

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PERU

SOCIAL ENTREPRENEURSHIP PROGRAM

EXECUTIVE SUMMARY

**RESPONSIBLE PRODUCTION AND MARKETING BY
SMALL-SCALE COFFEE GROWERS**

(PE-S1002)

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I. BASIC PROJECT INFORMATION

A. Executing agency

1.1 Rainforest Trading S.A.C.

B. Amount and source of financing

| | IDB US\$ | Rainforest US\$ | Total US\$ |
|--------------------------------|---|-----------------|----------------|
| Reimbursable financing: | 435,000 | 300,000 | 735,000 |
| Technical-cooperation funding: | <u>185,000</u> | <u>120,000</u> | <u>305,000</u> |
| Total: | 620,000 | 420,000 | 1,040,000 |
| Source: | Swedish Fund for the Financing of Small Projects (SWP/ST) | | |

C. Terms and conditions

| | |
|-----------------------------------|----------------------|
| Amortization period: | 7 years |
| Grace period (for the principal): | 2 years |
| Interest rate: | 5% per annum |
| Currency: | United States dollar |

D. Declaration of nonobjection

1.2 The Peruvian International Cooperation Agency (APCI) gave clearance for the Bank financing for the project in a memorandum dated 25 February 2005.

E. Problem to be addressed

1.3 The project is designed to assist small-scale coffee growers in the high jungle area of Peru known as "ceja de selva" (Amazonas, Cajamarca, and San Martín Departments). Agroecological conditions in this area are ideal for high-quality coffee production. High-quality coffees and coffees produced under environmentally and socially sustainable systems command premium prices. In fact, these specialty coffees are the only segment of the coffee industry showing a consistently high rate of growth. Demand for and the volume of trading in high-

quality coffees on world markets are steadily mounting amid the current coffee crisis.¹

- 1.4 To capitalize on these opportunities, 11 organizations whose members include some 3,600 local coffee-growing households have formed a production/trading consortium with the social enterprise known as Rainforest Trading S.A.C. Rainforest is a Peruvian firm whose shareholders include coffee grower cooperatives created for purposes of marketing the coffee produced by its member organizations on preferred markets, where better producer prices can be negotiated.² Before partnering with Rainforest, the coffee growers relied on middlemen to sell their crops, and these intermediaries would generally take advantage of their ignorance and illiquidity, buying up their entire crop as conventional coffee at disproportionately low prices. The certifications earned by 6 of these organizations have enabled them to sell part of their crop on fair trade and organic markets paying premiums of US\$56/quintal and US\$20/quintal, respectively, over conventional coffee prices.
- 1.5 In spite of these favorable conditions, the ability of small-scale growers to capitalize on these market opportunities, purchase fixed productive capital, and boost their earnings has been hampered by the following constraints:
- 1.6 **Limited access to liquidity in the post-harvest period:** With Peru's financial system providing virtually no financing whatsoever for small-scale farming,³ small coffee growers have no funds with which to finance their harvest and cover their living costs during this period, which forces them to sell part of their coffee crop to the "conventional" market intermediary at the beginning of the harvest season without any quality assurance, losing roughly 25% of the value of their production. Unless able to deliver their coffee to Rainforest for sale on niche (fair trade and organic) markets demanding higher quality and paying premium prices, coffee growers are denied access to the benefits afforded by these markets. As far as Rainforest is concerned, without internal sources of financing other than funding

¹ According to the International Coffee Organization and the Specialty Coffee Association of America, specialty coffee sales have been growing at a rate of from 5% to 10% a year, based on conservative estimates.

² The company has two modes of operation: (i) direct sales of coffee purchased from the growers organizations; and (ii) provision of export and marketing consulting services to the growers organizations which, in turn, sell directly to international clients, supported by logistics facilities furnished by Rainforest. Approximately 70% of the volume of exports by Rainforest stem from contracts in which the firm operates as a broker between the growers and international buyers.

