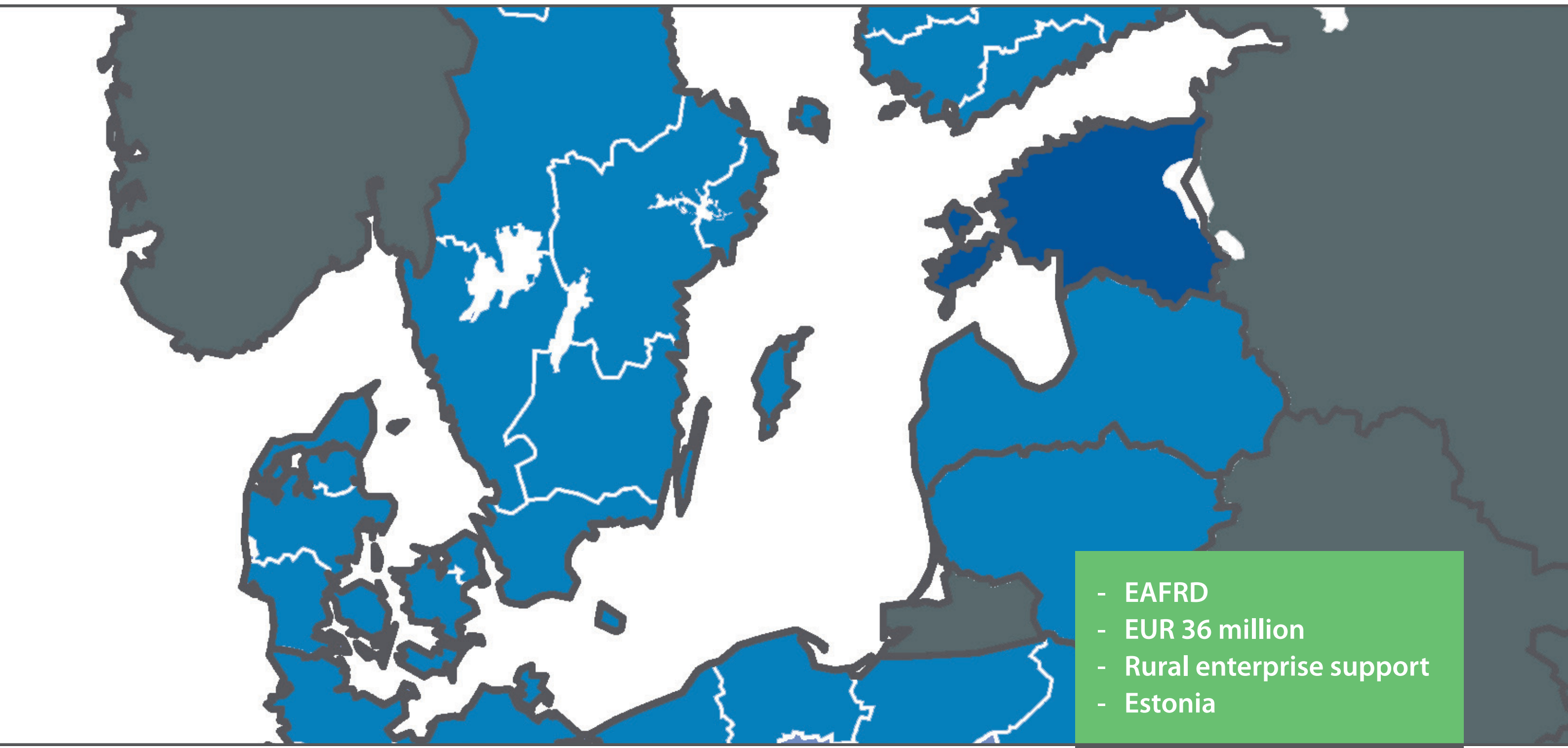


- EAFRD
- EUR 36 million
- Rural enterprise support
- Estonia

... supporting rural growth and investment through financial instruments ...

Loans for rural development 2014-2020, Estonia

Case Study

European Commission

European Investment Bank
The EU bank

DISCLAIMER

The authors of this study are a consortium of five companies: Sweco (lead), t33, University of Strathclyde – EPRC, infeurope and Spatial Foresight.

