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

June 2020

FINANCING GAP IN THE AGRICULTURE SECTOR

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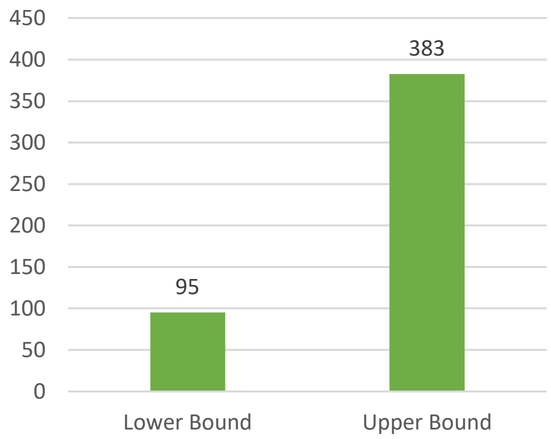
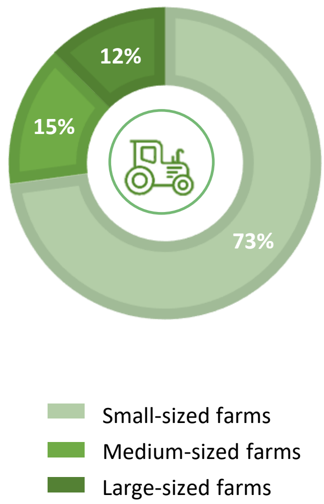
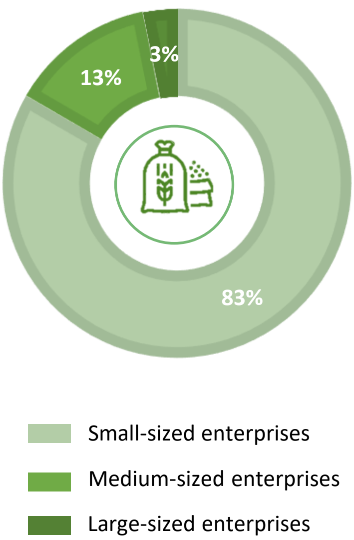


BY FARM SIZE

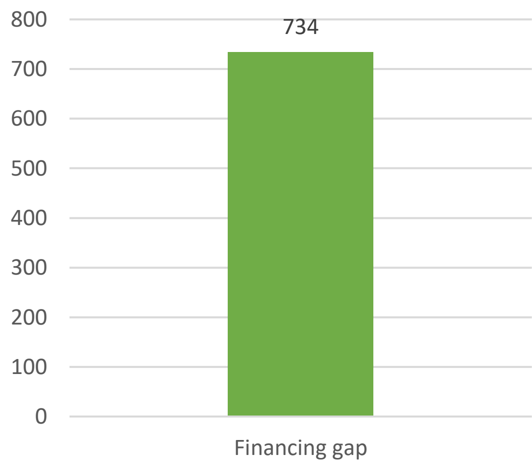


FINANCING GAP IN THE AGRI-FOOD SECTOR

BY ENTERPRISE SIZE



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



Source: *fi-compass* 2020

EXECUTIVE SUMMARY

This report gives an insight into the agriculture and agri-food financing in Portugal 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 Portugal

The agriculture sector in Portugal shows a positive attitude towards investments. Between 2008-2018, the overall level of investment increased by 31%. The total investment volume was over EUR 1 billion in 2018.

The analysis highlights four main investment drivers of the Portuguese agriculture sector:

(i) Expansion of production to capture new market shares, made possible by increased access to water through public irrigation investments;
(ii) Investments in order to adapt products to new markets;
(iii) Investments in improved competitiveness and cost efficiency of production; and
(iv) Investments in land, particularly land associated with increased water availability.

Farmers' access to finance from financial institutions is facilitated by support received under the Common Agricultural Policy (CAP). Direct payments strengthen the cash flow of Portuguese farmers, allowing them to undertake investments and create the financial headroom that enables access to financing from banks, for which cash flow is an important component of their credit assessments. In addition, investment supporting grants from the European Agriculture Fund for Rural Development (EAFRD) provide farmers with the possibility to make investments in their businesses that they would otherwise be unable to make. For many farmers, obtaining financing under the three Rural Development Programmes (RDPs; Mainland, Azores, and Madeira) is of material help for also obtaining a bank loan. According to the EAFRD managing authority of Mainland Portugal, an insufficient RDP budget means that they cannot support all eligible applications for investment support. At the end of 2019, the demand for EAFRD on-farm investment grants was more than twice the available budgets, especially under the Mainland RDP. Consequently, projects with a total financing value of EUR 2.2 billion could not be realised in agriculture.