³ Thirty percent (30%) of the total US\$71 million in financing for the 2002–2003 coffee season was raised by growers using family labor, 60% was furnished by suppliers and informal lenders and credit intermediaries, and a mere 10% was provided by formal financial institutions serving the region (rural and municipal savings and loans and small and microenterprise development entities or EDPYMEs). Commercial banks do not get involved in lending to small farmers for risk management and loan security reasons, limiting their lending operations to medium-sized and large farmers.

from previously negotiated contracts with its international customers, it is unable to capitalize on high market price opportunities presenting themselves at the beginning and towards the end of the season, thus limiting its chances of maximizing the profits earned by coffee growers.

- 1.7 **Quality:** Approximately 25% of coffee production does not meet all the requirements of the coffee buyers supplied by Rainforest, either because it is not of high enough quality or because it is not certified (as organic or fair trade coffee). If the coffee growers had more access to technical assistance services, they could: (a) better control production and processing defects⁴ impacting directly on green coffee quality; and (b) meet product certification requirements.
- 1.8 **Limited access to the specialty coffees market:** Without a high enough volume and quality product to supply coffee to preferred markets, local coffee growers and Rainforest have had limited success in deepening and diversifying their specialty coffee markets, losing out on opportunities for access to a wider range of international clients and, thus, command premium prices for larger numbers of growers.
- 1.9 **Beneficiaries:** More than 30% of the coffee growers affiliated with Rainforest are quechua-speaking indigenous settlers originally from the sierra regions.⁵ Their main livelihood is farming and coffee is one of their most important crops, accounting for a large share of their income. Roughly 80% of the coffee growers are small farmers with 2 to 3 hectares of land planted with coffee. They also grow other crops such as bananas, tubers, and grains, most of which are sold on the local market and used for household consumption. Their average net annual household income is approximately US\$1,500.00. The project's intended direct beneficiaries include some 1,200 affiliated farmers in cooperatives and coffee growers organizations located primarily in San Martín Department, which are also members of the Rainforest consortium. The project will also benefit indirectly all affiliated farmers (3,600) in the Departments of Amazonas and Cajamarca. DOC 5 in the Project Technical Files contains a list of these groups.

⁴ Possible causes of defects include poor plantation (fungi, pests or insects) and harvest (use of immature or overripe berries, or presence of mold or foreign matter) management, unduly long storage periods or shipping times (overfermentation), faulty processing (mainly inadequate drying, as well as improper storage or contamination) or other factors incompatible with "responsible production."

⁵ Including growers from the Aguaruna, Huambisa and Lamista communities, as well as immigrants from the Department of Cajamarca (Chota and Cutervo).

II. THE PROJECT

A. Objectives

- 2.1 The project's main objective is to boost the income of small-scale coffee growers in the "ceja de selva" or high jungle area of Peru by improving the quality of their products, crop yields and their access to international specialty coffee markets with certified, responsibly produced and marketed coffee products.
- 2.2 The specific objectives of the project are: (i) to improve the quality of coffee production and processing to facilitate the certification of coffee grower organizations and raise their productivity in a responsible manner; (ii) to boost the exportable supply of coffee to international markets by increasing Rainforest's working capital for prefinancing collection and marketing activities for the coffee crops of affiliated small-scale growers; and (iii) to strengthen Rainforest's capacity to promote the coffee produced by the small growers and expand their markets.

B. Description

- 2.3 To meet its objectives, the project will be divided into two components: US\$735,000 in reimbursable financing (IDB: US\$435,000 and Rainforest: US\$300,000) and US\$305,000 in nonreimbursable technical-cooperation funding (IDB: US\$185,000 and Rainforest: US\$120,000), with Rainforest Trading S.A.C serving as the executing agency for both components.
- 2.4 The **reimbursable financing component** would be used: (i) to furnish Rainforest with US\$250,000 in funding for onlending to small grower organizations to finance the cost of harvesting and assembling their coffee crops at the beginning of and throughout the season, to boost the exportable supply of coffee; and (ii) purchase US\$185,000 worth of specialized coffee sorting and drying equipment, which are considered crucial steps in the processing of coffee and determining factors in the ensuing quality of the tradable coffee. The loan will be made in three disbursements of US\$185,000, US\$150,000, and US\$100,000, of which at least the first two are to be made during the first year of the project. Rainforest's contribution includes US\$50,000 in cash from the capital increase to be subscribed by its current members, plus another US\$250,000 from other international sources of financing.⁶ The Bank loan carries a "shadow" interest rate of 10% a year, of which 5% will be payable to the Bank, and the other 5% will be used to set up an investment fund (FIE) that will benefit coffee growers organizations directly through purchases of small-scale machinery and equipment and strengthening certification processes.
- 2.5 The **technical-cooperation component** is designed to help boost the quality and quantity of coffee production through technical assistance services aimed at raising productivity, strengthening responsible production and certification processes, and

