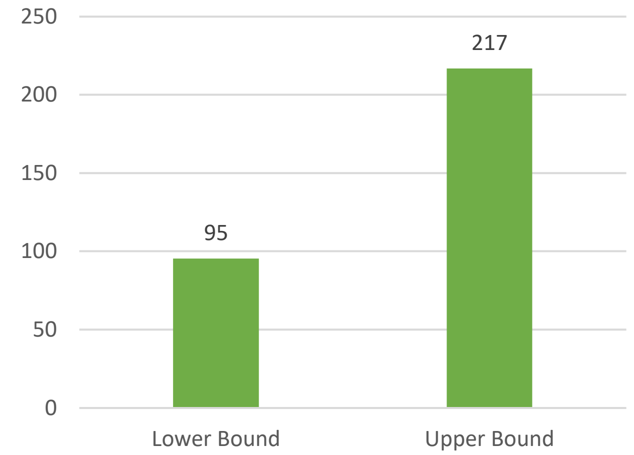
Financial needs in the agriculture and agri-food sectors in the Czech Republic

June 2020

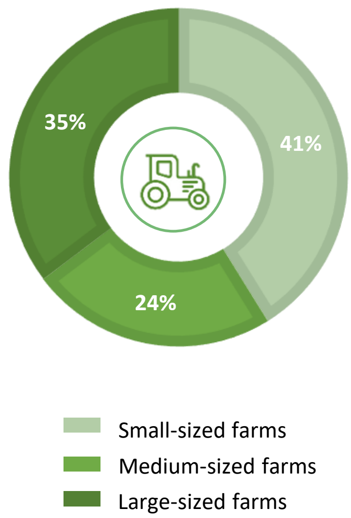
CZECH REPUBLIC

FINANCING GAP IN THE AGRICULTURE SECTOR

FINANCING GAP IN THE AGRICULTURE SECTOR (EUR MILLION)

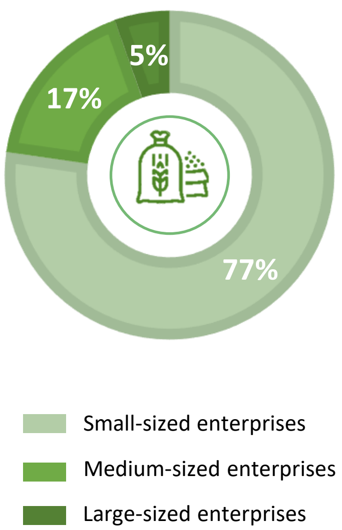


BY FARM SIZE

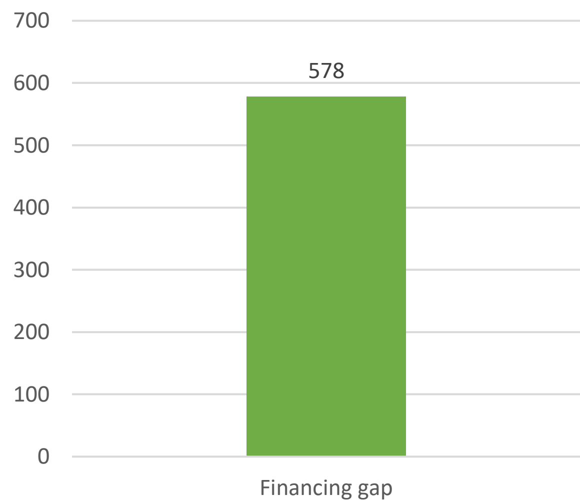


FINANCING GAP IN THE AGRI-FOOD SECTOR

BY ENTERPRISE SIZE



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



Source: *fi-compass* 2020

EXECUTIVE SUMMARY

This report gives an insight into agriculture and agri-food financing in the Czech Republic 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, namely the *fi-compass* survey on financial needs and access to finance of EU agriculture 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 Czech Republic

Investment in the Czech agriculture sector has been growing in recent years. Since 2015, the Gross Value Added (GVA) and Gross Fixed Capital Formation[1] (GFCF) in the agriculture sector has been increasing. In 2018, GFCF reached its highest level in a decade.

The main drivers of the demand for finance in agriculture are:

- **Investments in modernisation, especially in new machinery, equipment and technical facilities,** which help Czech farmers control their rising costs of production and preserve their profitability. Livestock farmers often purchase better feeding or milking equipment, while crop farmers invest in more efficient tractors, tillers, sprayers, and greenhouses.
- **High land prices**, as bank financing and national loan schemes are used for investments in land. However, land prices have been rising due to increased competition.
- **Working capital needs**, with farmers needing to purchase agriculture inputs and to cover expenses throughout the growing season.
- **Investments to adapt to climate change,** such as the purchase of specialised machinery and equipment, in order to make adaptations in infrastructure and production methods.

