Training Manual: The Basics of Financing Agriculture

Module 5.4 | Investing in SMEs

Acknowledgement

The Agriculture Finance Training Manual is part of AgriFin's Agriculture Finance Training Tools. The Manual was developed by IPC - Internationale Projekt Consult GmbH as part of AgriFin's technical advisory project for Cameroon Cooperative Credit Union League (CamCCUL).

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Session Overview

LEARNING OBJECTIVE	Investing in SMEs requires a thorough understanding of the risks involved, usage of the loan, disbursement schedule, and other related decisions. An Agricultural Loan Officer (ALO) must be able to evaluate all elements that affect an SME client's business and thus in turn may have an adverse effect on the investment in the SME.
SCOPE	By the end of this session, the trainee will have an understanding of the following elements of investing in SMEs: • Overview of the types of investment risks and their potential impact on the loan's recovery • Evaluate the need for the loan to make a strong case for the investment • Provide guidance on evaluating internal and client financing needs • An introduction to the potential internal and external factors that may affect the investment, such as the business cash flow or the industry trends and proposed investment enabling environment • The session ends with a summary of key points that an ALO must consider in reviewing the investment potential of an SME
TARGET	Agriculture loan officers, trainers, agriculture experts with limited financial analysis training, and other professionals interested in agriculture financing
DURATION	1 hour

Content

1. Introduction: Investment risks and SMEs (I)

Often, a client takes an investment decision spontaneously, without careful consideration of all relevant factors that may be decisive for the successful implementation of the project.

What role do risks play for SMEs?

- Depending on their market position, some enterprises may be able to eliminate many risks by passing them on to suppliers or customers
- But in most cases, the larger the enterprise becomes the more risks emerge, for example:
  - Can an enterprise with different inputs ensure that all suppliers deliver as planned?
  - When an employee becomes sick, do others have the ability to do his/her job?

1. Introduction: Investment risks and SMEs (II)

So why should the LO assess the client’s investment project?

Because neglecting important factors can lead to liquidity shortages, delays in the implementation or even complete failure of the investment

- This affects the client’s ability to pay back his loan
- Investment failure may also affect the credit cycle as a whole
  - o A client whose business failed will be in a difficult position to obtain new loans

If you want to ensure loan success, you should analyse the loan purpose carefully!

- Analyse the different risks connected to the project, Market risk and macroeconomic risks can affect the demand needed to break even
- Liquidity risk can stop the investment project as a whole, for example:

1a. Example of Investment risks in SMEs (I)

The market-product matrix can give a first impression what risks are associated with a certain investment:

Market-product matrix

1a. Example of Investment risks in SMEs (II)

Investment in existing market / existing product

- Risk level: relatively low
- Aim: consolidated or grow current market share
- Consideration: current market share, size of the market, market potential, analysis of competition

Investment in existing market / new product

- Risk level: medium
- Aim: extension of own product range
- Consideration: how can the new product serve the existing market?

1a. Example of Investment risks in SMEs (III)

Investment in existing product / new market

- Risk level: medium
- Aim: capturing of new market
- Consideration: market survey, marketing activities

Investment in new market / new product

- Risk level: high
- Aim: strategic benefit for the whole business
- Consideration: own financing strength, complex planning and preparation
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2. Need for Investment

In this section we will develop the steps for analysing the client‘s investment decision by checking whether he/she…

- ….really needs the investment
- ….considers all costs and estimates them realistically
- …has a realistic idea on the investment‘s financing sources
- …is aware of the time it takes to become profitable
- …has the appropriate enabling conditions as they might differ depending on time, place, person, etc.
- …is aware of the effects a new business might have on his/her other business activities

2a. Types of Investment (I)

Classification according to the source of financing…

- Own equity (completely funded by retained earnings)
- Own equity and additional equity from outside
- Equity and external financing
- Mostly external financing

Classification according to the effect on the productive assets…

- Maintenance investment
- Replacement investment
- Expansion investment

2a. Types of Investment (II)

Classification according to the position of the assets in the balance sheet:

- Current assets
- Equipment
- Land and buildings

2b. Starting Questions (I)

So before starting to plan an investment, it should be evaluated whether this investment is really needed at this moment.

The client should be able to answer the following questions:

- Why do I need to invest and what is the expected effect?
  - Increase stock for seasonal sales?
  - Reduce costs?
  - Increase capacity?
  - Increase product quality?
  - Increase convenience for customers, staff or business owner?, …
  - Attract clients through new premises?

