fi compass
EAFRD

Financial needs in the agriculture and agri-food sectors in Estonia

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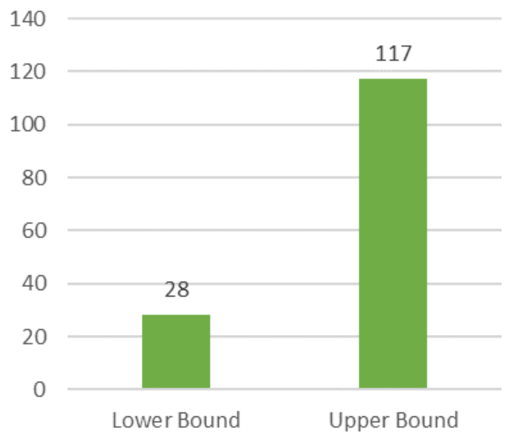
European Commission

European Investment Bank
The EU bank

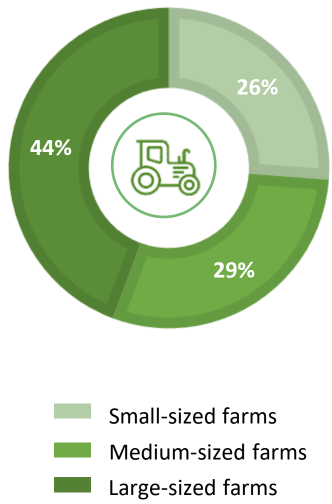
ESTONIA

FINANCING GAP IN THE AGRICULTURE SECTOR

FINANCING GAP IN THE AGRICULTURE SECTOR (EUR MILLION)

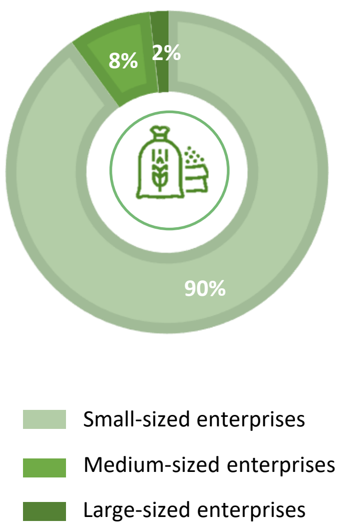


BY FARM SIZE

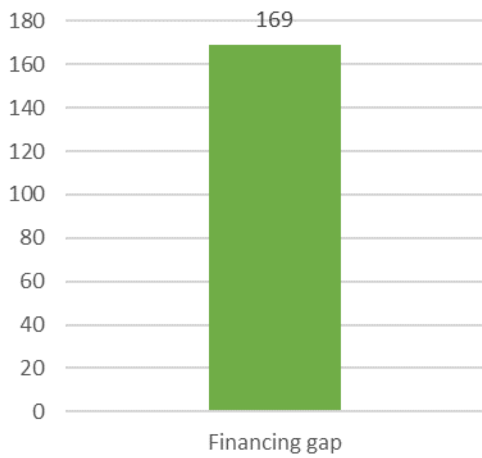


FINANCING GAP IN THE AGRI-FOOD SECTOR

BY ENTERPRISE SIZE



FINANCING GAP IN THE AGRI-FOOD SECTOR (EUR MILLION)



Source: *fi-compass* 2020

EXECUTIVE SUMMARY

This report gives an insight into agriculture and agri-food financing in Estonia by providing an understanding of investment drivers, financing supply and financing difficulties, as well as on the existing financing gap.

The analysis draws on the results from two comprehensive and representative EU-level surveys carried out in 2018 and 2019. These were the *fi-compass* survey on financial needs and access to finance of EU agricultural enterprises and a survey of the financial needs of EU agri-food processing enterprises. The report does not take into account the impact of the ongoing COVID-19 health crisis and/or the effect of any new support scheme being set-up by the Member State and/or changes in legal basis and/or policies at European level to mitigate the crisis, as surveys and data available covered a period prior to its outbreak. This would need to be subject to further analyses by interested stakeholders, administrations and/or researchers.