Support from the Common Agricultural Policy (CAP) contributes to income stabilisation and also stimulates investments. Both direct payments and rural development (RDP) grants provide an important source of income for farmers. They also facilitate access to finance, as banks see these grants and payments as a guarantee for loan re-payments. In addition, the European Agriculture Fund for Rural Development (EAFRD) investment support contributes to an increasing demand for finance since grant projects under the EAFRD have to be co-financed by the farmers, who use either their own resources or apply for bank financing. The availability of grants has also enabled young farmers to invest.

The supply of finance to the Czech agriculture sector is provided primarily by generalist commercial banks. The largest banks, which are often subsidiaries of international groups, provide Czech farms with a large variety of loan products. These products are adequately provided, as banks have accessible branches across the country. All banks employ agriculture specialists who can supply farmers with targeted financial advice.

1 GFCF measures the value of acquisitions of new or existing fixed assets. GFCF/GVA is used as a measure for how much of the new value added in the economy is invested rather than consumed. Increase of the GFCF is a measure of business confidence, a belief in that investments will be profitable in the future. In times of economic uncertainty or recession, typically business investment in fixed assets will be reduced, since it ties up additional capital for a longer interval of time, with a risk that it will not pay itself off.

In addition to the commercial banks, **the Czech government funded Farming and Forestry Relief and Guarantee Fund (PGRLF)** provides the agriculture sector with a variety of publicly funded financial services, including subsidy schemes and guarantees, as well as working capital, and short and medium-term solutions. As part of a dedicated Farmers Programme, investment loans with subsidised interest rates are provided to the sector. PGRLF contributes 16% of the total financing provided to agriculture on an annual basis.

The **total supply of finance to agriculture is increasing.** In 2017, the supply was estimated at EUR 584.13 million. The loan portfolio for agriculture, forestry and fishing has been growing over the last 6 years, demonstrating that the Czech financial market for the agriculture sector is well established and is performing well. Czech farmers continue to benefit from historically low interest rates, and this boosts the banks' interest in the sector. While loan products generally differ only slightly, competition provides benefits to farmers as banks strive to tailor their products to their clients' individual needs. Banks have dedicated agriculture finance teams that can provide clients with the specific type of finance product they require.

It is estimated that a financing gap of between EUR 95 million and EUR 217 million exists within the Czech agriculture sector. The gap mostly concerns small-sized farms (although large farms are not far behind) and long-term investments. **New financial instruments could help to close this financing gap**.

The ex-ante assessment for the introduction of financial instruments in RDP 2021-2027 concluded that a financing gap for Czech agriculture exists. The introduction of concessional loans (together with technical grants/mentoring) and guarantees can contribute to closing the financing gap. It also recommended supporting young farmers with a financial instrument combining technical support with subsidised interest rates for loans and the provision of start-up capital could be considered.

The financing gap comprises of two separate components:

- The first component consists of the estimated value of loan applications submitted in the past year by **viable farms, which were rejected by banks**, or which translated into loan offers refused by the applicants due to unacceptable lending conditions. Overall, 10% of loan applications are rejected in the Czech Republic, according to the *fi-compass* survey.
- The second component relates to the estimated value of loan applications that are **not submitted by farms considered viable, due to discouragement stemming from a fear of possible rejection**. Almost 7% of respondents to the *fi-compass* survey did not apply for a loan in 2017 because they were afraid of being rejected by banks.

Farmers believe banks are reluctant to lend to them due to a **lack of credit history**, which is something that affects younger farmers in particular, and due to the **credit policies of the banks.** Given the increasing number of non-performing loans, banks are strictly following their policies concerning borrower's liquidity, profitability and indebtedness indicators. They place an importance on credit history, which is something that many farmers, and small-sized farms in particular, often lack.

Banks have also pointed out that a number of the potential investments presented by farmers have been assessed as being economically unviable and, thus, could not be financed. In addition, the inability of farmers to prepare convincing business plans, as well as a general lack of knowledge, were also mentioned.

The **supply side is constrained by an increasing level of risk aversion in lending**. To avoid non-performing loans, banks are more conservative and have exposure limits for specific sub-sectors and regions. Hence, banks may not fund additional clients from a specific sub-sector or geographic location. In addition, banks are particularly reluctant to finance young farmers.

Young farmers are significantly constrained in accessing finance. Beyond the constraints outlined above, young farmers also lack sufficient levels of collateral to secure a loan (in addition to lacking credit history). For investment loans specifically, banks require fixed assets of high value as collateral and many young farmers cannot provide such assets to the banks. They also cannot compensate (or partly compensate) for the absence of collateral. That is why many banks are reluctant to finance this specific client segment.

