

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**PERU**

**SOCIAL ENTREPRENEURSHIP PROGRAM (SEP)  
PROMOTING COCOA INDUSTRIALIZATION**

**(PE-S1001)**

**FINANCING AND TECHNICAL-COOPERATION PROPOSAL**

This document was prepared by the project team consisting of Dieter Wittkowski, Team Leader; Michael O'Donnell (COF/CPE); Carlos Puig (Consultant); and Margarita Reyes (SDS/MSM) who helped produce this document.

## PERU

### EXECUTIVE SUMMARY

**Executing agency:** Industrias Alimentarias La Convención S.A. (INDACO)  
[La Convención Foodstuffs Industries Corporation]

<b>Amount and source:</b>	<b>IDB</b>	<b>Local</b>	<b>Total</b>
Financing:	US\$360,000	US\$203,000	US\$563,000
Nonreimbursable technical coop.:	US\$140,000	US\$ 52,000	US\$192,000
Total:	US\$500,000	US\$255,000	US\$755,000

All funding is provided by the Swedish Trust Fund for the Financing of Small Projects.

<b>Financial terms and conditions:</b>	Amortization period:	12 years
	Grace period:	4 years
	Interest rate:	4% (in US\$)
	Disbursement period:	48 months
	Execution period:	42 months

The grace period will only apply to amortization of the principal, not to interest. The loan will be denominated in US dollars.

**Problem to be addressed:** Under the current conditions, small-scale cocoa producers in La Convención are faced with a number of interrelated problems that prevent them from producing and marketing their cocoa profitably and competitively and, hence, from boosting their productivity, the prices they obtain for their products and, ultimately, their family income. The main problems include: (i) *lack of commercial and production organization*: Small-scale cocoa farmers produce, collect, and sell their cocoa in a totally fragmented fashion without attempting to capitalize on the advantages inherent in supplying a consistent quality product in volume. The lack of production and supply management has a negative impact on product quality, production costs, selling prices, and, thus, producer incomes; (ii) *low productivity levels and insufficient post-harvest handling*: The cocoa producers' current production yield (350 kg of cocoa beans per hectare) is much lower than average standard production for the sector (750 kg/hectare or more) and this is mainly due to the fact that, despite having very high quality raw material, producers do not invest in improving product quality, as the current market offers no incentives to do so; and (iii) *difficulties in gaining access to market data and higher-value*

*markets*: Lack of access to data on prices, markets, and production quality means that most small-scale cocoa producers are unaware that they have an excellent quality commodity with the potential to fetch good prices on international markets. Furthermore, small-scale cocoa producers do not have access to higher-value markets that would allow them to take advantage of their high-quality production and sell their processed product to demanding niche markets.

**Objectives:**

The overall objective of the project is to help boost the income and solidify the employment of small-scale cocoa producers in La Convención province (Cusco) in a sustainable manner.

The purpose of the project is to develop and strengthen the cocoa production, processing, and marketing chain by implementing appropriate production, organizational, and business technologies that add value and promote the efficient integration of small-scale producers into domestic and international markets.

The technical-cooperation resources for this project will be used to provide small-scale producers with technical assistance, training, and coordination services aimed at: (i) boosting productivity and the quality of the cocoa produced; (ii) promoting planning and the introduction of technology in cocoa growing, including a pilot experiment on organic certification; (iii) ensuring a higher degree of coordination and organization in production to make it possible to collect larger volumes on an ongoing basis, by establishing four new collection and quality control centers; and (iv) ensuring direct involvement in the processing and marketing of cocoa products. Project financing will be used to: (i) construct, equip, and start up a cocoa processing plant (with the producers' association as the main shareholder) that will purchase, process, and market cocoa supplied by the organized group of small-scale producers; and (ii) provide the working capital required to ensure the plant operates properly.

**Description:**

The project has two components: (i) a reimbursable financing component; and (ii) a nonreimbursable technical-cooperation component.

**Financing component:** (Bank: US\$360,000; Local counterpart: US\$203,000): As a means of helping to solve the problems of limited value added and small-scale cocoa producers lack of access to higher-value markets, the financing in this component will be allocated to: (i) *investing in production facilities* (US\$435,500) to start up a cocoa processing plant; and (ii) providing *working capital* for the plant (US\$127,500) to facilitate the introduction of the business chain.

