



# Social Entrepreneurship Program

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**To:** The Board of Executive Directors  
**From:** The Secretary  
**Subject:** Honduras. Executive summary of a proposal for integrating small-scale producers into Honduran agribusiness chains

**Inquiries to:** Mr. Alejandro Escobar (extension 3725)

**Remarks:** This operation is presented in accordance with Resolution DE-183/98 authorizing the "Reform of the Small Projects Program and creation of a Social Entrepreneurship Program," and meets the criteria established in document GP-75-9.

On **27 October 2006**, the date on which the five-day circulation period required for this document expires, the President, or such officer as he may designate, will approve this operation.

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DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

## **HONDURAS**

### **SOCIAL ENTREPRENEURSHIP PROGRAM**

#### **EXECUTIVE SUMMARY**

### **INTEGRATING SMALL-SCALE PRODUCERS INTO HONDURAN AGRIBUSINESS CHAINS**

**(HO-S1007)**

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## I. BASIC PROJECT INFORMATION

### A. Executing agency

- 1.1 Fundación para el Desarrollo Empresarial Rural [Foundation for Rural Business Development] (FUNDER)

### B. Amount and source of financing

	IDB US\$	FUNDER US\$	Total US\$
Reimbursable loan:	300,000	150,000	450,000
Technical cooperation:	<u>160,000</u>	<u>240,000</u>	<u>400,000</u>
Total:	460,000	390,000	850,000

Source: Net income of the Fund for Special Operations (FSO).

### C. Terms and conditions

Amortization period:	10 years
Grace period:	4 years for principal
Interest rate:	4% per annum
Currency:	Lempiras Maintenance of value
Loan execution period	36 months
Loan disbursement period	48 months

### D. Statement of no objection

- 1.2 In official letter DGIP-069-2006 of 3 July 2006, the Government of the Republic of Honduras confirmed that the project is in line with its policies to strengthen the agricultural sector and contribute to its development.

### E. Problem to be addressed

- 1.3 **The importance of agribusiness in fighting rural poverty.** Honduras has a population of nearly 7 million people, and almost 40% of the economically active population work in the agricultural sector. Most of the poor 64% of the population live in rural areas, where agriculture is the main activity. Increasing opportunities have emerged in recent years for the processing of primary farm produce, paving the way for small and medium-sized agricultural business startups. Such initiatives represent creative and innovative ways of raising farm output and developing the entrepreneurial vision of small-scale producers.
- 1.4 Four small group enterprises<sup>1</sup> supported by Fundación para el Desarrollo Empresarial Rural (FUNDER) have been pursuing production-oriented initiatives at

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<sup>1</sup> Mora Lenca (Guajiquiro, Department of La Paz), Tropical Yojoa (Santa Cruz de Yojoa, Department of Cortés), Humuya Frutas (Comayagua, Department of Comayagua), Café Márcala (Márcala, Department of La Paz).

the local,<sup>2</sup> regional and international levels, achieving sales of close to US\$500,000 in 2005. The principal shareholders are approximately 400 small-scale producers whose annual incomes range from US\$500 to US\$2,600, and who have organized in a number of the country's rural areas. As shareholders of these small processing enterprises, the producers and their families, who depend on farming, have tapped into local and international markets, raised their output, and now obtain higher prices for their produce. With the technical and infrastructure support received to date, these enterprises have organized production in such a way as add value, channeling significant profits to the small-scale producers, who are both partners in and suppliers of these enterprises. The enterprises have had such an economic and social impact that a growing number of such producers want to join. Many have paid for shares of the enterprises at real values that reflect growing profits. The following table provides an overview of the producers and enterprises:

Enterprises	Partners	Location	Business	Average annual income of partners
Café Orgánico Marcala	108	Marcala	Fine organic coffees	US\$2,060
Tropical Yojoa	52	Santa Cruz de Yojoa	Waxed cassava, sweet potato, frozen cassava, and cassava flour	US\$1,620
Humuya Frutas	90	Comayagua	Fresh mango for export Processed green mango	US\$1,975
Mora Lenca	153	Guajiquiro	Fresh blackberry Blackberry concentrate	US\$512
<b>Total</b>	<b>403</b>			Average: US\$1,541

