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

June 2020

FINANCING GAP IN THE AGRICULTURE SECTOR

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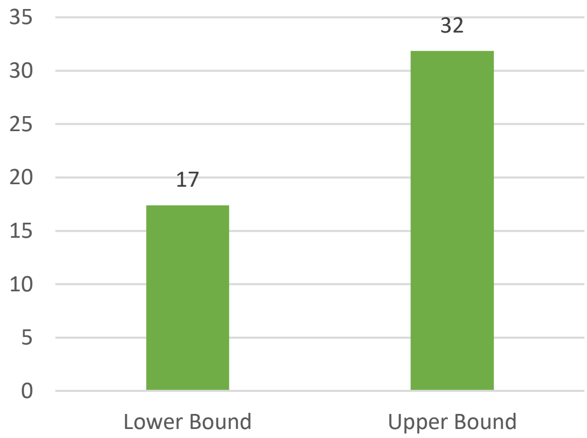
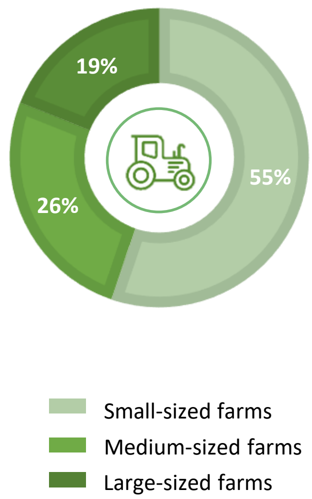
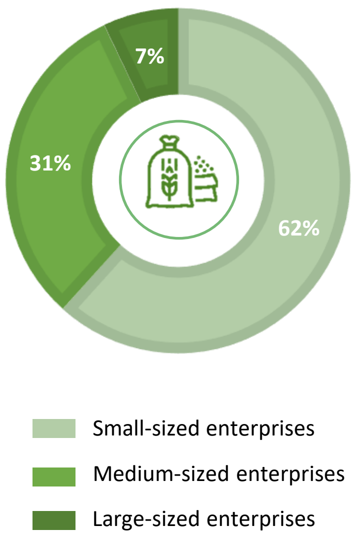


BY FARM SIZE

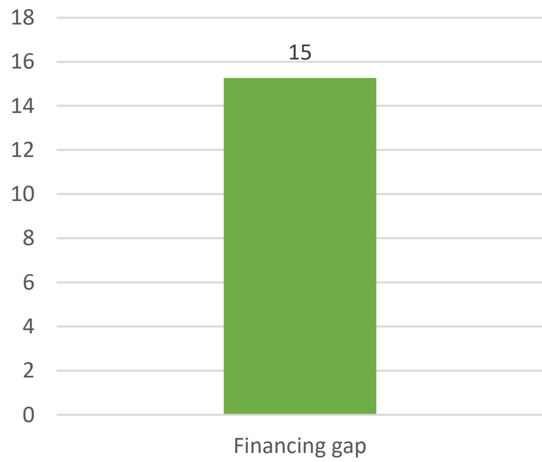


FINANCING GAP IN THE AGRI-FOOD SECTOR

BY ENTERPRISE SIZE



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



Source: *fi-compass* 2020

EXECUTIVE SUMMARY

This study gives an insight into agriculture and agri-food financing in Latvia by providing an understanding of the 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, namely 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 Latvia

The agriculture sector in Latvia shows a positive attitude towards investment. One of the main investment drivers is the **modernisation** of production mechanisms. Investment in modern production technologies (including precision farming) facilitates production expansion and helps to improve efficiency.

Another important investment driver is the need to purchase agricultural land. This is particularly the case for crop farmers choosing to further specialise rather than diversifying their activities. Agricultural land is also needed by young farmers.

Demand for finance is led by investment trends, but **the need for working capital also significantly contributes**. More working capital is required due to the overall growth of the sector and rising labour costs.

The CAP is an important vehicle for investment support. It sustains the demand for finance and facilitates the access to financing resources. The analysis shows that direct payments (Pillar I) and rural development grants (Pillar II) play an important role in stimulating demand for finance. The demand is strongly influenced and facilitated by the investment support under the EAFRD and the respective Rural Development Programme 2014-2020. Demand for grants under the RDP exceeds significantly what is available for agriculture. A similar trend, although less marked, could be noticed for the start-up aid for young farmers. Overall, the execution of the RDP investment support is one of the highest in the EU 28.