- Did he/she check whether there is demand to justify increased stock or production capacities?
  - New contracts, new customers or inquiries for a new product?
  - Existing orders? Market analysis?

- Can the client quantify the demand?

2b. Starting Questions (II)

- Is the relation between investment cost and expected inflows reasonable?
    - Sometimes investments are made for large amounts of money but in the end the inflows are minor (e.g. constructing a house for 500,000 USD and renting it to someone for 2.000 USD per month);

- Does it make sense to invest at this point in time?
    - It may be reasonable to invest later, when market conditions are more favorable (e.g. exchange rate, interest rate, supply, demand…)

Note that in order to assess the client's answers, you must have knowledge on the market conditions as well!

- Only this allows you to assess and quantify the risks of the project

3. Total Costs

Insufficient financing is the major risk for a project

- Therefore, no matter whether an investment in fixed assets, construction or stock is planned, the total cost of the investment must be established.
- The total costs of the investment not only include the value of the equipment (or stock etc.) at its purchase price but also costs associated with the acquisition, such as:
    - Transport
    - Customs
    - Agents
    - Taxes
    - Additional purchases needed to complete the investment
    - Permissions/other documents
    - Etc.

3. Total Costs (contd.)

In summary:

- The calculated costs need to cover all aspects from the beginning to the 100% realization of the project.
- Assumptions of the expenses must be traceable and realistic
- Unforeseeable expenses can easily make up to 30% of the project volume (especially in construction projects)

A good estimate of total costs is important to select the most suitable product for the client.

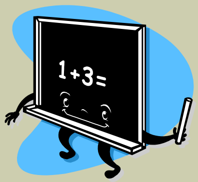
Also, the related costs a project has, depend on the type of investment:

For example in construction:

- Purchasing fixed assets (machines, equipment, vehicles)
- Purchasing (importing) goods
- Establishing a new business

Identify the type of costs and risks related to each stage of the investment realization!

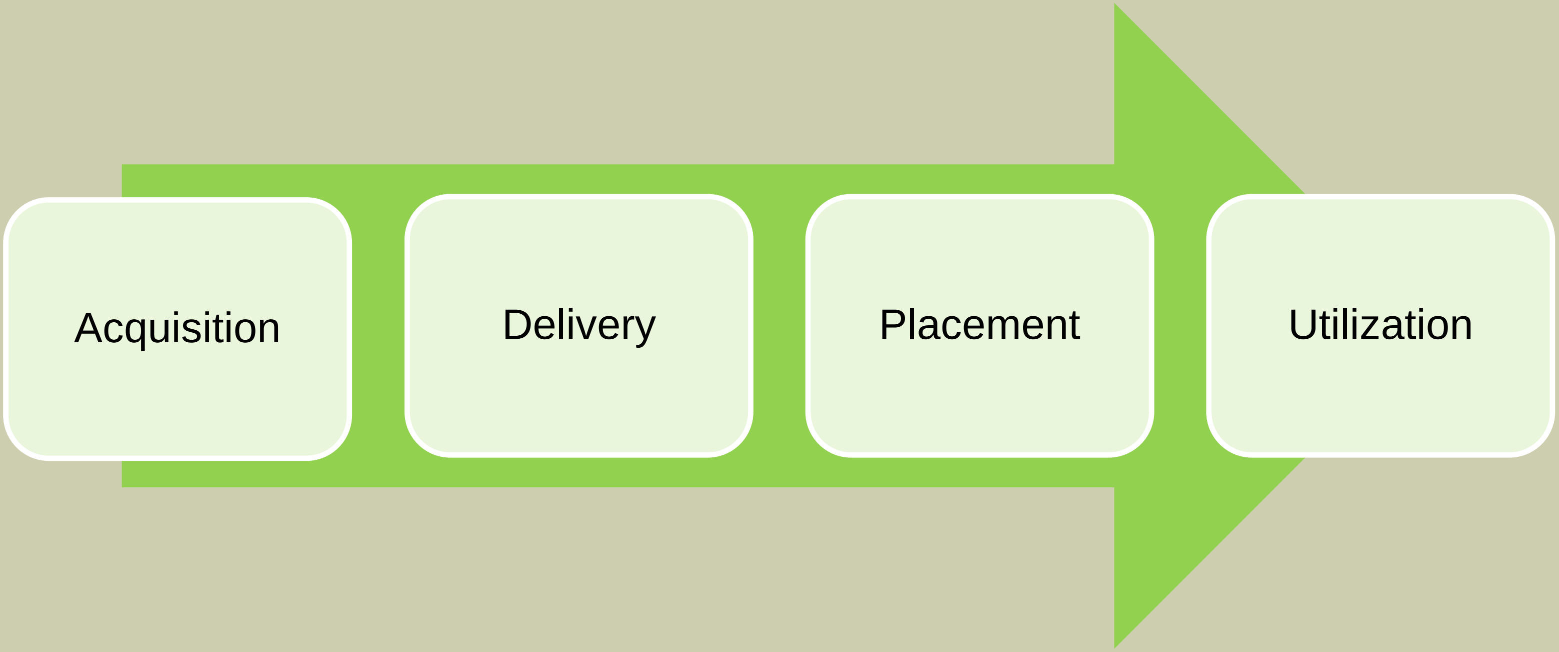
3a. Cost Items: Purchase of Working Capital