Financing gap for the agriculture sector in Estonia

In recent years, investments in the Estonian agriculture sector have been influenced by a crisis in the pig and dairy sub-sectors. The crisis originated with the outbreak of African Swine Fever (ASF) in 2014 and the consequential Russian trade embargo, which severely affected most pig and dairy farms. Between 2014 and 2015, Gross Fixed Capital Formation[1] (GFCF) decreased by 36% from EUR 237 million to EUR 151 million. The recovery from this sudden decrease in production capacity was accompanied by high demand for investment. It was only after 2016 that economic indicators for agriculture started to develop positively. According to the *fi-compass* survey, 49% of Estonian farmers applied for finance in 2017, compared to an EU 24 average of below 30%.

Overall, the report identifies two main investment drivers:

(i) **Expansion of production capacity**;

(ii) **Increased efficiency and modernisation of equipment, machinery and technologies**.

According to the *fi-compass* survey, 60% of the demand for credit was driven by expansion needs. The recovery of meat prices after the end of the ASF crisis had a positive impact on investment demand. Dairy farms mainly invested in increasing their production capacities, while purchase of land had an important role in both the crop sub-sector and the diary sector. The proportion of Estonian farms making investments in land purchases, at 33%, is much higher than elsewhere in the EU.

The need for working capital is another driver of the demand for finance in agriculture. However, a significant part of the short-term financing is provided by input suppliers, with only 8% of loans contracted in recent years being used to finance running costs (short-term loans). The demand for short-term financing arises from the intensification of agricultural production[2], an increase in production costs, and low economic margins.

The Common Agricultural Policy (CAP) is a vehicle for investment support. Direct payments help to stabilise farmers' incomes and are treated by banks as a guarantee for the repayment of (short-term) loans to farmers, in which case no other collateral may be required. Several investment support measures provided under the European Agriculture Fund for Rural Development (EAFRD) also sustain demand for investment

1 GFCF measures the value of acquisitions of new or existing fixed assets. GFCF/GVA is used as a measure for how much of the new value added in the economy is invested rather than consumed. Increase of the GFCF is a measure of business confidence, a belief in that investments will be profitable in the future. In times of economic uncertainty or recession, typically business investment in fixed assets will be reduced, since it ties up additional capital for a longer interval of time, with a risk that it will not pay itself off.

2 Production has become more intensive and this requires more variable inputs, which input suppliers provide together with short-term financing.

finance. The amount requested by Estonian farmers by the end of 2019 indicate a large-scale unmet demand for grants.

The supply of finance is concentrated within two banks, representing more than 50% of the borrowing needs in the agriculture sector. Also, agricultural input and equipment suppliers offer short-term credit and leasing options. The Rural Development Foundation (RDF) helps improve access to finance through loans, credit insurance and guarantees. Since 2016, agricultural enterprises can also benefit from loans from funds financed under the EAFRD Programme and co-financed by banks. This financial instrument offers two types of loans: a growth loan for micro and small-sized enterprises, and a long-term investment loan. Due to demand, the total loans budget has been increased from EUR 36 million to EUR 39 million

The total outstanding loan volume for agriculture, forestry and fishing increased by more than 190% between 2014 and 2018, to reach an estimated EUR 454, despite the ASF crisis. Short-term loans and leasing products, with an estimated total contract value of EUR 254 million in 2017, are an important element of the financing mechanisms used by the sector

The financing gap for the Estonian agriculture sector is estimated between EUR 28 million and EUR 117 million. A first component of the gap corresponds to the estimated value of loan applications from viable enterprises that were rejected by banks, or where the loan offer was refused by the applicants due to non-acceptable lending conditions. The second component corresponds to the estimated value of loan applications not submitted by viable farmers because they were discouraged by fear of a possible rejection. Young farmers and new entrants account for an important part of the financing gap with an estimated share of 44% or between EUR 15 million and EUR 52 million.