Financing supply is provided by different intermediaries including four main banks (with a total market share of 72% in 2017), a state-owned development finance institution called ALTUM, and other actors (leasing companies, cooperative agribusiness companies, commodity traders and non-bank lenders). A significant share of short-term finance is provided by cooperatives. ALTUM implements national support programmes to compensate market failures and provides support, mainly in the form of financial instruments.

The bank loans dynamics in the period 2015-2018 indicates that, despite the decrease in the aggregate lending at national level, loans to the agriculture sector are increasing both in terms of amount and share in total lending.

This report shows that there is a potential for new financial instruments for the agriculture sector, with a **financing gap estimated between EUR 17 million and EUR 32 million.** Around 55% of the gap value relates to small-sized farms (below 20 ha). In terms of financial products, more than 75% of the gap relates to medium and long-term investment loans:

- A first component of the gap is constituted by the estimated value of loan applications submitted in the past year by **viable enterprises, which were rejected by banks,** or which translated into loan offers refused by the applicants due to non-acceptable lending conditions.
- The second component of the gap relates to the estimated value of the loan applications that are **not submitted by farmers considered viable due to discouragement by a possible rejection**. The *fi-*

compass survey results reveal that this financing gap component is dominant, and it relates to all maturities. Discouragement may be based on own experience or experience of other farmers, as well as it can be the consequence of the preliminary informal meeting with banks.

Several factors that cause viable loan applications by farmers to be rejected, refused, or farmers to be discouraged from applying, have been identified. The main problems hindering farmers' access to finance are related to insufficient collateral, lack of credit history and other bank requirements that can be discouraging. Some farmers also lack sufficient management experience and have existing credits, which affects their creditworthiness The supply of finance to agriculture is constrained by high concentration, resulting in limited choice among banks and other lenders, by the absence of fixed interest rate loans, which forces farmers to bear the interest rate risk, and by inadequate supply of long-term loans, causing problems to finance the construction of buildings and the purchase of land.

According to interviews, access to credit is particularly constrained for new entrants and young farmers, due to the lack of credit history, experience, and skills.

RECOMMENDATIONS

Several recommendations for public interventions could be considered:

- Despite the fact that ALTUM offers specialised loans to young farmers and new entrants, these groups still face restricted access to finance. Young farmers point out that the interest rates are too high although these loans have lower requirements for collateral (compared to bank loans). Consequently, ALTUM's loans do not sufficiently close the financing gap for young farmers and new entrants. Specialised loans with reduced interest rates could close the financing gap for young farmers, new entrants and small-sized farms more efficiently.
- Currently, ALTUM offers only so-called individual guarantees, whereas portfolio guarantees, which are more flexible for banks, are not available to the agriculture sector. The introduction of portfolio guarantees in the financing of agriculture could increase the efficiency of guarantee type of financial instruments.
- There are occasions when farmers want to exit the sector and sell the whole farm, but there are no sector specific financial instruments to support such transactions. It would be necessary to provide integrated loans for the purchase of functioning farms, especially for new entrants, and thus facilitating the generation renewal in agriculture.
- Due to a high loan-to-deposit ratio required for medium and, especially, long-term loans, the supply of bank medium and long-term credit is limited. The provision of long-term loans by ALTUM doesn't seem to be sufficient to cover the financing gap, and seems to be in any case more targeted to large-sized farms. Loans with maturity of over ten years are non-existent but they are essential to finance long-term investments, such as the construction of agricultural buildings, purchase of agricultural land, etc. Therefore, it is worth considering the development of financial instruments (e.g. specialised public loans to banks or intermediate loans) that would support the supply of long-term loans in the market in particular for small-sized farms.
- The majority of loans are floating rate loans and farmers bear interest rate risk, whilst at the same time operate in a risky sector. Therefore, it is necessary to develop financial instruments that promote fixed-rate loans, especially for medium to long-term products.
- Considering the share of small-sized farms that uses informal financing from family members or friends, a micro-credit instrument (in the form of a guarantee or a risk sharing loan fund) might be an appropriate solution to promote their financial inclusion.
- Lack of management experience and existing current liabilities hinder the success of the loan applications. Possibilities to promote business ideas and exchange of management experience between farmers could be helpful.