Commercial banks are active in the supply of finance to agriculture, with three banks offering loans specifically targeted to the agriculture sector. Three types of bank loan are available to the agriculture sector in Portugal: medium and long-term investment loans, short-term working capital loans, and loans linked to the direct payment support, which advance the support level to facilitate farmers' cash flow. The available loan types cover different purposes, such as maintenance and repair, working capital, on-farm investments, and land acquisition.

According to banks interviewed for this study, young farmers receive approximately 5% of overall bank finance provided to the sector.

The mutual credit guarantee fund Agrogarante manages guarantees to reduce the risk of loans to the agriculture sector. Further, a capped portfolio guarantee instrument funded by EAFRD funded is being implemented, with the first products offered by four financial intermediaries available on the market from March 2020. Loan products linked to this guarantee instrument will be available to agriculture producers (with a focus on young farmers), agriculture cooperatives, producer organisations, and small and medium-sized enterprises (SMEs) involved in processing and marketing of agricultural products.

Despite the wide offer of products, the study has identified a financing gap of between EUR 95 million and EUR 383 million for the Portuguese agriculture sector. Approximately three-quarters of the funding gap relates to small-sized farms[1], among which young farmers constitute an important part. In terms of financial products, almost two-thirds of the gap relates to long-term financing[2].

The principle reasons for viable farms to be unable to access finance are:

- the high investment risk associated with the agriculture sector;
- a lack of adequate collateral;
- a lack of adequate credit history;
- a low level of financial literacy among agricultural producers; and,
- the reduced risk-taking capacity of Portuguese banks after the financial crisis.

Banks perceive agriculture as a rather volatile sector of the economy. This perception, combined with criteria for the assessment of operations that are the same as those used for SMEs from other economic sectors, can limit farmers' access to finance. Often, banks do not consider young farmers, new entrants and small-sized farms as interesting clients, while banks in Portugal do not typically provide credit to business start-ups in the agriculture sector.

RECOMMENDATIONS

Based on the findings of this report, the following recommendations could be considered to further improve the access to finance for the agriculture sector:

- Implementation of the EAFRD guarantee fund, which has just started, can be expected to contribute to the reduction of the financing gap for SMEs. The fund should reduce the risk for credit institutions lending for agriculture-related activities and, thereby, improve financing conditions for SMEs in the agriculture and agri-food sectors. At a later stage, the operation of the guarantee instrument should be evaluated in terms of addressing the needs of young farmers and small-sized enterprises.
- A pilot risk-sharing loan instrument to provide targeted support to young farmers and small-sized enterprises could be considered. As banks tend to apply higher interest rates to these segments, such an instrument should combine risk coverage for banks with the possibility for reduced interest rates and longer loan maturities.
- Opportunities offered by the new legal framework – such as greater ease of combining grants and financial instruments, and the possibility to finance land purchases of young farmers – should be investigated with the aim of increasing the impact of future interventions affecting the availability and supply of financial instruments.
- The sector could benefit from additional synergies with the activity of Agrogarante. Making the guarantees provided by Agrogarante more attractive to farmers could be achieved by reducing the red tape associated with the loan applications, as well as reducing the length of application processes
- The introduction of financial instruments should be accompanied by the provision of technical support to small-sized farms and young farmers to increase their awareness and understanding of available financial products and to improve their capacity to prepare loan applications.

1 The *fi-compass* survey divided farms in three size categories: small (<20 hectares), medium-sized (20-100 hectares), large (>100 hectares).

2 The *fi-compass* survey defined short-term loans: <18 months, medium-term loans: 18 months – 5 years, long-term loans: >5 years maturity.