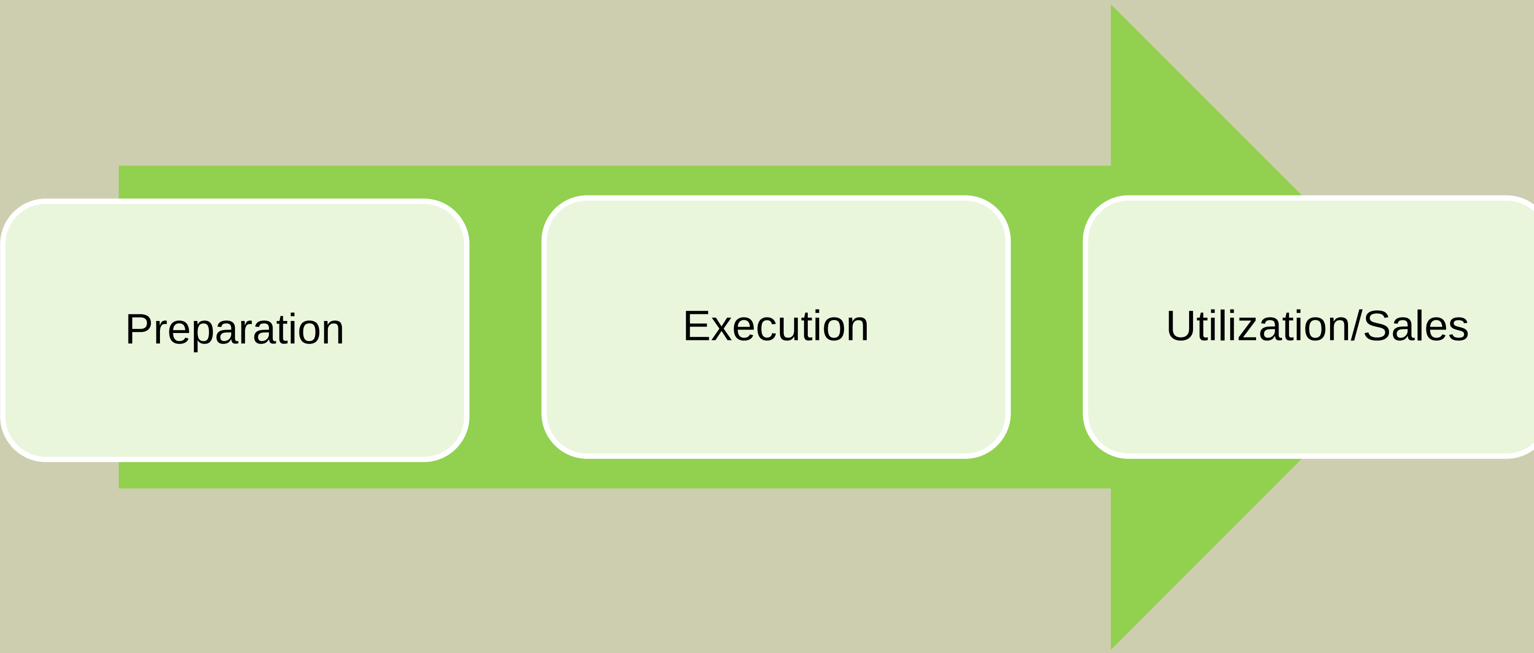
What are the major cost items?

