company	More than one owner/partner – limited personal liability of partners. Can have pass through income tax	• Laws regulating LLC type companies are different in each country • Combines the limited personal liability of a corporation with the tax advantages of a partnership • Can raise both equity and debt with less reporting requirements
Private Limited Company	More than one owner/partner – liability is limited to the extent of the unpaid amount on the shares	• Can raise both equity and debt financing • Shares are usually transferred by private agreement between the seller and the buyer
Producer Companies (in India)	Any 10 or more persons engaged in an activity connected with, or related to, primary produce can participate in the ownership	• Liability of the members will be limited to the amount, if any, unpaid on the shares • Membership restricted to 50 members • Functions as a private limited company on registration
Hybrid Structures		
Cooperatives	Autonomous association of persons who voluntarily cooperate for their mutual social, economic, and cultural benefit	• Can have both limited and unlimited liability status • Can be taxed but have several exemptions depending on the country • Can raise debt on individual person's guarantee with liability limited to ownership of the cooperative
NGO-business entities	Business entity focuses on revenue generating activities, channels some revenues and costs to NGO which focuses on social impact	• NGO can raise grants funding • For-profit business entity is registered as private limited • Can raise both debt and equity
Non-Profit Structures		
Non-profit Organization	Organization cannot share profits with members or shareholders	• Major sources of funding are donations and grants • Profits are not distributed amongst the members • Cannot raise equity • Can raise debt financing

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This research was written by Alison Eskesen, Director of Research and Programs at Shujog, Rashi Agrawal, Manager at Shujog and Noopur Desai, Senior Analyst at Shujog. Oxfam acknowledges the help of Dominic Ramirez and Oskar Haq in its production.

For more information, or to comment on this report, email OHaq@oxfam.org.uk

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