1.04 Establish a catalytic SME financing facility to transform food systems

The Solution: A multi-donor funded Facility (see Annex 1) that will provide catalytic capital to a range of actors and institutions investing in agri-food SMEs or supporting their capacity to develop viable business models that contribute to positive impact in food systems. The Facility's capital will be used to scale and mobilise SME financing in accordance with impact criteria developed and tracked by the Facility to transform food systems along the impact areas of nutrition, sustainability, resilience, and equity.

Components of the Facility. The Facility will consist of three main components:

1) Catalytic capital mechanism to channel finance to agri-food SMEs and cover financing costs
2) Funding for alignment of impact criteria developed and tracked by the Facility.
3) Funding of a digital learning platform to share best practice and deliver technical assistance (TA) to agri-food SMEs.

Providers of funds. The Facility will mobilise capital from governments, grantors, and others willing to take on a high risk and cover certain costs to increase available funding to high-impact SMEs. Funders will prioritise scale and impact maximisation rather than returns and be willing to cover costs and take certain high-impact potential investment risks that other existing organisations and actors (including impact investors, DFIs and multilateral organisations) are not currently willing to take on the scale needed. National governments are likely to be the main funders, as they have the necessary scale of resources the Facility calls for and will be able to focus on achieving transformative impact rather than prioritising monetary returns or capital preservation.

Type of capital. The Facility's capital will take the form of first loss, guarantees, and financial incentives. It will not seek to generate commercial returns but rather maximise financial leverage and achieve impact at scale. The catalytic capital will be provided primarily in domestic currency and used to: de-risk investments through first-loss capita to impact funds using blended-capital structures, or subordinated loans and/or guarantees to financial service providers (FSPs, including national banks); lower the high operating cost of servicing SMEs; and make businesses more investible and socially beneficial through both core business and impact-oriented TA and financial incentives such as time-bound pay-for-impact financing.

Regional operation. The Facility should operate at regional levels (e.g., Africa, Latin America), and its impact criteria should reflect regional priorities and countries' food systems goals, such as national adaptation plans or nutrition strategies. Financing should occur primarily in domestic currency.

Direct recipients. The direct recipients of the Facility's capital will be FSPs and private impact investment funds, as well as enterprise support organisations or networks, business development services (BDS), and/or TA providers.

Final recipients of capital. The capital will be channelled to SMEs that operate at different stages of the food value chain (from farm to fork) provided that their business models meet a series of impact criteria. To assure and measure the positive impact, standardised impact metrics will be a key component of the Facility.

Source of the Solution: The idea emerged as a co-creation from an ad-hoc group of institutions with shared objectives in scaling up finance for agri-food SMEs. Initial members include: AfDB, GAIN, SAFIN Secretariat, GAFSP, and ResponsAbility. It was also informed by an independent Food Systems Dialogue held by SAPIN. It builds on a set of related pre-existing initiatives that include:

- Investment initiatives: GAIN's N3F, 2X Challenge, ABC Fund, Aceli Africa
- Global/regional networks, partnerships or forums: SAFIN, Gavi, AGRA, WEF

- Research: World Bank: finance gap; The Lancet: impact of unhealthy diet; Nature: agri-food transformation

Problem addressed within food systems: Agri-food SMEs in emerging economies usually mention finance as their top challenge. Therefore, making the financial ecosystem more supportive of SMEs is critical to allow them to play their role in food system transformation effectively. This is particularly important given the role of agri-food SMEs in food systems. SMEs represent 90% of businesses and >50% of jobs. In low-income countries, 70-90% of all food consumed is produced, processed, transported, and sold by SMEs. Even in Africa, where subsistence farming is still common, SMEs supply most food consumed by low-income consumers (GAIN), and 80% of all processed food consumed in the region comes from SMEs (Reardon, et al.).

This solution will address three barriers SMEs currently face with regards to financing. First, high risk and cost of financing has led to a shortage of finance for agri-food SMEs, particularly for small-ticket SMEs operating in local food markets (vs. export commodity chains) and for early-stage investments in developing new business models and product offerings that can address demand for nutritious foods or contribute to nature-positive solutions in food systems. In Africa alone, there is an annual financing gap of about USD 100 billion for agri-food enterprises with needs between USD 25,000 and 5 million (Aceli Africa). In many contexts, agri-food SMEs find it particularly difficult to access finance in local currency. Second, financial institutions and investors with interest or capacity to reach agri-food SMEs often face high transaction costs and risks when serving this market and/or do not face sufficient incentives to expand their product and service offerings to be able to serve this market more efficiently. Third, FSPs, investors, donors, and government are not aligned around clear and practically measurable impact standards for agri-food SME finance, which limits learning across the ecosystem and hinders a transparent and competitive process of allocation of concessional funds to maximise impact.