*Production investment subcomponent:* (Bank: US\$317,500; Local counterpart: US\$118,000). With the aim of starting up a cocoa processing and marketing plant and developing the organized collection and marketing of cocoa and cocoa derivatives, this subcomponent will provide for the acquisition of facilities, equipment, and tools including: (i) the land for the plant site (Local counterpart: US\$10,000); (ii) the physical construction of the cocoa processing and marketing plant in Quillabamba for processing, packaging, distributing, marketing, and exporting cocoa-based products. This subcomponent involves civil works for the construction of the cocoa plant infrastructure (Local counterpart: US\$105,000); (iii) locally purchased equipment and machinery for the plant (Bank: US\$82,500); (iv) imported equipment for the plant (cocoa butter press, sheller, liquor mill, cake breaker, cocoa duster, butter silos, roaster, *inter alia*) (Bank: US\$225,000); and (v) short-term consulting services for plant installation and start up (Bank: US\$10,000; Local counterpart: US\$3,000).

*Working capital for marketing subcomponent:* (Bank: US\$42,500; Local: US\$85,000). It is essential that the plant have sufficient liquidity from the outset to guarantee production storage and ensure the payment of plant workers and the small-scale producers to enable them to compete with brokers, other plants, and marketing and collection/storage companies. Consequently, working capital for processing and marketing is required on an ongoing basis. These funds are indispensable to operate the entire commercial system surrounding the plant and the 600 small-scale producers involved. Working capital funds will facilitate implementation of the business component in the collection, processing, and marketing of cocoa by small-scale producers. The Bank will disburse funds to INDACO, which will then be fully responsible for repayment to the Bank. INDACO's counterpart working capital contribution will comprise: (i) an INDACO cash contribution totaling US\$40,000; and (ii) 800 hundredweights of cocoa beans from small-scale producers (2 hundredweights per producer x 400 producers) through the La Convención and Yanatile Valley Cocoa Producers' Association (APROCAV) at plant start-up (estimated value: US\$45,000). The APROCAV raw material contribution to working capital will be considered an increase in capital, thus augmenting its shareholding in INDACO.

**Technical-cooperation component:** (Bank: US\$140,000; INDACO: US\$52,000). With a view to helping solve the problems relating to disorganized production and business aspects, low productivity, and insufficient post-harvest handling, the technical-cooperation funds are targeted at the following subcomponents: (i) strengthening the

production- and business-related organizational structure of small-scale cocoa producers; (ii) improving producers' productivity and post-harvest handling; (iii) providing support in trading, marketing, and opening markets for processed cocoa products; (iv) providing support in the coordination and implementation of the project; and (v) evaluation and auditing.

**Environmental and social review:**

The Committee on Environment and Social Impact (CESI) reviewed this project at its meeting (36-03) on 3 October 2003, and approved the project profile. It should be mentioned that the project would benefit members of the native communities in the region. The project's area of influence includes approximately 12 native communities with a total population of roughly 12,000 indigenous inhabitants, mainly from the Machiguenga and Ashaninka native peoples.

**Beneficiaries:**

Initially, the direct beneficiaries in terms of product marketing will be the approximately 400 members of APROCAV, and 200 additional producers from nearby communities will gradually be incorporated. In addition, 1,200 field jobs will be solidified by hiring unskilled labor to harvest, ferment, and dry the cocoa beans in producers' farms.

**Risks:**

The five *main potential risks* facing the project are: (i) INDACO's lack of experience in the cocoa trade, thus making it dependent on the technical competence of its technical and management team; (ii) that the quality of the processed cocoa will not meet market requirements; (iii) failure to meet marketing goals in terms of projected sales volume and/or prices; (iv) that price fluctuations on the international cocoa derivatives market will affect the financial projections; (v) that expected project benefits will not reach the small-scale producers.

The project includes the following measures to mitigate these risks:

**Risk (i):** INDACO has already identified and recruited a cocoa processing plant manager with over 20 years experience in processing and marketing agro-industrial products and this will help to ensure the appropriate management of the collection, processing, and marketing processes. In addition, the Bank will verify that this technical and managerial capacity is maintained at the plant on an ongoing basis via relevant information submitted in semiannual reports;

**Risk (ii):** This risk will be mitigated by the quality and management of the processing plant. The proposed plant meets international food processing requirements and standards and will be capable of manufacturing cocoa products that are in a position to compete with

the highest quality products available worldwide. Furthermore, processing quality will be ensured via the professional capacity of the manager selected to operate the plant. The manager concerned has extensive experience in both manufacturing cocoa-based products and marketing them in the domestic and international markets;

**Risk (iii):** Notwithstanding the fact that INDACO has established the project's marketing goals based on its experience with other products, market surveys, negotiations with potential buyers, and conservative projections, this risk will be mitigated through its strategy of forging partnerships with domestic and international companies that need to purchase substantial volumes of cocoa-based products throughout the year. In addition, INDACO's capacity to conclude new sales contracts will be reinforced with technical-cooperation funds that INDACO will use to hire two experts in marketing cocoa-based products (domestic market and international market). These experts will assist in identifying and opening new markets in addition to those already envisaged by INDACO, establish contact with new buyers, develop a domestic marketing strategy and an export strategy, and submit concrete recommendations on marketing the products concerned and establishing new and more advantageous markets;