Acquisition → Delivery → Stock → Sale

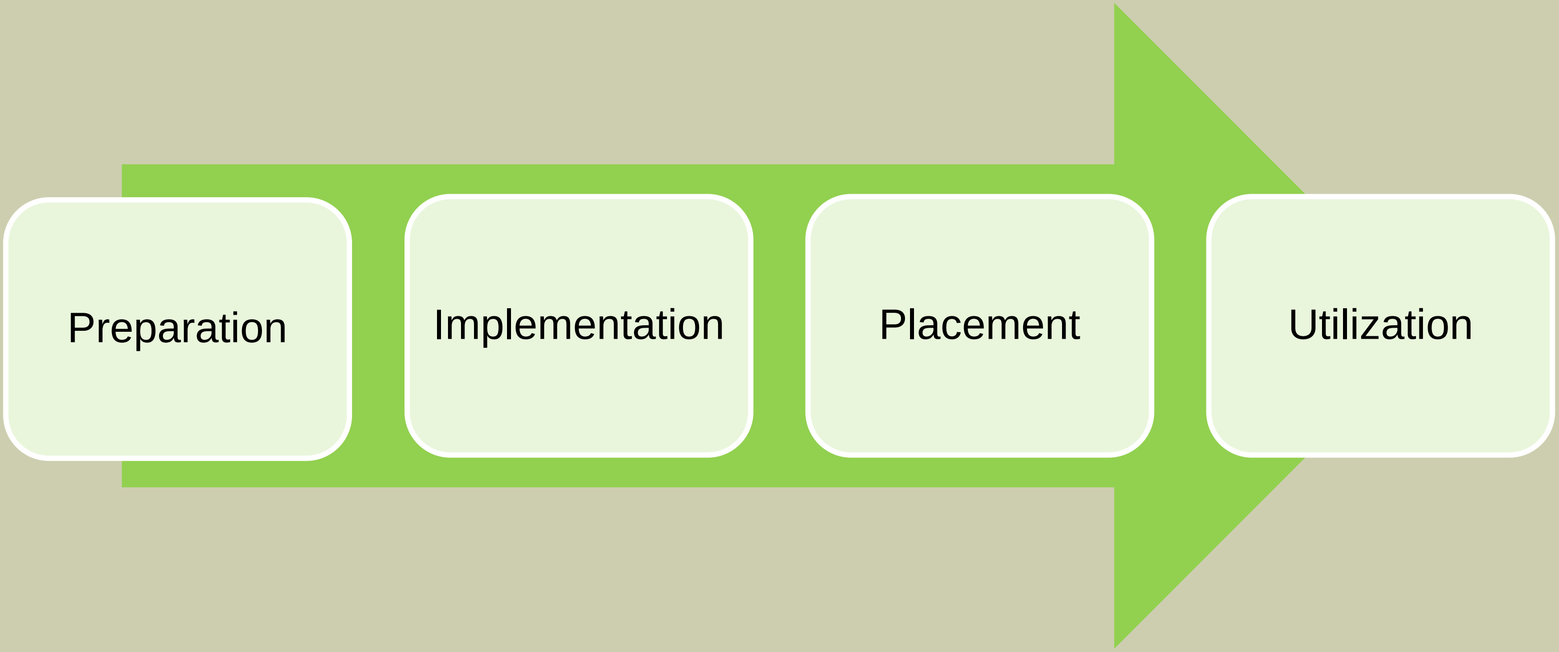
3b. Cost Items: Purchase of Fixed Assets



3c. Cost Items: Construction



3d. Cost Items: Starting a New Business



4. Adequate Financing

Questions to be addressed in this section:

- Which financing sources does the client have
- What are adequate financing sources?
  - Which type of banking product / finance is most suitable for the project?
- When will the client need the financing?

4a. Adequate Financing: Sources (I)

Internal

- Retained earnings
- Sale of current assets
- Sale of fixed assets

External

- Bank loan
- Other
- Factoring
- Leasing
- Equity Injection

4a. Adequate Financing: Sources (II)

The client comes to you because he/she wants to access external financing. It should be made sure that the term of the credit is equal (or at least close to equal) to the time it takes the investment to generate inflows.

Example:

- What happens, if the client takes a short-term loan to construct a new point of sale or a hotel?
  - Construction takes time and will not produce cash inflows right from the day of the acquisition of material (as opposed to the purchase of goods that can be sold immediately).
  - However, the installments for the short-term loan are due right away. This can very quickly bring the client into a situation where he/she has no liquidity to continue his/her business' operations, i.e. to purchase goods or to pay the installments.