Financing gap for the agri-food sector in Portugal

Since 2012, gross investment in the Portuguese agri-food sector has been increasing. In 2017**,** the investment level reached EUR 2.1 billion. The highest investment levels were registered in the bakery and farinaceous sub-sectors, followed by the dairy sub-sector. According to Federação das Indústrias Portuguesas Agro-Alimentares (FIPA), companies must invest regularly if they are to remain in business in the highly competitive Portugese agri-food sector. Thus, the modernisation of factories, as well as investments in marketing strategies, market research and equipment, are essential for all companies. The analysis highlights some of the main **drivers for the demand for finance by the Portuguese agri-food sector:**

(i) modernisation in order to improve cost efficiency and expand production;
(ii) internationalisation;
(iii) investments in training and the development of new products; and
(iv) investments in working capital.

Although Portuguese agri-food enterprises have high equity ratios, there is still a sizeable demand for finance. Support from the EAFRD for processing, marketing, and development of agricultural products plays a vital role in stimulating investments undertaken by the agri-food sector, which is demonstrated by the high application levels for EAFRD support.

Since 2014, the total amount of credit provided to the agri-food sector has been stable, at approximately EUR 3 billion. Based on the agri-food survey, in 2018 only 28% of Portuguese agri-food enterprises applied for finance, compared to an average of 46% for the EU 24. The report also reveals that fewer Portuguese companies report difficulties in meeting their financing needs than their counterparts in the rest of the EU. Rather, in 2018, the main challenges reported by Portuguese agri-food companies were access to qualified labour (33% of companies) and high production costs (31% of companies).

The financial landscape for the agri-food sector is comparable to that of the agriculture sector, and the main actors include the same commercial banks. Four mutual guarantee societies play an important role providing credit guarantees to the sector. Further, as of March 2020, the EAFRD capped portfolio guarantee instrument (referred to above for the agriculture sector) is also available to agri-food sector in Mainland Portugal[3].

Based on the analysis, the financing gap for the agri-food sector is estimated to be EUR 734 million. Within this estimate, 83% (EUR 612 million) is attributed to smaller enterprises (<50 employees). In terms of financial products, almost half of the financing gap relates to long-term loans with a maturity of more than five years.

The main drivers of the gap include:

- a limited risk-taking capacity by Portuguese banks after the financial crisis 2009-2012;
- a lack of adequate collateral;
- a lack of credit history and personal relations with the banks of agri-food companies; and
- a relatively low level of financial literacy amongst micro businesses and small-sized enterprises.

Usually company assets are used as guarantees, rather than personal collateral. According to agri-food sector representatives, it is not uncommon for the bank to request the company itself as the guarantee for a loan. SMEs and micro-enterprises in the agri-food sector are particularly challenged when it comes to meeting banks' collateral requirements. In addition, loan conditions are less favourable for micro-businesses and SMEs, particularly for start-ups, who are associated with higher risks. Young entrepreneurs and small-sized companies are also subject to more stringent assessment criteria, causing particularly complicated access to finance for these segments. Furthermore, according to the Agri-food survey, 14% of the agri-food companies

3 Press statements: https://www.portugal.gov.pt/pt/gc22/comunicacao/noticia?i=linha-de-credito-superior-a-300-milhoes-para-impulsionar-agricultura.

in Portugal did not apply for bank loans, and 15% did not apply for credit lines, because of their fear of rejection. These values are almost twice as high as the EU 24 average. Another important reason for Portuguese agri-food companies to not apply for finance is that they find the application processes lengthier and more complicated than their European counterparts.

RECOMMENDATIONS

Based on the findings of this report, the following recommendations could be considered to further improve access to finance for the agri-food sector:

- The EAFRD guarantee fund currently being implemented could reduce the financing gap for SMEs in the agri-food sector. At a later stage, an evaluation should be made of the capital adequacy of the fund and of its concrete ability to address the needs of start-ups and small-sized enterprises.
- A pilot risk-sharing loan instrument to provide targeted support to start-ups, micro and small-sized enterprises could be considered. As banks tend to apply higher interest rates to these segments, such an instrument should combine risk coverage for banks with the possibility for reduced interest rates.
- The opportunities offered by the new legal framework, particularly in terms of easier combinations of financial instruments and grants, should be explored with the aim of increasing the impact of future interventions.
- Considering the lack of finance for start-ups, which is linked to their lack of own equity, the potential of introducing a targeted equity instrument should be investigated.
- The introduction of financial instruments should be accompanied by the provision of technical support to start-ups and small-sized enterprises to increase their awareness and understanding of available financial products and to improve their capacity to prepare loan applications.