RECOMMENDATIONS

Based on the analysis conducted for this report, and on the basis of information gathered among stakeholders, the following recommendations for public intervention could be considered:

- While guarantee instruments exist in the Czech Republic, they are not currently available to all farmers. Thus, guarantee instruments that could also be supported under the CAP Strategic Plan in the new programming period 2021-2027, and for which the vast majority of Czech farmers would be potentially eligible, might facilitate the flow of investment financing in the event of limited collateral. This would be particularly important for young farmers.
- Small-sized farms and young farmers should be among the main target groups of any new initiative. The opportunities offered by the new legal framework, such as the easier combination of financial instruments and grant support or the possibility to finance the purchase of land for young farmers, might offer interesting opportunities to increase the effectiveness of the instrument towards those segments.
- Even though banks offer different loan products to farmers, additional low interest working capital loans could help farmers to overcome temporary difficulties caused by climate change events/disasters, with such loans being made available immediately after a disaster occurs. In this context, the new flexibility on working capital introduced for financial instruments under the EAFRD legislation post-2020 proposal should be evaluated.
- Some small-sized farms and new entrants, find it difficult to prepare a business plan for new investments. Although main banks servicing the sector have specialised teams closely supporting the farmers applying for loans, a technical support and capacity building measures for those farmers could be considered to strengthen their ability to present convincing investment proposals and to thus receive a loan. Those measures could also support farmers in better understanding the entire loan process and the need for documentation. They could also be supported in providing such documentation.

Financing gap for the agri-food sector in Czech Republic

Investments in the Czech agri-food sector have increased in recent years. The Gross Fixed Capital Formation (GFCF) in both food and beverage manufacturing has been growing, with the GFCF of food products reaching its highest value in a decade. Since 2016, GFCF in the beverage industry has also been growing, as has the Gross Value Added. These indicators suggest a positive environment for investment.

The main **drivers of the demand for finance in the agri-food sector** are:

- **Investments in the modernisation of facilities and in technology**. The international agri-food industry is very competitive and, in order to maintain a competitive edge and consumer appeal, Czech agri-food enterprises need to invest in technology and automation. Technology that facilitates the use of renewable energies and the efficient use of resources, while also contributing to increased productivity, has been a large part of investments.
- **Renovation or construction of facilities**. Many agri-food enterprises invested in the construction and improvement of buildings, mobile or equipment stores, and storage facilities.
- **Inventory and working capital needs.** Czech agri-food enterprises experienced increases in production costs that were not followed by similar increases in the sale price of their products. The shrinking margins required many agri-food enterprises to borrow for working capital purposes.

RDP investment support for marketing and processing also shapes investment trends in the agri-food sector. In the Czech Republic, many agri-food enterprises rely on the support of the RDP and national subsidy schemes to invest.

The supply of finance in the agri-food sector is predominantly provided by banks. There is no particular specialisation of financial intermediaries in the agri-food sector, but the banks have sufficient experience and knowledge of the sector and are geographically well-organised. The banking market is fairly competitive, which allows a diverse range of products to be offered that cater to most individual needs.

Alongside banks, two institutions have a special place in the market, with both having been established by the Czech government to serve as providers of national subsidy schemes and guarantee instruments. Similar to the importance of PGRLF services in support of the agriculture sector, as regards the agri-food sector, the Czech Moravian Guarantee and Development Bank (CMGDB) plays an important role as a provider of guarantee instruments.

It is estimated that a financing gap of around EUR 578 million exists within the Czech agri-food sector. Around 75% of the gap value relates to small-sized enterprises. In terms of financial products, almost 40% of the gap relates to long-term loans and 20% to short-term loans. The need for credit lines and overdrafts accounts for around 20% of the gap. Like for the agriculture sector, **new financial instruments could help to close the financing gap.** Respondents to the Agri-food survey indicated that they would like to see more public guarantees.

About 25% of loan applications from Czech agri-food enterprises are rejected by banks. The main reasons for rejection are business risk that is too high, insufficient collateral, incompatibility between the repayment schedule and the enterprises' cash flow, unconvincing business plans and a lack of financial literacy. Another significant reason for rejection is when applicants are start-ups, as they often cannot provide adequate levels of collateral and lack credit history.

Overall, Czech agri-food enterprises show a good level of information in connection with financing their business and investing in assets.

While the supply of finance to the agri-food sector is reasonably healthy in the Czech Republic, and largely addresses the differentiated needs of the various actors in the sector, a challenge for the banks is that the monetary policy of the Czech National Bank has tightened, resulting in higher interest rates. In addition, agri-food enterprises tend to pursue investments that do not generate levels of cash flow needed to repay loans.

RECOMMENDATIONS

Cooperation between banks and agri-food enterprises works reasonably well. Loan products are available and their scale and focus varies. Still, the following recommendations should be considered, with the aim of closing the financing gap in the agri-food sector:

- Despite the diverse offering of public support, a significant gap has been identified on the market, with relation to small-scale enterprises and start-ups. This suggests that an assessment of the current instruments and their ability to address financial constraints of those target groups might be useful.
- In particular, the current provision of public guarantees seems to lack specific focus on the agri-food sector and covers mostly short-term loans. A specific guarantee or risk-sharing instrument for the sector might help to address lack of collateral for investment loans in the sector. This would operate in synergy with the instrument suggested for the agriculture sector. The opportunities offered by the new EAFRD legal framework, as for example the possibility of an easier combination of financial instruments and grant support might offer the possibility to better serve in particular small-scale enterprises and start-ups.
- The possibility to set-up a pilot equity or quasi-equity financial instrument, to support start-ups with innovative projects might be analysed.