5. Cash Flow: Timing for the Client (I)

Investments that are conducted on a longer term, such as construction projects or new businesses might require financing at several stages.

Therefore, a project cash flow can be helpful to identify the financing gaps

- Relevant for liquidity risk

In order to make the cash flow a useful tool the LO should consider the following:

- Timing of cash flow
- Amounts
- Source / purpose

5a. Cash Flow: Timing for the Client (II)

It is useful to start with a list of expenses to be made including their amounts and their timing:

Time of payments	Project stage	Amount
April 2013	Purchase of Land, design of building, building permission	FCFA 8 Millions
May 2013	Laying of foundation	FCFA 5 Millions
June 2013	Purchase of building materials	FCFA 20 Millions
July 2013	Payment of contractor A	FCFA 1.4 Millions
August 2013	Payment of contractor B	FCFA 1.9 Millions
TOTAL		**FCFA 36.3 Millions**

Afterwards, the project cash flow can be projected

5. Cash Flow: Timing for the Bank (I)

		April	May	June	July
Cash at the beginning of the month		20,000,000	12,500,000	7,800,000	930,000
Cash inflows	Sale of goods	500,000		130,000	50,000
	Sale of machinery		300,000		
	Loan to buy material			13,000,000	
	Total inflows	500,000	300,000	13,130,000	50,000
Cash outflows	Purchase of land, design of building, building permit	8,000,000			
	Laying of foundation		5,000,000		
	Purchase of material			20,000,000	
	Payment, contractor A				1,400,000
	Payment, contractor B				
	Total outflows	8,000,000	5,000,000	20,000,000	1,400,000
Net cash flow		-7,500,000	-4,700,000	130,000	-1,350,000
Cash at the end of the month		12,500,000	7,800,000	930,000	-420,000
Additional financing needed		NO	NO	NO	YES

Although the client has taken out a loan, it is clear that he/she will require additional funds in July – and contractor B has not even been paid yet!

6. Effects of Existing Business

What has to be kept in mind when the client already has a business and whishes to invest in a new activity?

- Often, much more time and effort is invested in the new activity, often at the expense of the existing activity.
- If the new activity does not generate revenue immediately, it is the old activity that finances it.
  - As a consequence a lack of funds for the old business often appears, which means in many cases that its stock starts to decrease. This means that the business is very often not able to respond to its clients' needs and expectations anymore. In the worst case, a business loses its stock as well as its clients, leading to a breakdown of the activity.

→ Planning (especially of cash flows) should include all business activities in order to see whether there will be enough liquidity to finance both activities

6. Effects of Existing Business (contd.)

Financing a new, not yet profitable activity from an old one can have many consequences:

- Lack of liquidity in the old business
  - Difficulties can arise in servicing debts or buying inventories
  - Investments in the old business cannot be financed opportunity costs!
- Neglecting the old business may even lead to losing customers and hence the breakdown of the activity.

To avoid this:

- Planning (especially of cash flows) should include all business activities in order to see whether there will be enough liquidity to finance both activities
- Clients should plan the time required for both activities
  - Maybe the investment requires additional staff

7. Enabling Conditions

Very often an investment area is chosen only because it works well on the market or because it works well for a friend or neighbor etc.

This is often the case when an entrepreneur seeks to expand his business by investing in another activity i.e. to diversify his/her business activities.

A business/product (for example) may work well for one person and not for another one for different reasons:

- The entrepreneur does not have the expertise necessary for the type of business/product
- The target group is not the same
- The conditions of the market are not the same (anymore): demand, competition, prices, etc. in the area
- Etc.

Thus, the Loan Officer has to assess the investment plan thoroughly

- Can the investment be successful, given the client, his abilities and region of operation?
- Can a business model simply be reproduced?

8. Summary

Ensure that you check whether…

- ….the client really needs the investment
- ….you have considered all costs and estimate them realistically
- ….are aware of the risks
    - related to the project cash flow
    - related to the project‘s profitability
    - related to the client and his/her capabilities
- …you and the client have agreed on adequate financing
- …the appropriate enabling conditions are in place as they might differ depending on time, place, person, etc.
- …the new business impacts any existing activities

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We welcome your feedback to help us further refine these training materials. Please contact us at agrifin@worldbank.org.