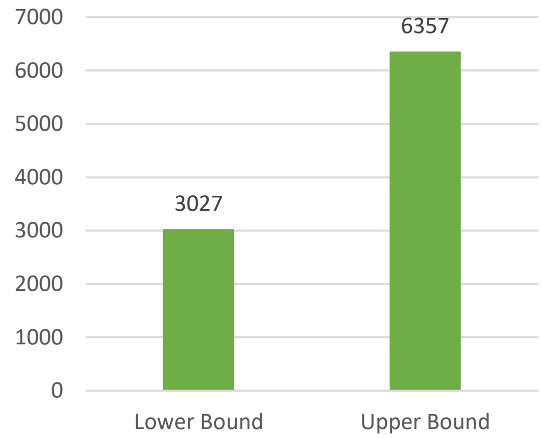
Financial needs in the agriculture and agri-food sectors in Spain

June 2020

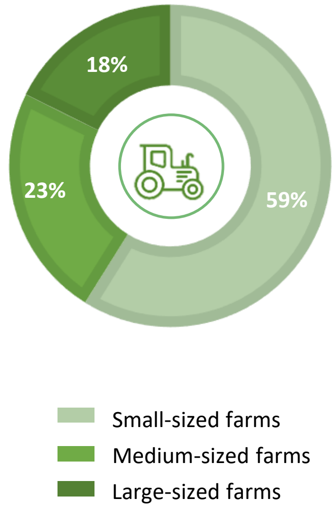
SPAIN

FINANCING GAP IN THE AGRICULTURE SECTOR

FINANCING GAP IN THE AGRICULTURE SECTOR (EUR MILLION)

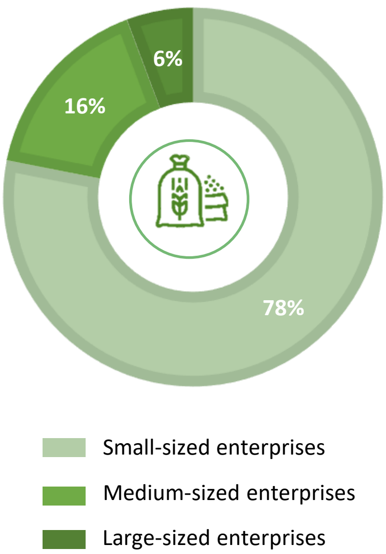


BY FARM SIZE

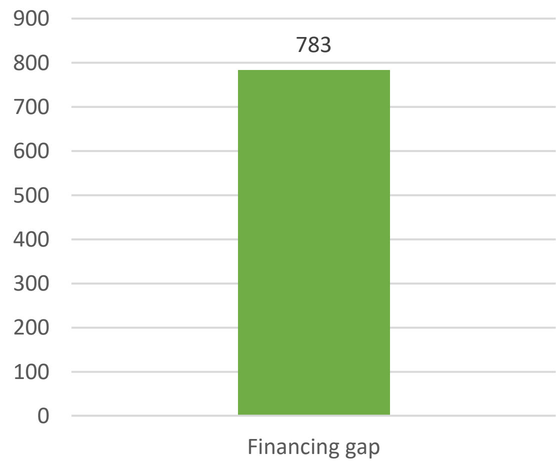


FINANCING GAP IN THE AGRI-FOOD SECTOR

BY ENTERPRISE SIZE



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



Source: *fi-compass* 2020

EXECUTIVE SUMMARY

This study gives an insight into agriculture and agri-food financing in Spain 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. These were the *fi-compass* survey on financial needs and access to finance of EU agricultural 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 Spain

The Spanish farmers' demand for finance, and the credit supplied to the agriculture sector has grown significantly since 2014. According to the *fi-compass* survey results, more than 70% of Spanish farmers applied for finance in 2017, which is substantially higher than the EU 24 average of 30%. At the end of 2018, the credit balance (total outstanding loan volume) to the primary agriculture sector was EUR 20.4 billion, which is an increase of 5.9% since 2017, compared to a decrease of 7.3% for all economic activities.