**Risk (iv):** The type of cocoa selected (criollo or chuncho) targets a high quality market segment (chocolate manufacturing); this Latin America-specific market niche makes up no more than 5% of the global cocoa market. Prices in this segment are not as volatile as cocoa bean or hybrid cocoa prices and, consequently, no significant fluctuations in projected prices are expected. In addition, as the plant will produce a variety of different cocoa derivatives, production plans can be reprogrammed to maximize revenue based on the most suitable alternative; and

**Risk (v):** Since the cocoa producers' association (APROCAV) is the main shareholder in INDACO and participates actively on the Board of Directors as Chair, it is assured that purchasing and management policy for the plant will benefit its members. In addition, the regulations governing the use of working capital include raw material purchasing policies that guarantee that small-scale producers will be the majority supplier of cocoa beans to the processing plant. Lastly, when the plant becomes profitable, small-scale producers will share directly in business profits since their association is the main shareholder in INDACO.

**Role of the project in the Bank's country, regional, and sector strategy:**

Project activities are consistent with the priorities of the Bank's new country strategy with Peru (document GN-2205-1 of 24 September 2002) in that: (i) there will be financial services (processing plant financing) and nonfinancial services (marketing, training, and organization) for small-scale farmers' production activities, to *increase competitiveness and productivity* and boost their participation in higher-value markets; (ii) opportunities will be created to *boost the income* of low-income rural families; and (iii) *poverty reduction* initiatives will be supported through sustainable services that reach the poor in La Convención Province in the Department of Cusco.

**Coordination with other official development institutions:**

During the design phase, the project team contacted other development institutions engaged in financing or implementing support programs for the Peruvian cocoa production chain, the incorporation of small-scale cocoa producers into higher-value markets, improving these producers' productivity, and strengthening grassroots organizations. These included the Poverty Reduction and Alleviation (PRA) project and the National Commission for Development and Life without Drugs (DEVIDA), both financed by the United States Agency for International Development (USAID). The project team also coordinated with representatives from the United Nations International Drug Control Programme (UNDCP), which had supported a program for cocoa production promotion in La Convención in the 1990s. These contacts were instrumental for collecting data on markets, strategies for supporting small-scale producers, and lessons learned in the project zone. In the implementation phase, INDACO will attempt to achieve complementarity with other initiatives by the IDB and other development institutions currently under way, with a view to achieving synergies with this project. Among these, it is worth mentioning the Bank loan for the Camisea Project (loan PE-0222) as a result of which La Convención Province will receive gas pipeline royalty payments. The communities in the area of influence of the current project will likely be able to search for opportunities to complement project activities with activities to be financed with that provincial revenue.

**Rationale:**

The project is justified in that: (i) it will help increase the net income of a group of approximately 600 low-income small-scale producers by 50%; (ii) it will boost the quality of cocoa produced and marketed by small-scale producers, with a projected increase of 25% in the price they fetch; (iii) it will establish closer and more permanent ties between organized small-scale producers and higher-value markets, with projected annual sales of up to US\$1.4 million in the third year of the project; and (iv) the executing agency, INDACO, mainly supports small-scale producers and has substantial experience in

handling agro-industrial projects and has the capacity to carry out the proposed activities.

**Special  
contractual  
conditions:**

As a condition precedent to first disbursement in the production investment subcomponent (reimbursable financing), INDACO will present to the Bank's satisfaction: (i) the selection of suppliers and/or manufacturers of the machinery and equipment required for the project for the Bank's no objection; (ii) evidence that it has legal possession, all easements, and other ownership rights to the land and buildings where the plant will be constructed; (iii) the approval by the municipality of Quillabamba of the plant construction plans and visible proof of possession of all necessary licenses and authorizations issued by the competent authorities under national legislation to begin construction; (iv) evidence that at least 75% of the plant infrastructure construction work has been completed; and (v) evidence that a plant manager with a proven track record and sufficient technical ability to appropriately handle the production- and business-related aspects of the plant has been selected.

As a condition precedent to disbursement of working capital funds (reimbursable financing), INDACO will present to the Bank's satisfaction: (i) evidence of the INDACO contribution in cash (US\$40,000); (ii) evidence of the signing of the agreement between APROCAV and INDACO specifying the agreements reached with APROCAV ensuring that said Association will supply the plant with raw materials, and recognition of its raw material contribution to working capital as an increase in APROCAV's share in INDACO capital; and (iii) the regulations governing the use of working capital, subject to prior agreement with the Bank and approval by the INDACO Board of Directors, including the regulations governing purchases of cocoa beans from project beneficiaries.