- 1.5 The enterprises have had an impact not only on the 400 producers who are partners, but also on the supplier families of the enterprises, the processors associated with them, and technical specialists in rural areas. By creating significant linkages with local and regional as well as export markets, the enterprises deliver steady demand to their partners and providers. The payment methods they use are suited to the producers' and suppliers' needs, and technical assistance is provided in some cases to raise farm output. However, the greatest benefit for rural producers and microentrepreneurs has been to provide access to new markets. This entails new approaches and marketing practices, as well as more technologically sophisticated processes that better enable producers to meet the new demands associated with regional trade liberalization.
- 1.6 Their small size gives these enterprises certain advantages in adapting to, and competing in, increasingly segmented and shifting markets. But by the same token they face certain obstacles to consolidation. The majority lack the technical and financial means to adopt even rudimentary technological advances in their

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<sup>2</sup> Through chains of local and regional supermarkets.

production systems and still face constraints on access to working capital, which limits their flexibility to market their partners' products and develop new markets. The principal products are fresh and processed blackberries, coffee, processed cassava, and mango for export.

1.7 The **main problems** faced by these small-scale producer enterprises are:

- (i) **Quality and diversification.** Lack of skills and training on the part of small-scale rural producers prevents them from meeting minimum quality, health and safety standards, and makes it difficult for them to provide a steady supply of their products. In order to sustainably link producers and providers to agribusiness chains, they need to: (a) improve controls over production and processing defects, which directly affect quality; (b) meet requirements for certification and good agricultural practice standards; (c) diversify their crops and systems in order to reduce the risks associated with monoculture; and (d) introduce irrigation as a means of countering the risks of drought.
- (ii) **Weak management and sustainability of current and future initiatives.** Given that these enterprises are young, and that some are still in the consolidation stage, they need specialized assistance to build their businesses. While they do have accounting systems and managerial and line personnel for day-to-day operation, these enterprises still need to develop skills for better financial management, market identification, business processes, and business plan development, so that they can grow in response to market demand while raising their business profile.
- (iii) **Lack of working capital and investment financing.** One obstacle faced by these small enterprises in their development that limits the amount, continuity, and quality of their output is the lack of sufficient, timely financing for investment and working capital. This is due to (a) the fact that their principal clients are local and regional supermarket chains that pay for produce on 90-day terms, creating liquidity problems for the producers; and (b) their size and institutional structure, which make it difficult to attract sufficient investment for expansion and continued growth. While their credit needs are greater than can be supplied by local microfinance institutions, they are unable to access financing through the banking system, since they have no credit history and 100% of their assets and net worth are in rural areas.

1.8 **FUNDER support for micro and small agribusiness enterprises.** Fundación para el Desarrollo Empresarial Rural (FUNDER) is a nonprofit entity organized under Honduran law. It promotes social and economic development and seeks to improve quality of life in the rural sector through advisory services and training for social entrepreneurship development.<sup>3</sup> One of its strategies is to support initiatives of small-scale producers with a business approach geared toward long-term sustainability. FUNDER provided seed money for these small business startups and

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<sup>3</sup> According to FUNDER's bylaws.

later provided credit to help them grow. Its strategy is to gradually move the producers toward management and full ownership of the enterprises. To accomplish this, FUNDER provides support and training, eventually selling its shares and transferring any profits to the communities in which the enterprises are located. This project seeks to raise the standard of living of the families of small-scale producers by strengthening their businesses, expanding their impact, and reaching more producers with financing and technical assistance. Thus, the project is fully consistent with the policies of the Social Entrepreneurship Program. FUNDER is legally authorized to receive Bank financing and can make loans to, and invest in, micro and small enterprises, since this contributes to its mission and corporate purpose of improving the quality of life of rural families in Honduras.