⁶ Ecologic Finance and Hivos Triodos Bank.

instituting internal quality control and information systems to monitor the market development and production process. Specifically, this component will provide assistance in four areas: (i) establishment of an internal quality control system for production processes, introduction of new quality control methods for end products, farmer training activities, and procurement of three basic sets of coffee certification equipment to help small coffee growers achieve better quality and certification, which will result in three new certifications for currently noncertified organizations; (ii) market intelligence and development to provide current information on markets and new customers and help promote Rainforest coffee and that of its affiliated organizations; (iii) monitoring of production processes and technical assistance services through the establishment of a computerized ongoing monitoring and technical assistance system for coffee growers; and (iv) strengthening of operating procedures to develop Rainforest's lending and accounting capacity and buttress project implementation. This funding will also be used to finance the cost of project evaluations and audits. The plan of operations for the technical-cooperation component can be found in the project technical files.

C. Sustainability and results of the financial analysis

- 2.6 Project sustainability consists in two main factors which should ensure the achievement of its end goal, assuming there is no change in the status quo. First, with the growing demand for specialty coffees commanding a price premium over conventional coffee, farmers view this crop as an effective means of boosting their income. Secondly, Rainforest's ownership structure, which includes two international customers (the British firm Twin Trading Ltd.-Kafe Direct and the Dutch firm J. Th. Douqué's Koffie BV), holding 28% of its share capital, 3 individuals, with a 38.5% share, 3 growers cooperatives (Bagua Grande, La Prosperidad, and Frontera) and COCLA (the Federation of Agrarian Coffee Cooperatives) in Cuzco, holding 33.5% of its share capital, affords reasonable assurances of international market linkages with direct coffee producers and, thus, of the sustainability of the production-trading system on equitable terms and conditions for the members.
- 2.7 Moreover, the financial projections for the project show short and long-term earnings growing from 4.5% to 7% of sales over the term of the loan. These projections are grounded in conservative growth estimates based on an average price of US\$80/quintal⁷ and orders from international customers to whom Rainforest has been making sales for the past five years or so. Although Rainforest's debt-equity ratio (long-term liabilities divided by total equity) is a little high in year 1 of the project (2.16), it drops way down over the next three years to 1.34, 0.61, and eventually 0.28.

⁷ According to information furnished by Rainforest, based on prevailing market conditions for 2005, there is a high probability of a sharp jump in the average price to as much as US\$110/quintal.

D. Expected outputs and capture of benefits

- 2.8 Upon completion of the project, the following benefits are expected to be produced for coffee growers as well as Rainforest: **1. Coffee growers:** (i) boost their average net income from coffee sales by at least 40%; (ii) increase their average yields from 15 quintals/hectare to 18 quintals/hectare; (iii) boost the share of exportable coffee from 65% to 70%;⁸ (iv) boost sales of specialty coffees produced by affiliated growers by over 50%; (v) help 3 organizations equipped with regulatory, operational, internal quality control systems earn new certifications (by internationally recognized specialized coffee certification bodies) for the sale of their coffee in specialty markets; (vi) obtain an average annual price for their products 30% above the average domestic price paid to coffee growers; (vii) fund purchases of small-scale machinery and equipment for their organizations using income generated by the “shadow” interest rate for the Bank loan; and (viii) help 1,200 growers establish a system for converting coffee mill wastes into organic fertilizer; **2. Rainforest:** (i) boost its in-plant coffee processing capacity by 30%; (ii) help attract two new international customers; and (iii) provide sufficient funding for the prefinancing of coffee collection and marketing activities enabling it to buy up coffee crops at the beginning of the season to capitalize on high market price opportunities throughout the season. The logical framework and table of project indicators present annualized indicators for these benefits, along with other process indicators (see the project technical files).