Financing gap for the agri-food sector in Latvia

The investment dynamic is also positive in the agri-food sector in Latvia. This is shown by the analysis, which highlights four main investment drivers of the Latvian agri-food sector:

- The need to increase production efficiency (including expansion of production capacities) and production process automation (driven by a labour shortage).
- The development of new products (e.g. organic products).
- Product promotion on the market (e.g. new packaging).
- The development of exports.

Results from the study also reveal that the **need of working capital represents one of the main drivers of the demand for finance in the Latvian agri-food sector**. Loans for working capital are important for running and developing businesses and they can account for up to 80% of total loans in an enterprise.

The supply of finance to the sector is provided by a group of financial intermediaries composed of banks, the state-owned development finance institution ALTUM and leasing companies. The market share of the four banks (including their leasing subsidiaries) is approximately 70%. Financial Instruments for the agri-food sector are provided through the financial products of ALTUM (with national funding), mainly as loans and guarantees.

The study shows that there is a potential for new financial instruments, with a **market gap in the agri-food sector estimated to be EUR 15.3 million**. Unmet financing needs are concentrated in specific segments of the sector. Around 47% of the gap value relates to small-sized enterprises (below 50 employees). In terms of financial products, almost 50% of the gap relates to long-term investment loans. Whilst important constraints exist for large-sized enterprises and in accessing short-term financing.

The main reason for the rejection of investment loan applications is **insufficient own funding**, as banks require applicants own financial contribution to reduce moral hazard. Another reason for loan application rejection is **insufficient collateral**. As there is a restricted secondary market for fixed assets, banks significantly discount the value of collateral (especially equipment and inventory), which makes it difficult to raise finance even if enterprises have assets to pledge.

Qualitative information reveals that the **discouragement to apply for finance is mainly related to bank requirements**, in particular related to collateral requirements.

The three main supply side constraints identified for the agriculture sector (**lending market concentration**, **lack of fixed interest rate loans** and **inadequate supply of long-term loans**, especially for investment in assets with a long-life cycle) also apply to the agri-food sector. Furthermore, there is an **additional constraint related to working capital financing**, as banks offer mostly short-term loans or credit lines for a maximum duration of 12 months, whilst enterprises would need longer term credit lines to finance their permanent working capital cost.

Interviews have also highlighted the difficulties to obtain finance for large strategic projects (above EUR 50 million), which would be essential to increase the competitiveness and the value added in the sector. Such projects, however, may impact negatively on the local smaller agri-food producers, in sub-sectors well represented by them.

RECOMMENDATIONS

Several **recommendations** for public interventions could be considered for the future:

- A significant problem for enterprises in the agri-food sector is the financing of working capital. Banks typically offer only loans and credit lines with a maximum 12-months maturity, whilst enterprises would need a more stable provision of funds for their capital needs. Therefore, there is a need for financial instruments (e.g. specialised loans, guarantees for medium-term credit lines, etc.) to address this market failure.

- The supply of bank medium and long-term credit is constrained. Banks are not willing to offer longer loan maturity for more than five-seven years, but loans with a maturity of ten years or more are necessary to finance the construction of buildings, the purchase of specific industrial equipment and investment in other assets with long lifecycles. Therefore, it is worth considering the development of financial instruments (e.g. specialised public loans to banks or intermediated loans) that would support the supply of long-term loans in the market. The specialised loans targeted at enterprises that undertake such investment projects can be the possible solution, as well.
- It is worth considering the development of financial instruments (e.g. specialised public loans to banks, including through the EAFRD) that would support the supply of loans with fixed-interest rates, particularly for medium and long-term maturity, for which there is a limited availability in the market.
- ALTUM's loans do not sufficiently close the financing gap for new entrants and start-ups, as banks reluctantly finance this segment. Specialised loans with reduced interest rates could stimulate the setting-up of new companies with new ideas and close the financing gap for start-ups more efficiently.
- A significant obstacle for start-ups and new entrants is the low level of own funds and equity that limits their creditworthiness. Therefore, it is worth considering improving equity financial instrument (e.g. some type of acceleration funding or venture funding) in the agri-food sector as the existing equity financial instrument are more indented for other industries.
- Another significant problem for the agri-food sector is the very constrained supply of finance to large strategic projects (projects with the amount of investment EUR 50 million, EUR 75 million and more). At present it is very difficult to raise financing for these projects, but such projects are essential to ensure the strategic growth in the agri-food sector. Public support to address this problem seems to be justified. Financial instruments could be used as long as a sufficient critical mass can be reached.