Abbreviations

Abbreviation	Full name
EAFRD	European Agricultural Fund for Rural Development
ECB	European Central Bank
EFF	European Fisheries Fund (2007–2013)
EMFF	European Maritime and Fisheries Fund (2014–2020)
EMoRA	Estonian Ministry of Rural Affairs
ESIF	European Structural and Investment Funds
MES	Maaelu Edendamise Sihtasutus (rural development foundation)
SME	Small and medium-sized enterprise

Table of contents

1 Summary

This case study reviews the implementation of the European Agricultural Fund for Rural Development (EAFRD) financial instrument 2014-2020, which provides loans to micro, small and medium-sized Estonian agricultural and rural enterprises. Allocating EUR 36 million from Estonian Rural Development Programme funds to this instrument should fill a market gap in financing for rural enterprises, as identified by the financial instrument ex-ante assessment. Their limited access to credit is due to unfavourable conditions provided by banks (high interest rates, short repayment periods, high collateral). Especially in sectors such as milk production, commercial banks are very reluctant to provide loans. Advantageous loans through the financial instrument under review are helping to generate investment in agricultural and rural development projects. For example, with a loan from the financial instrument farmer Ando Mägi (name changed for data protection purposes) could increase the capacity of his grain dryer and improve grain storage, keeping pace with his increased grain production (see Section 5).

This case study shows how access to funding can be encouraged using EAFRD co-funded loans as financial instruments that can be combined with grants, both under the same Rural Development Programme measures. Growth and investment loans are provided by the implementing body Maaelu Edendamise Sihtasutus (MES), the Estonian rural development foundation, at interest rates that are lower than the market rates, or for longer repayment periods than commercial loans. More importantly, EAFRD co-funded loans support growth and investment for agricultural and rural entrepreneurs, whose projects are considered as too risky by commercial banks. Special interest rates are provided to young farmers, producer groups and other groups such as start-ups, microenterprises, disabled people and women. Although the opening for applications was as recent as February 2016, demand from potential final recipients is high and 30 applications (EUR 6.5 million, 18% of allocated budget) had been approved by September 2016. An additional EUR 5.5 million of private co-investment has been attracted so far by the financial instrument.

Design and set-up of this financial instrument were challenging for the managing authority as there was no previous experience of EAFRD financial instruments in Estonia. Starting the ex-ante assessment with limited guidance material and using a state institution as implementing body were challenges which were overcome through clear governance and very close cooperation between the managing authority and the implementing body. Long-term and positive experience with similar instruments funded by the national budget, as well as European Fisheries Fund (EFF) investment loans during the 2007–2013 programming period, contributed to successful implementation. Designed specifically for the needs of agricultural and rural entrepreneurs, the financial instrument is well on track to help achieve priority and target area objectives of the Rural Development Programme.

Loans for rural development 2014-2020, Estonia

THE FINANCIAL INSTRUMENT

Funding source

EAFRD, Estonian Rural Development Programme 2014–2020

Type of financial products

Growth and investment loans
Guarantees for producer groups and young farmers (not opened yet)

Financial size

EUR 36 million Rural Development Programme resources (EUR 32.4 million EAFRD contribution, EUR 3.6 million national contribution)

Thematic focus

Investments in agricultural holdings (focus area 2A); investments in processing and marketing agricultural products (3A, 6A); investments in diversifying towards non-agricultural activity (5C, 6A)

Timing

From 2016 to 2023

Partners involved

Ministry of Rural Affairs (managing authority)
Rural development foundation (MES; implementing body)
Agricultural Registers and Information Board (paying agency)
Credit and financial institutions (co-investors)

ACHIEVEMENTS

Absorption rate

Applications received for 36%, with approvals for 18%, of the Rural Development Programme resources (EAFRD and national contribution) by September 2016

EU leverage[1]

2 times (as of September 2016)

Leverage of public resources[2]

1.8 times (as of September 2016)

Main achievements

As of September 2016:
46 applications received (26 growth and 20 investment loans, EUR 13.2 million)
30 applications approved (23 growth and 7 investment loans, EUR 6.5 million, of which EUR 5.85 million from EAFRD and EUR 0.65 million from national contribution)
EUR 5.5 million in private co-investment from banks (investment loans)
Most of the approved loans (19) target measure 4.1 'investments to improve the performance of agricultural enterprises'

1 EU leverage is calculated as the total amount of finance to eligible final recipients, i.e. EUR 12 million, divided by the total amount of EAFRD allocation to this financial instrument, i.e. EUR 5.85 million. It does not include the reuse of resources returned to the instrument.

2 Leverage of public resources is calculated as the total amount of finance to eligible final recipients, i.e. EUR 12 million, divided by the total amount of public resources allocated to the financial instrument, i.e. EUR 6.5 million. It does not include the reuse of resources returned to the instrument.