E. The Bank’s strategy

- 2.9 The project activities are in line with the priorities established in the Bank’s new strategy with Peru (document GN-2205-1 dated 24 September 2002) in that: (i) they provide financial (loans to growers organizations for collection and marketing operations and financing for processing plant equipment) and nonfinancial (technical assistance in quality assurance and training) services for small-scale farming activities designed to *improve the productivity and competitiveness* of smallholders and boost their share in high value markets; (ii) they afford opportunities for *boosting the income* of low-income campesino families; and (iii) they backstop *poverty reduction* efforts with sustainable services reaching the poorest segments of the population of Amazonas, Cajamarca, and San Martín Departments.

F. Coordination with other international cooperation agencies

- 2.10 A number of agencies and organizations have been helping to promote coffee production activities in the San Martín, Amazonas, and Cajamarca area. USAID has been funding a number of projects for the replacement of coca crops under its Alternative Development Program, working with NGOs such as CEDISA, RAAA,

⁸ The share of output with a minimum number of defects qualifying it as coffee for export. The maximum number of defects allowed for conventional coffee is 23 and for specialty coffees 10 to 15.

Caritas, and the Poverty Reduction and Alleviation (PRA) Program Implementing Unit. The European Union, in conjunction with German Agro Action, GTZ (the German Technical Cooperation Agency, KfW, and the UNDCP are also financing coffee projects. Most of these organizations help fund technical assistance services for coffee production and finance small-scale community-based production infrastructure. Rainforest has been working with several of these agencies (particularly with the Caja Rural San Martín and the PRA) to raise enough funding to provide its 11 affiliated organizations with technical assistance in coffee production in order to maximize profits for coffee growers.

- 2.11 Another Bank project under way in this area (project PE-0193) is being carried out by the Fondo Nacional de Compensación y Desarrollo Social [National Compensation and Social Development Fund] (FONCODES). This is a multisector program geared mainly to financing community-based production infrastructure, requiring matching funding from the beneficiaries. Rainforest will look for opportunities to work with this project to improve access to funding for community-based production infrastructure.

G. Summary of the environmental and social review

- 2.12 The Committee on Environment and Social Impact (CESI) reviewed the project on 17 December 2004, and requested that clarification on the following points be incorporated into the project report: (i) the expansion the agricultural frontier; (ii) the environmental impact of coffee production; (iii) wastes and fertilizer; and (iv) certification. The project measures taken to address these issues are described in a separate document, in the project technical files.

H. Special contractual conditions

- 2.13 For the first disbursement of **reimbursable financing** Rainforest Trading S.A.C. must submit: (i) the minutes of the board of directors meeting approving the US\$50,000 increase in its share capital and evidence that US\$25,000 of this sum has been paid in; (ii) the program Credit Regulations⁹ approved by its board of directors; (iii) the Capital Investment Fund (FIE) regulations approved by its board of directors; (iv) evidence that a project coordinator has been selected.
- 2.14 For the first disbursement of **technical-cooperation funding**, Rainforest must submit: (i) a work plan for the first twelve months of the project, including a schedule of project activities and timetable for the fulfillment of the performance indicators as the basis for monitoring and overseeing project implementation; and (ii) terms of reference for engaging consulting services for work to be performed during the ensuing six-month period.

⁹ The basic terms of the Credit Regulations are spelled out in DOC 2 in the project technical files.

- 2.15 Disbursements of *more than 20%* of the technical-cooperation funding will be conditional on submission by Rainforest of the findings by the financial advisory assistance consultancy in lending/accounting-related matters and the status of efforts to implement the recommendations accepted by the firm. Disbursement of *more than 50%* of the technical-cooperation funding will be conditional on Rainforest demonstrating that the remainder of the capital increase (US\$25,000) has been contributed as part of the counterpart contribution for the reimbursable financing component.
- 2.16 As one of the financing conditions Rainforest may not distribute earnings of any kind earned by the company to its members during project implementation.