- 1.9 FUNDER has over 10 years of experience in the rural and agricultural sector, managing productive infrastructure, business financing, and development projects. In terms of financing, it has assisted in the creation of over 470 savings and loans with a loan portfolio of US\$1.1 million as of end-2005, serving approximately 9,000 families.<sup>4</sup> It also is currently executing an agricultural modernization project that identifies, analyzes and supports small-scale fruit and vegetable farmers. Following an evaluation and advisory process, these farmers are given access to financing for irrigation through a local bank. Lastly, FUNDER has financed small agribusiness enterprises through seed capital and working capital loans, enabling them to grow and serve an increasing number of small-scale producers.
- 1.10 **Beneficiaries.** The project's direct beneficiaries will be the families of approximately 700 small-scale producers with average annual incomes of US\$1,500.<sup>5</sup> Of these, 500 are, or will be, partners in the enterprises, and 200 will be new suppliers for the project's agribusiness activities. The families are located in the departments of Cortés, Comayagua, La Paz, and Olancho, and their principal economic activities are agriculture, small livestock operations, informal businesses and off-farm labor. The small-scale producers that are partners and suppliers of the enterprises have an average of 3 to 5 hectares under cultivation, producing crops such as corn and beans for their own consumption, as well as market crops such as cassava, blackberries, coffee, mangos, and selected vegetable crops such as chili peppers.

## II. THE PROJECT

### A. Objectives

- 2.1 The project objective is to help increase small-scale producer incomes through partnership in enterprises that add value, market their produce, and integrate them into Honduran agribusiness chains. The purpose of the project is to strengthen small-scale producer businesses financially and in terms of production, marketing and management.

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<sup>4</sup> A summary of this activity can be found in Annex II, Institutional Analysis.

<sup>5</sup> According to FUNDER survey and baseline for enterprise partners in the respective areas.

- 2.2 The project will accomplish this through the following lines of action: (i) support FUNDER in expanding its working capital and investment financing to small enterprises on financial terms they can afford; (ii) strengthen the technical and operational capacity of the small enterprises, so that they can improve the quality and diversification of their output, introducing organic certification in some cases and developing new products in others, in order to expand their markets; and (iii) support FUNDER in its role as provider of technical assistance and training to improve the management and sustainability of the small enterprises by helping them to understand the markets in which they operate, and learn effective financial and business management practices.

## **B. Description**

- 2.3 The project has two components: a US\$450,000 reimbursable loan component (IDB: US\$300,000; FUNDER: US\$150,000), and a US\$400,000 nonreimbursable technical cooperation component (IDB: US\$160,000; FUNDER: US\$240,000). Both will be executed by the nongovernmental organization, Fundación para el Desarrollo Empresarial Rural (FUNDER).
- 2.4 The US\$450,000 **reimbursable loan component** (IDB: US\$300,000; FUNDER: US\$150,000) will be used to make loans for working capital and investment in machinery and equipment, so that the small enterprises and producers can expand their marketing and improve the quality of their processes and products. Although the project has preidentified beneficiary enterprises and producers, they will be required to meet a series of conditions before receiving financing. These social, business, financial, and environmental criteria are described in the project Operating Regulations and Credit Regulations (see Document 1). As present, four existing enterprises will be beneficiaries of the loans, as well as two others still in the startup and development stage and four enterprises identified as potential businesses to develop.
- 2.5 The Bank financing will be in local currency at an annual interest rate of 4% plus maintenance of value (average 8%). The loan will be repaid over a 10-year term, with a 4-year grace period for principal. Interest will be payable semiannually on the outstanding balance. FUNDER will onlend the Bank resources to the enterprises (in amounts of US\$5,000 to US\$50,000) at an average interest rate of 19%, and to the producers (in amounts of US\$1,000 to US\$5,000) at an average rate of 21%. The loan term will vary according to the type of activity. Investment loan terms will be up to 4 years, while working capital loans may be for 6 to 18 months. The terms of the Bank's loan to FUNDER and of the respective loans to the small enterprises and producers will not distort the local lending market, but seek to provide terms and conditions more suited to agricultural businesses than are generally available, thus directly benefiting producers.<sup>6</sup> FUNDER will allocate three percentage points of the interest rate charged to beneficiaries for the creation of a technical assistance fund for producers. The fund will accumulate from year to year and be used in accordance with operating regulations subject to the following main criteria:

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<sup>6</sup> See the annex on Financial Terms for the Project for a more detailed explanation of the interest rate.

- (i) FUNDER will deposit the money in a separate bank account; (ii) the fund will benefit only FUNDER “client” enterprises, i.e. those receiving financial or other services from it; and (iii) the fund will be used for agribusiness advisory services, and for technical assistance and training of enterprise managers, partners, and staff.
- 2.6 The **technical cooperation component** will fund technical assistance and training to: (i) meet the requirements for organic and/or fair-trade certification of produce (coffee and blackberries), meet minimum quality standards, and introduce an automated internal quality control system (certification of good manufacturing practices) with market feedback from the planting process through sale of the final product; (ii) develop marketing products and systems to guide management of distribution, packing, health and other factors in response to market demand; (iii) provide the minimum equipment and training necessary for effective irrigation; (iv) promote understanding of how the markets for different products operate, through sharing of experiences and educational tours of domestic markets and supermarkets with international buyers; (v) develop business plans; (vi) provide training in the management and startup of businesses (management, financial management, operations, and marketing); and (vii) provide training in gender inclusion in executive management of the enterprises. This support is described in greater detail in the plan of operations for the technical cooperation component.

#### **C. Sustainability and results of the financial analysis**

- 2.7 The project’s financial viability was assessed on the basis of: (i) analysis of FUNDER’s capacity to maintain a sound financial position, meet its financial obligations to the Bank, and continue to expand its strategy for working with small enterprises beyond the lifetime of the project; and (ii) professionalization and consolidation of the producer enterprises, some of which already show positive signs and good business practices, such as (a) having taken on professional and technical staff as shareholders, so that they become committed providers of knowledge and advice; (b) increasing their capital stock, in some cases, to meet investment needs; and (c) having repaid past loans for equipment and working capital. The knowledge gained under the technical cooperation component will remain with the enterprises for the benefit of the producers, while investments and loans will be repaid according to investment plans that FUNDER will develop with each enterprise, based on its extensive experience.
- 2.8 FUNDER has assets of nearly US\$3 million and liabilities of US\$1.8 million (of which 76% are long-term accounts payable), and net worth of US\$1.2 million. Its income statement as of December 2005 shows annual income of approximately US\$1.3 million, mostly in relation to projects in execution, coming mainly from the European Union, the United States Department of Agriculture (USDA) and the Ministry of Agriculture, as well as from the sale of services.

#### **D. Credit risk to the Bank**

- 2.9 FUNDER has reached an operational level and net worth such that it runs sizeable regular surpluses. For several consecutive years it has effectively administered funds from other cooperation agencies, leading increasingly to contracts for execution and advisory services in the Honduran rural sector. The Bank loan



represents a small portion of FUNDER's total funding (22% of its total liabilities as of December 2005). Thus, while this operation does involve some credit risk to the Bank, the risk is certainly manageable, given FUNDER's history.