This positive development takes place in the context of a dynamic sector, which has been growing over the last few years mostly thanks to export performance. The agriculture output increased by 15.4% between 2014 and 2017. **The analysis highlights the following investment drivers**, which generate demand for finance:

- **Improvement of productivity:** Agricultural producers are investing in order to increase their efficiency of production. Low profit margins drive the need for more cost-efficient production. Investments concern the acquisition of new machinery, equipment and facilities, as well as investments in irrigation systems.
- **Expansion of production**: Agricultural producers also invest in land, including improvements in soil quality such as orchards and vineyards, and the purchase of additional land, as well as in increased capacities, such as the plantation of new trees (olive trees, fruit trees), new greenhouses and new facilities for pork farming.
- Although the growth in the demand for finance is mainly driven by investments in physical assets, **the need for working capital has also significantly contributed to the credit growth over the last years**. Between 2016 and 2018, the amount of working capital for the sector has increased at an average annual rate above 10%. This increase is mainly explained by the need to cover the increase of production costs (e.g. increasing costs of electricity, fuel, and feed for livestock).

The existence of CAP payments is generally considered to support farmers' activities and investments as well facilitating their access to credit as it improves farmers repayment capacity of loans, and/or provides a form of guarantee to the banks. The track records of payments received from the CAP, as well as payment entitlements held, are used by banks as collateral for the farmers' loan applications. For investments in fixed assets, CAP aid is counted by the banks as part of the farmer's ability to generate resources. Moreover, CAP payments are of particularly high relevance to young farmers, as they can contribute to reduce the entry barriers to the sector, in particular for new entrants without land or an inherited family farm, or credit history, by providing a form of guarantee to the banks.

- The EAFRD implementation in 2014-2019 shows that the investment demand by farmers significantly overtakes the available grant budgets. By the end of 2019, farmers had requested grants of a total amount of more than EUR 3.2 billion for on-farm investments and start-up activities of young farmers, of which EUR 1.5 billion was beyond what the regional RDPs' budgets could offer, indicating a significant unmet demand for financing.

- At the same time, access to finance seems to be a decreasing problem for the agriculture sector, for all activities besides these considered as being 'entrepreneurial', as evidenced by the lending provided by the public credit institute, Instituto de Crédito Oficial, ICO, to the agriculture sector.

The study shows that financial instruments can be beneficial to the agriculture sector in Spain, as the market gap is estimated to be between EUR 3 billion and 6.4 billion. The financing gap mainly concerns small-sized farms (below 20 hectares (ha)), which is by far, the most common farm size category in Spain[1]. Most difficulties relate to the access to long-term loans. The existence of a gap should not necessarily be understood as a result of a dysfunctional market. In the case of Spain, it is likely to be due to a potential for further expansion, considering the growth of the agriculture sector and the positive attitude towards investment shown in recent years. Financial instruments could help the financial sector keep up with the growing demand for finance due to a high investment appetite of the sector.

The drivers of the financing gap can be identified from the following factors:

- **The lack of collateral** due to the small-sized farm size and the fragmentation of Spanish agricultural enterprises. This is a problem for all farms, but particularly for new entrants and young farmers without prior experience and family relationships in the sector to support them, and often with poor access to land. As the effects of the financial crisis are still lingering in the banking system, the Spanish financial institutions give strong importance to the availability of guarantees and the solvency of borrowers. Additionally, the ex-ante assessment[2] undertaken for Spain found that the financial institutions required higher guarantees for providing loans to the agriculture sector than to other economic sectors. This problem was found to be particularly significant for young farmers and new entrants.
- **The lack of credit history**, which particularly impacts new entrants. Banks' risk appetite to finance new investments may still be bound by the consequences of the financial crisis.
- **The lack of adequate business plans and an insufficient level of farmers' knowledge on financing may also be a problem,** especially the lack of knowledge related to business management and finance. Occasionally, the lack of professional training is also an obstacle for obtaining finance.

Other explanatory factors, albeit probably of a more limited relevance for the overall financing gap, is the **banking policy capping the amount to lend per sector, the lack of water rights by the potential borrower, and financial exclusion**, i.e. the unavailability of financial providers operating in rural areas.

Young farmers might represent approximately 35% of the overall gap. Between 55% and 76% of the rejected and viable loan applications (rejection rate varies with the maturity of the loan) came from applicants below 40 years of age. Similarly, between 20% and 24% of the discouraged applications came from young farmers. Using this information to provide a different breakdown of farms with constrained access to finance, the financing gap for young farmers is estimated to be between EUR 1.3 billion and EUR 2 billion. Several interviewees pointed out that there is a perceived problem of access to finance for young farmers who enter farming without land.