This report identifies several reasons why viable loan applications by farmers are rejected, refused or farmers are discouraged from applying:

- Insufficient collateral to meet banks' requirements: financial institutions often request large guarantees, frequently above 100% of the loan value. Farms without the required collateral, such as those with little or no arable land, or young farmers and new entrants, either see their loan application rejected or are discouraged from applying.
- High lending risk: an unstable economic environment and increased competitive pressure means that lending to several sub-sectors has become increasingly risky. This has led banks to adopt a cautious lending policy, especially when they do not have a specialised agricultural lending unit. This is an important factor for small-sized farms.
- Many farmers lack financial planning skills, making it difficult for them to plan and deliver payments to banks. This has also caused problems in preparing business plans and negotiating loan terms with banks. Furthermore, especially farmers with weak financial skills can be discouraged from making loan applications because of the administrative burden.
- The preference of financial institutions to offer medium-term loans with maturities of five to seven years means that there is a lack of long-term financing options.

RECOMMENDATIONS

The EAFRD loan instrument managed by Rural Development Foundation has successfully supported farmers' access to finance and has good take-up and appreciation among stakeholders. The continuity of the instrument should be assured in the 2021-2027 programming period, subject to a 'health check' of the current set-up and/or findings of the ex-ante EAFRD assessment(s) for the new period. In this setting, the following points should be considered when reformulating existing instruments or proposing new ones:

- There appears to be insufficient availability of long-term loans in the market and further actions to strengthen their supply may be warranted.
- Although current EAFRD instrument have achieved substantial take-up among young farmers, this market segment still represents more than 40% of the estimated financing gap.

- The scope of existing loan instruments could be extended beyond current limits; for example, to cover loans between EUR 100 000 and EUR 250 000.
- As financing costs for farms are above those for other enterprises in Estonia, current loan conditions for farmers might be revised to provide for additional interest rate reductions.
- As lack of collateral still represents one of the main constraints on access to finance, the current public guarantee offering should be reviewed to assess the adequacy of the available budget, alongside access conditions and costs.
- Opportunities offered by the new legal framework – such as the easier combination of financial instruments and grant support, possibilities to finance the purchase of land for young farmers – should be explored to see if they can be used to increase the effectiveness of financial instruments, particularly for young farmers and small-sized enterprises.
- As lack of financial and business knowledge is signalled as an important constraint, especially for small and medium-sized farms, technical assistance support could be provided to strengthen capacities to develop business plans and improve financial management of farmers. Strengthening understanding of the agriculture sector and agriculture production within banks could also make a difference in the future financing of the sector.

Financing gap for the agri-food sector in Estonia

Between 2014 and 2017, investments in the Estonian agri-food sector fell by 9%, from EUR 113 million to EUR 103 million. This negative trend can be explained by the difficulties encountered in the agriculture sector.

Demand for finance is driven by the necessity to increase production efficiency and capacity. Agri-food enterprises mainly invest in equipment for modernisation and automation of production. As agricultural production in Estonia has increased by more than agri-food processing capacity, there is a need to increase processing capacity. Modern infrastructures and production processes are also necessary to add value to local agricultural production. Lack of qualified labour is another important driver of investments in capacity expansion. Demand is also driven by the transition towards a green and circular economy which, among others, requires investments to improve the energy efficiency within the sector.

The need for working capital is another driver of demand for finance, especially for small-sized enterprises. Short-term financing is often needed in response to the long terms of payment conditions imposed by the retailing sector. The highest needs for short-term loans are encountered in the dairy, and fruit and vegetables processing sub-sectors.