**E. Expected outcomes and capture of benefits**

- 2.10 The small-scale producers, group enterprises, and FUNDER are expected to see the following outcomes upon conclusion of the project: **Producers:** (i) 700 small-scale farmers and their families will be involved in the enterprises as shareholders or direct suppliers, and are in a position to improve productivity and create more jobs; (ii) producers will experience an increase of 30% in their net income by project year three; and (iii) there will be an at least 30% increase in average crop yield for producers associated with the enterprises, due to implementation of good agricultural practices and irrigation; **Enterprises:** (i) four small-scale producer enterprises will be strengthened, have their own business plans and enjoy additional annual sales of US\$400,000 by year three; (ii) organic and/or fair-trade certification will be secured for at least two products (coffee and blackberries); (iii) two additional enterprises will be organized and operating with annual sales of US\$100,000 by year three; (iv) each small enterprise will have a technical team to continue technical assistance programs in the field in connection with certification, quality control and good agricultural practices; (v) at least four enterprises will obtain certification in good manufacturing practices; (vi) at least 30% of executive management jobs will be held by women; and (vii) each enterprise will have sufficient funds to consolidate its net worth and to bulk/warehouse and market its partners' products.
- 2.11 The project will have major economic benefits for the families of the small-scale producers who are partners and suppliers of the micro and small enterprises. This benefit will be the result of financing to meet the growth needs of the producers and suppliers, enabling them to capitalize and integrate a greater number of partners and producers into their agribusiness chain. With the project, the beneficiary families will see their traditional crops of cassava, blackberry, coffee and mango acquire greater commercial value through technological development and the value added by their own enterprises. New markets opened for their produce will connect the producer families to new trends, new marketing practices, and more technologically sophisticated processes that better enable them to meet the new challenges of regional trade liberalization.

**F. The Bank's strategy and related operations**

- 2.12 The project activities are consistent with the priorities of the April 2004 update of the Bank's country strategy with Honduras (document GN-2251-3), in promoting the competitiveness of the agricultural productive sector. The project is also consistent with the Bank's poverty reduction strategy with the country, in that it targets productive activity in the poorest areas.

**G. Cooperation with other international cooperation agencies**

- 2.13 FUNDER receives support for its agribusiness activities from the United States Department of Agriculture (USDA) and the European Community's PROACTA

program to support the processing and marketing of the produce of small-scale farmers in Honduras. These organizations' funds, though variable and negotiated on a year-to-year basis, have enabled FUNDER to support agribusiness initiatives, and this project will benefit indirectly from the ongoing support of these international programs.

## **H. Summary of environmental and social review**

- 2.14 The Committee on Environment and Social Impact (CESI) reviewed this operation at its 21 April 2006 meeting and recommended including a description of how it will address the potential environmental and social impacts of the activities to be financed. FUNDER's approach is to increase area yield, thus relieving pressure on the agricultural frontier and land use. Of the land benefited by the enterprises, 74% is cultivated with perennial crops that contribute to soil and water conservation in rural areas, while the other 26% is cultivated with annual crops for which soil conservation practices are employed. The project will not increase the area under cultivation, but rather seeks to make existing productive systems more profitable.
- 2.15 Most of the small processing enterprises involved are legally organized and operating, all having obtained the necessary environmental permits for their various processes. Given the low volume of operations and minimal impact on the environment, they have obtained permits from the Ministry of Natural Resources, the Ministry of Public Health, and the National Agricultural Health Service (SENASA).

## **I. Special conditions**

- 2.16 As a condition precedent to the first disbursement of the **reimbursable loan** resources, FUNDER will submit: (i) evidence that its board of directors has approved and implemented the Credit Regulations for the project; (ii) a medium-term financing plan for each enterprise, based on demand and the enterprise's needs; and (iii) the Operating Regulations governing the technical assistance fund for producers and enterprises, duly approved by FUNDER's board of governors.
- 2.17 As a condition precedent to the first disbursement of the **technical cooperation** resources, FUNDER will submit: (i) evidence that the project coordinator has been selected; and (ii) terms of reference for the consulting services to be commissioned during the following six months.
- 2.18 The following have been agreed upon as execution conditions: (i) as a condition for execution of the technical cooperation component, not more than 60% of the loan proceeds may be disbursed before at least 30% of the technical cooperation funds have been disbursed; (ii) before more than 80% of the loan proceeds may be disbursed and/or before the end of project year three, FUNDER will demonstrate that it does not hold more than 25% of the shares of the project enterprises; (iii) FUNDER will not distribute any equity or profits to its own members during the term of the Bank loan; and (iv) FUNDER loan contracts with the enterprises will include mechanisms for compliance with the environmental mitigation measures of the financed projects, and these mechanisms will be described in the progress reports.