The Spanish agricultural finance market offers a varied and extensive supply of finance. Multiple actors play an active role. These include private banks, Cajas rurales (rural cooperative banks), credit sections of agriculture cooperatives, and the Instituto de Crédito Oficial (ICO), a public agency with a large network of branches. The offer of financial products in Spain is extensive, there are several types of loans with different terms and purposes, these are investment loans, working capital loans and liquidity loans. ICO offers subsidised loans to finance investment operations and to increase the liquidity of companies.

Since 2017, a centralised **financial instrument,** co-ordinated by the National Ministry of Agriculture and **funded through the European Agricultural Fund for Rural Development (EAFRD), is available in Spain.** It provides preferential loans with a public guarantee, which is financed through the EAFRD, for the agriculture,

1 The *fi-compass* survey, on which the estimations are based, divided farms in three size categories: small-sized farms (below 20 hectares), medium-sized farms (20-100 hectares), large-sized farms (>100 hectares).
2020.

2 MAPA, 2016, Evaluación ex ante de un nuevo Instrumento financiero plurirregional para los fondos FEADER 2014-

agri-food and forestry sectors. Its implementation was motivated by the higher levels of collateral required for the agriculture sector. So far Castilla y León and Extremadura (as of 2020) have included the use of the centralised financial instrument in their RDPs and the RDP of Galicia is currently being amended. It is up to the regions to decide on the targeted sectors and final recipients, the financial product (loans or guarantees), as well as budget, etc. Other regions, which have completed an ex-ante assessment of a financial instrument, and which may make use of this financial instrument are Castilla La Mancha, Asturias, Murcia, Madrid and Aragón.

RECOMMENDATIONS

The following recommendation could be considered to improve the offer of financial instruments supporting the agriculture sector:

- The main constraints to access credit relate to risk management and asymmetrical information (lack of collateral and lack of credit history). These elements are the focus of the recently set-up guarantee financial instrument to support the sector. Considering the high level of liquidity and the low interest rates in the market, for potential new instruments, guarantee instruments should be preferred over loan instruments.
- Efforts could be focused on facilitating access to finance for small-sized farms and young farmers/new entrants. A potential focus on small-sized farms should not lose sight of the fact that there is an ongoing consolidation process, whereby the development towards large-sized farms continues.
- Considering the high share of farmers requesting finance from private individuals, a specific instrument for micro-finance (under the EAFRD) might be considered.
- Additional assessments of needs at regional level are needed to ensure a greater outreach of any new centralised financial instrument supported by the EAFRD. The new post-2020 legal basis will allow the set-up of diverse schemes that can benefit the aforementioned target groups (young farmers, start-ups, small-sized farms). These could cover working capital finance, counter-guarantees, combinations between financial instruments, grants and/or interest rate subsidies, including through a single operation.
- To further enrich the knowledge on the potential from using EAFRD financial instruments, analyses on the usefulness of equity funding for specific sub-sectors could be undertaken, in particular areas where digitisation and innovation are growing alongside green investment finance.
- Financial exclusion is a growing problem affecting rural areas where there is a risk of depopulation. Promoting banking activity and presence in the most remote rural areas could be one of the objectives of the financial instruments.
- Since lack of knowledge and financial literacy amongst farmers seems to be a major constraint, financial instruments could be combined or complemented by training in business management and finance for farmers, including help with the completion of loan application forms, creation of business plans etc., especially in view of the trend towards larger, more professional farms.
- Given that access to land is complicated in some territories due to its fragmentation, it may be relevant, within the framework allowed by the EU legislation, to allow land purchase and land renting as eligible actions within the focus of financial instruments.
- Spain is going to be one of the countries hardest hit by climate change, and the rain fed production is likely to suffer high rates of abandonment. Spain's agriculture future depends on irrigation, but it will only be sustainable with the following production conditions; extension, efficiency and the improved use of technologies, which will require strong investments in the transformation of current irrigation systems. This needs to be taken into consideration when developing tools to further facilitate access to finance.

Financing gap for the agri-food sector in Spain

The investment dynamic is also positive for the agri-food sector in Spain. In 2018, 64% of Spanish agri-food firms applied for loans, the highest share of all EU 24 countries, and 18% higher than the EU 24 average. Export growth is the main dynamic behind the increase of demand for finance. The analysis identifies the following investment drivers of the Spanish agri-food sector:

(i) **Modernisation and expansion of production capacity**: The Spanish agri-food sector borrowed mainly to invest in the expansion of fixed assets and in working capital and inventories.