The EAFRD provides investment support for agri-food processors through grants. By the end of 2019, however, demand for grants exceeded the amount of financing available. Additionally, Rural Development Programme (RDP) support for processing and marketing provided seems to have had an important impact on the long-term investment loans taken up by small-sized enterprises.

The supply of finance is characterised by a high concentration of the banking sector. The Estonian banking sector is dominated by large foreign banks, with four banks holding approximately 84% of total assets in the banking sector. In 2018, the two biggest commercial banks held a market share of 62% for loans to non-financial enterprises. A specific feature of the supply of finance is that more than 90% of loans issued in Estonia have floating interest rates that exceed the Euro zone average by approximately one third.

The EAFRD financial instrument (growth loan for micro and small-sized enterprises and long-term loans for SMEs) was created with an objectives to facilitate access to finance by providing co-shared loans with commercial banks. The involvement of a player with knowledge of the agriculture sector, such as the Rural Development Foundation, has proven pivotal for banks to accept joining the scheme. Other financial instruments, such as those financed under the ERDF, are also available to SMEs in general. While agri-food businesses are eligible for such support they have received less than 5% from the overall portfolio of these financial instruments.

Despite the existing offer of preferential loans, many small-sized firms cannot access finance because of their weak economic performance. Banks consider lending to agri-food companies risky as the sector is subject to price fluctuations and agricultural crises. Banks set strict credit requirements and pay close attention to the history of the company and the project promoters. According to the Agri-food survey results, bank loans registered a higher rejection rate in Estonia (14%) than the average for the EU 24 (8%).

The financing gap in the agri-food sector is estimated at EUR 169 million. Unmet financing needs are concentrated among small-sized firms, with 90% of the gap value attributed to enterprises of less than 50 employees. The main drivers for the rejection of investment loan applications and for firms being discouraged from applying for finance include:

- **Inadequate collateral:** for small-sized businesses located in rural areas, their lack of collateral guarantees mainly stems from the low value of infrastructures in illiquid rural estate markets. This constraint is partially addressed by existing financial instruments. However, in some cases, banks consider the current guarantee instruments offered by KredEx unprofitable, and thus refuse to provide finance to the sector because of its high risk.
- **Bank policy regarding long-term finance and inadequate business plans**: banks prefer to offer shorter-term loans with refinancing facilities. According to capital providers, low financial awareness of micro, small and medium-sized companies is a problem.
- **High-risk for start-up finance**: this pertains to innovation and the launch of new products, as well as the lack of business and credit history of new start-ups.
- **Difficulties financing large-scale projects**.

RECOMMENDATIONS

Based on the findings of this study, the following recommendations could be considered to improve the offer of financial instruments supporting Estonian agri-food sector:

- The EAFRD loan instrument managed by Rural Development Foundation has proved successful in supporting agri-food enterprises to access finance, showing a good take-up and appreciation among stakeholders. Nonetheless, the continuity of such an instrument should be subject to an assessment of efficiency, impacts and achievement of targets.
- The existing public guarantee offering could be reviewed, for example to analyse the adequacy of the available budget and the access conditions. The analysis in this report indicates that the uptake of such instruments in the agri-food sector is limited, while lack of collateral still represents one of the main constraints in the market. Stakeholders have also indicated that the pricing policy of the instruments is a critical element.
- New entrants need specific attention as their innovative ideas and lack of business history, combined with small, if any, levels of collateral have proved to be a problem for banks. As noted for the agriculture sector, both for guarantee and loan instruments, the opportunities offered by the new legal framework, such as the easier combination of financial instruments and grant support, might offer interesting opportunities to increase the effectiveness of financial instruments in supporting new entrants and small-sized enterprises.
- Specific support for large strategic projects (above EUR 10 million) could also be considered if there is sufficient critical mass of demand - such support could be provided through specific financial instruments. The provision of technical support to help small-sized enterprises in preparing their cash flow projections and business plan may also be considered, since limited financial knowledge among entrepreneurs has been signalled as a difficulty by interviewed financial institutions.