**J. Reports, evaluations and audits**

- 2.19 **Reports.** FUNDER will deliver progress reports to the Bank's Country Office within 60 days after the end of each six-month period. The reports will cover progress toward project objectives, status of performance indicators, problems in execution and actions taken to address them, the principal activities planned in the next six-month period, and remarks on the validity and relevance of the performance indicators. Also to be included, at a minimum, are: (a) for the **reimbursable loan** component, information on: (i) the number of enterprises that are part of the FUNDER system, along with sales and profit figures; (ii) the number of loans, average amounts and total placements with the enterprises (including both investment and working capital loans); (iii) portfolio performance indicators, including at-risk portfolio and current portfolio balance, disbursements classified by amount and repayment periods; (iv) mitigation measures taken by the enterprises and producers to comply with environmental and health requirements, in accordance with the Credit Regulations and loan contracts; (v) the number of irrigation systems introduced; and (b) for the **technical cooperation** component, (i) information on who has been trained, and in what subject areas; (ii) a summary of work done by consultants and technical assistance provided; (iii) operational training and environmental training provided to users; and (iv) remarks on the performance of project personnel.
- 2.20 **Evaluations.** The project will have two evaluations, done by individual consultants selected and contracted by the Bank's Country Office in Honduras using the technical cooperation resources. A midterm evaluation will be done once 50% of the loan proceeds have been disbursed, or 24 months after the first disbursement of the loan, whichever occurs first. The first evaluation will measure at least: (i) the project's response to the problems originally identified that gave rise to it; (ii) progress toward project objectives and status of the performance indicators; (iii) lessons learned, and recommendations for improving the project; and (iv) the institutional capacity of the executing agency.
- 2.21 The final evaluation, to be done 42 months after the first disbursement of the loan proceeds, will measure and document the following, in addition to the parameters measured in the first evaluation: (i) the project's effect on the groups studied in the midterm evaluation; (ii) the extent to which the project objectives have been met; (iii) lessons learned; and (iv) project sustainability.
- 2.22 **Audits.** FUNDER will contract for annual audits of the reimbursable loan component. The audits will be conducted in accordance with applicable Bank policies and be paid for out of the technical cooperation resources. FUNDER will cover the cost of a final financial report prepared by independent auditors accepted by the Bank, which will show how the technical cooperation resources were used.

**K. Project risks and mitigants**

- 2.23 **Market conditions.** There is a risk that the marketing targets in terms of sales volumes and/or prices will not be met. Although the data do indicate strong demand for the produce of small-scale farmers on the domestic market, especially the supermarket sector, and suggest that there is room for continued growth in sales

volume, uncertainty remains as to how the market as a whole will behave. This is particularly true in light of the recently signed free trade agreement between Central America and the United States, which may have both favorable consequences (a larger market) and unfavorable consequences (greater pressure for price competition in imported produce). While this risk is difficult to mitigate, the technical cooperation component includes such activities as training, organic certification, and ongoing improvement in quality and marketing processes, to lower the price and market risk.

- 2.24 **Natural disasters.** Another risk is that natural disasters (droughts, floods, hurricanes, etc.) may adversely affect farming in the project target areas, and/or that crops may be harmed by insects and other pests, as well as diseases. Although natural risks are difficult to mitigate, the project will help to diversify agricultural output, so that producers grow both annual and perennial crops, including traditional and nontraditional crops for both market and own consumption. This will lower the risk of losing an entire harvest and the income associated with it in the wake of a natural disaster. Good crop management through technical assistance (in good agricultural practices, certification, and installation of microirrigation systems) will help to mitigate this risk.

**L. Exceptions to Bank policies**

- 2.25 None.