(ii) **Product development and training of employees**: According to the study results, 22% of the applicants for credit did so for the purpose of developing new products, and 10% for the purpose of hiring and training employees, figures that are substantially higher than the EU 24 average.

CAP, and in particular the EAFRD support, plays a positive role for the sector. In this context, the sector-specific sub-measure in the RDP, which is programmed by all Spanish regions, is key. For the period 2014-2019, in total EUR 1.2 billion were paid out under the calls for applications. A total financial demand of at least EUR 2.4 billion has been registered under the sub-measure, of which at least EUR 1.2 billion has not been satisfied.

The total amount of credit provided to the agri-food sector is growing steadily, similarly for the agriculture sector, and contrary to the rest of the economy. Overall, this indicates a positive attitude of the banking system towards the agri-food sector, which was confirmed by interviews conducted with banks for this study. In addition, the sector's share of non-performing loans is lower than that for the overall economy. **On 31 December 2018, the total outstanding loan volume in the Spanish agri-food sector was EUR 22.7 billion.**

However, based on the analysis, a financing gap has been identified and estimated to be EUR 783 million. Most of this gap is concentrated within small-sized companies [4] of approximately EUR 612 million. In terms of financial products, as for the agriculture sector, the largest financing gap relates to long-term loans, followed by medium-term loans.

The general drivers of the financing gap for the agri-food sector in Spain are related to the following:

- **Lack of collateral:** Based on interviews with stakeholders from the sector, the smallest companies (ten or less employees) have more difficulties obtaining sufficient guarantees and therefore are the most discouraged from applying for finance.
- **Bureaucratic application processes:** Difficulties encountered when complying with the information requirements requested by banks is highlighted as an obstacle, again, mainly for the smallest enterprises, and also due to lack of knowledge and insufficient financial literacy.
- **Lack of credit history**: This can also be considered an important driver particularly affecting young entrepreneurs and start-ups. Banks commented during the interviews that start-ups might be too risky for the banking sector, and that equity instruments might be more useful to promote their development.

In addition, it was further pointed out during interviews with representatives from the agri-food sector, that the **supply of credit for Research and Development (R&D) by the agri-food sector is inadequate**, and associated with high risks, which can be linked to the lack of knowledge from the supply side on those specific investments, in combination with banks being risk avert.

Besides the traditional banks, there is a growing network of business nurseries, accelerators and business incubators providing finance to the agri-food sector. They provide various forms of assistance to support business projects in their earliest stages, such as training, advice, seed and venture capital and helping to find capital. **Public support is also provided for the agri-food sector by the public agency ICO**, and since

3 The survey divided companies into small-sized companies (< 50 employees), medium-sized companies (50-250 employees), and large-sized companies (> 250 employees).

2017, a **financial instrument funded through the EAFRD is also available** as explained above for the agriculture sector.

RECOMMENDATIONS

Based on the findings of this report, the following recommendations could be considered to improve the agri-food sector's access to finance:

- High risk investments, for example those related to investments in R&D, face difficulties in accessing finance. For these investments, the products offered by banks are not well fitted. It is possible that a targeted guarantee policy for this type of activities would contribute to the continued growth of the sector. Furthermore, in order to facilitate investments in environmental sustainability by the agri-food sector, financial instruments facilitating this would be useful.
- Financial instruments could focus in particular on young entrepreneurs and start-ups, which are the groups affected the most by the current financing constraints.
- Equity or quasi-equity financial instruments, (e.g. convertible loans) might help with addressing the financing constraints affecting start-ups and new entrants in general. Because of this, efforts could be made to explore the possibilities for setting up specific and focused equity fund(s) for the agri-food sector, preferably at centralised level to allow economies of scale and ensure better coverage, based on current experience of business angles, equity investors, and backed-up by well-founded ex-ante assessments and analyses.
- Considering the role that exports plays for the development of the sector, it could be considered to improve the specific financial instruments offer, e.g. export credit insurance or export guarantee.
- In order to improve the agri-food sectors' access to finance, it would be useful to provide technical support for the smallest companies, with ten employees or less, in the design of business plans and fulfilment of paperwork relating to legal bank requirements.