As conditions precedent to the first disbursement of the *technical-cooperation* funds, INDACO will present to the Bank's satisfaction: (i) the terms of reference for the consulting and advisory services to be financed with technical-cooperation funds in the first year of the project; (ii) evidence that the project coordinator has been selected; and (iii) an implementation plan, in accordance with the established Bank format, including the targets set to ensure that project objectives and outcomes are achieved, stipulating those on which future disbursements are contingent. The implementation plan must include a schedule for compliance with the performance indicators stipulated in paragraph 4.33, as these indicators will make it possible to monitor and supervise progress.

For the disbursement of more than 60% of the *technical-cooperation* funds, INDACO will provide the Bank with evidence that the plant



and the collection, quality control, and organization centers are in operation with their respective cocoa processing equipment and machinery, working capital, and information and accounting systems.

In view of the need for sufficient liquidity to hire the experts and technicians essential to the project launch, the Bank will establish a revolving fund with sufficient resources to cover projected expenses for the first three months of the technical-cooperation component, in accordance with the program of activities and disbursement schedule to be submitted by INDACO for Bank approval.

**Recognition of expenditures:** The Bank may recognize production infrastructure expenditures of up to US\$30,000 incurred as from 15 March 2004 as part of the local counterpart contribution for the reimbursable financing component.

The ex post evaluation mechanism may be applied for the procurement of consulting services, goods, and other services (except for the terms of reference) up to a maximum of US\$5,000. Application for the prior no objection of the Bank will not be required for goods procured for a total value of less than US\$1,000, provided purchases are effected efficiently and are directly related to the activities in the work plan.

INDACO envisages the option of purchasing refurbished machinery to equip the plant with the various machines and processing equipment required. Procuring refurbished machinery for this project is justified in that: (i) it enables INDACO to have access to sufficiently advanced-generation modern technology at a very affordable cost in line with the company's current circumstances. The basic technology used in cocoa processing equipment design has remained essentially unchanged over the last 30 years and modernization of this area has been through the use of electronic systems. Consequently, when this equipment is used in a remote location, it is preferable to use the least sophisticated version possible and to ensure that the equipment is easy to operate and can be serviced quickly and universally; (ii) the product quality achieved is similar to that obtained with latest-generation equipment, the result is the same, and the final specification parameters for the finished product are identical in both cases; and (iii) it is often more cumbersome to use latest-generation technology due to the initial training costs and the need to have foreign skilled technicians on-site at start-up and for routine maintenance. Modern technology equipment breakdowns can mean downtimes of weeks, and the resulting additional cost of making provision for such a contingency can be very high. With equipment of the generation proposed, these effects are minimized and any difficulties can be overcome swiftly at

lower cost. All machinery and equipment will be selected and procured via price shopping, and all equipment must be accompanied by a reasonable use guarantee in line with standard market practice in this regard.

When the proposed facilities have been constructed and are operational, INDACO undertakes to use these Bank-financed assets for the benefit of the beneficiary group specified in this project throughout the loan amortization period at the very least.

**Reports and  
evaluations:**

**Reports:** INDACO will submit *progress reports* to the Bank's Country Office 45 days prior to the close of each calendar half year and a final report 60 days following the period for the last disbursement. These reports will include an analysis of compliance with performance indicators and progress made in implementing the work plan, including: (i) progress in small-scale producer training and technical assistance programs; (ii) an operational report on the plant and the collection, quality control, and organization centers in terms of collection, processing, sales, and small-scale producer participation; (iii) the degree of compliance with project objectives in terms of incorporating technology, boosting productivity, and improving quality; (iv) the percentage of products processed and sold by the plant stemming from raw materials supplied by producers receiving project-sponsored technical assistance and training; (v) increases in small-scale producer selling prices for cocoa and increases in the income of the producers participating in the project; (vi) data on the technical competence and performance of plant technical personnel and management and any changes in principal officer positions; and (vii) an updated summary of the INDACO contribution in cash and in kind as of the submission of each report. The initial project report should compile socioeconomic data on the target group prior to the project launch to make it possible to compare changes in the beneficiaries' productivity and income. The last of these reports will constitute the final report and must contain a summary of the progress made in achieving the original objectives.

**Evaluations:** The Bank will use technical-cooperation funds to commission a midterm and a final evaluation of the project. The Bank-commissioned midterm evaluation will be undertaken 18 months into the project and the final report performed after 42 months. The indicators in the Logical Framework and in the table of project performance indicators will be used as a basis for measuring project results.

**Exceptions to  
Bank policy:**

None.