How this solution will address that problem: The Facility will provide three main *inputs*: catalytic high-risk tolerance capital in various forms (i.e., first-loss and patient capital, subordinated debt, guarantees, Opex coverage, and the cost of providing TA); a set of standardised metrics that assesses different actors and organisations across impact areas including nutrition, sustainability, resilience, and equity; and provision of TA best practices and network of regional TA providers. As *outputs* of this, we expect that USD 10 billion of catalytic capital will help mobilise an additional USD 100 billion of investment capital. In addition, it will support enterprise support organisations and intermediaries that have a proven track record of supporting agri-food SMEs and regional knowledge of specialised TA providers. It will support the provision of finance and technical support for BDS and TA provided to agri-food SMEs and create a common set of impact metrics and KPIs to report against. This will lead to three main *outcomes*: greater financial flows towards agri-food SMEs; greater and more robust BDS and TA offerings to agri-food SMEs; and growth of a global pipeline of SMEs across the value chain and at various stages of development. In terms of impact, an increased supply of nutritious foods will help improve diets, leading to a healthier society; reduced food loss and greenhouse gas emissions (through the adoption of improved practices) will increase environmental sustainability and resilience; and improved financial and social performance of inclusive SMEs will lead to a more prosperous equitable society.

Solution's alignment to the 'game changing and systemic solution' criteria:

Impact potential at scale - The Facility's main innovation lies in the things it combines and the scale that it can achieve – it is really a 'systems approach' to tackling the SME financing gap. The Facility will catalyse impact and scale by de-risking and mobilising capital that previously did not flow towards agri-business SMEs. The solution will incentivise both investors and investees alike to align their operations along the Facility's impact criteria. Scale of impact is expected to take place at the three following levels:

1. Scale of financial mobilisation via leverage of de-risking capital and guarantees. No existing facility mobilises purely this type of high-risk and cost-covering capital. The ones currently in existence either provide grant capital in significantly smaller amounts that cannot achieve this scale or provide catalytic capital that seeks to generate some returns or capital preservation. In fact, this proposal has been developed partly due to the restricted amount of catalytic capital available to private funds and FSPs, as experienced by working group members.
2. Scale of capacity development and metrics alignment impact across the FSP, investor, and TA space, well beyond specific financial flows associated with the Facility. These set of metrics do not currently exist, and this facility would not just create the metrics but also incentivise investors and investees to follow them to access its capital. The Facility will use existing metrics and consolidate them to a set of metrics that cut across the main impact areas.
3. Scale of development of new business models in agri-food SMEs that address food system transformation challenges.

Actionability: The Facility is actionable because it is based on a recognition of the gaps and barriers that have been well-documented in the past, such as the high risk and high cost of financing SMEs, the need to lower transaction costs and provide impact- and business-related TA, and a need for metric standardisation. While it will accelerate scale by supporting and working with existing facilities and stakeholders across the existing landscape, such as multinational investment facilities (e.g., IFC's GAFSP, GCF) or private funds, it will be different from any organisation or facility currently in existence. It will invest in domestic and regional markets, be entirely focused on enabling business models that are food system-transforming at the SME level, combine catalytic capital and TA, and work on alignment through standardised metrics.

Sustainability. The Facility will catalyse and mobilise commercial capital that can be re-deployed to finance SMEs in the long-term. Beyond 2030 the need for catalytic capital should decline but a centralized mechanism for knowledge production and sharing, metrics setting, monitoring standards, rating impact investments etc. will continue to be a valued role the Facility might offer.

Current/likely political support: Although the initiative is still nascent, there are indications of likely support. The growing coalition of institutions co-creating this gamechanger is just a subset of the many agencies with commitments and programmes committed to advancing agri-food SME financing. A complementary mapping undertaken by the group suggests a wide range of support to leverage catalytic capital to transform food systems through agri-food SMEs. Government acceptance of the Facility as a solution to transform food systems will be vital given government funding is the key to mobilise the high-risk and high-cost capital that is needed. For this, it is important to emphasise that this proposal represents an opportunity for governments and others to mobilise a significant number of other resources (from multilaterals, commercial banks, investors, etc.), multiple times greater than their initial commitment.