I. Reports, evaluations, and audits

- 2.17 **Reports.** Rainforest Trading S.A.C. will submit progress reports to the Bank's Country Office on the last day of May and November of each year. These reports will examine the extent to which the performance indicators have been fulfilled, any problems encountered in connection with project implementation and the measures taken to overcome such problems and present projections for the following six-month period. At a minimum, they will also contain the following information: (a) **For the reimbursable financing component:** (i) the number of organizations and growers and the basic characteristics of project participants; (ii) a breakdown of monthly price margins obtained by the company and paid to the growers, including average domestic prices; (iii) loans made to coffee growers organizations and the past-due portfolio; (iv) the effective annual percentage rate on loans made to growers organizations compared with the average bank rate on loans to microenterprises; (v) a list of negotiated and completed contracts, specifying their volume and value; (vi) a summary of Rainforest's cash contribution to the project; (vii) results of Capital Investment Fund (FIE) operations, proposals financed, and their implementation; and (b) **For the technical-cooperation component:** (i) a summary of the work performed by consultants and technical assistance services rendered; (ii) purchases of equipment; (iii) a summary of outcomes from assistance to international trade fairs; (iv) information on new certifications acquired by the growers organizations with the help of technical-cooperation funding; (v) a summary of the progress made by the coffee growers organizations in the sustainable environmental management of coffee production and processing, including the conversion of waste into organic fertilizer and reforestation; (vi) the recipients of training services and the types of training dispensed; and (vii) information on the production process monitoring system.
- 2.18 **Evaluations.** Two project evaluations will be performed by individual consultants selected and hired by the Bank's Country Office in Peru with technical cooperation funding. A midterm evaluation will be conducted 18 months after the first disbursement, and a second evaluation 36 months after the date of the first disbursement. At a minimum, the first evaluation will examine: (i) progress in boosting producer income, product quality, and crop yields and in certification procedures, compared with the baseline situation; (ii) compliance with project

performance indicators; (iii) lessons learned and recommendations for strengthening the project; and (iv) the institutional capacity of the executing agency.

- 2.19 In addition to the areas dealt with in the midterm evaluation, the final evaluation will measure and document: (i) the project's impact on the groups examined in the initial evaluation; (ii) outcomes from the achievement of project objectives; (iii) lessons learned; and (iv) project sustainability.
- 2.20 **Audits.** The cost of annual audits for the loan component will come out of the technical-cooperation funding. Rainforest will defray the cost of a final audit of the technical-cooperation component upon project completion.

J. Project risks and mitigating factors

- 2.21 **Corporate-production culture.** One of the risks associated with the project lies in the inability of the coffee growers to adequately identify opportunities for marketing production in such a way as to meet minimum standards of quality for specialty markets. While the leadership of the growers organizations recognizes the advantages of expanding their specialty markets, in practice many affiliated growers who do not have enough of a spirit of entrepreneurship to capitalize on these advantages rely on the alternative of selling to the less-demanding conventional coffee market. The project intends to mitigate this risk through two types of measures: (i) the establishment of internal quality control systems for coffee production, backed by basic measuring equipment and regulations endorsed by the growers organizations; and (ii) training and technical assistance by Rainforest to raise grower awareness of the advantages of obtaining coffee certifications which would enable them to sell their products in specialty markets at premium prices.
- 2.22 **Market.** Though available information points to the continued growth of specialty markets for coffee products, it is important to bear in mind that, in general, the coffee market is a highly volatile market dependent on large numbers of vendors and buyers in different circumstances. While this risk may be difficult to mitigate, one measure envisaged involves using technical-cooperating funding to attract new customers by attending international trade fairs, which should help further diversify an already diversified customer portfolio. The diversification of their output into specialty products through access to training, technical assistance, and certifications should also help coffee growers lessen the impact of any downsizing in prices on the conventional coffee market.

K. Exceptions to Bank policy

- 2.23 None.