2 Objectives

As identified by the financial instrument's ex-ante assessment, commercial banks in Estonia are mostly engaged in relatively large-scale customers in business areas that are significant for the whole economy. This makes access to finance for micro, small and medium-sized enterprises (SMEs) in rural areas more difficult. Additionally, they often lack sufficient collateral and have unstable cash flows. Currently, serious economic difficulties in some sectors (milk and pig production) have dramatically increased risk and reduced the ability of Estonian farmers to obtain loans from banks.

Sub-optimal investment situations are most relevant for SMEs in agriculture, fisheries, food and beverage processing and other rural non-agricultural enterprises. Start-ups, including young farmers, and producer groups are especially facing difficulties to find funding.

In order to address the above-mentioned difficulties, a financial instrument has been set up for the Estonian Rural Development Programme 2014–2020 under measures M04 'investments in physical assets' and M06 'farm and business development', and specifically sub-measures M4.1 'investments in agricultural holdings', M4.2 'investments in processing and marketing agricultural products' and M6.4 'investments in creation and development of non-agricultural activities'.

The financial instrument contributes to priorities 2 'enhancing farm viability and competitiveness of all types of agriculture in all regions and promoting innovative farm technologies and the sustainable management of forests', 3 'promoting food chain organisation, including processing and marketing of agricultural products, animal welfare and risk management in agriculture', 5 'promoting resource efficiency and supporting the shift towards a low carbon and climate resilient economy in agriculture, food and forestry sectors' and 6 'promoting social inclusion, poverty reduction and economic development in rural areas'. More specifically, the financial instrument contributes to the focus areas 2A, 3A, 5C and 6A.

Financial products include **growth loans** for micro and small enterprises, **long-term investment loans** for SMEs and **guarantees** for young farmers and producer groups.[3]

When deciding to use financial instruments, the Estonian Ministry of Rural Affairs (EMoRA) considered the previous positive experience with financial instruments funded from the national budget. Implemented by MES, these provided loans, guarantees and interest/capital support for agricultural holdings, processors of agricultural products and SMEs in rural areas. EMoRA also had previous good experience with investment loans from the EFF, also implemented through MES.

3 Guarantees had not been implemented by October 2016.

3 Design and set-up

Estonia did not implement financial instruments through EAFRD during the programming period 2007–2013. However, national funds have been used to provide similar financial products to rural enterprises during the last 20 years.

The ex-ante assessment[4] was conducted from December 2013 to December 2014 and defined the financing gap. From September 2015 to January 2016 the implementing body was selected through a public procurement procedure. The funding agreement with MES was signed in January 2016 and EUR 36 million from the Rural Development Programme were made available for investments. The financial instrument was opened for applications in February 2016.

Time period	Action taken
October 2013 to November 2013	Public procurement for the selection of ex-ante assessor
December 2013 to December 2014	Ex-ante assessment
January 2015 to August 2015	Preliminary work on the implementation of the instrument and preliminary negotiations with the possible implementing body
September 2015 to January 2016	Selection of the implementing body
January 2016	Funding agreement signed
February 2016	Opening of applications
December 2023	End of the financing eligibility period

3.1 Ex-ante assessment

The external ex-ante assessor was selected through a public procurement procedure carried out by the managing authority between October and November 2013. The key requirements, as defined by EMoRA, included previous experience with evaluation of ESIF and qualified team members, including their previous experience with assessment of ESIF and auditing. The contract was awarded to Ernst & Young Baltic.

A common ex-ante assessment for EAFRD and EMFF was carried out by the assessor based on information available up to 18th June 2014.

The general content and requirements for the ex-ante assessment were set by the managing authority. The assessment included a web-survey and phone interviews with potential target groups. Earlier investment activities, market failures, future investment needs and the potential demand for financial instruments were analysed. Interviews with banks and other financial investors evaluated the supply of financing at the time. Previous results from surveys of non-agricultural rural enterprises were also taken into consideration.

The assessment was carried out in close collaboration with representatives of EMoRA and the

4 Ex-ante assessment report of financial instruments for 'Estonian Rural Development Programme 2014-2020' and 'European Maritime and Fisheries Fund (EMFF) 2014-2020 Operational Programme', Ernst & Young Baltic, 2014.

MES, who also agreed the methodological decisions and interpretations of the results.

The assessment concluded that about 60% of agriculture, fisheries, food and beverages enterprises as well as agricultural wholesalers and other non-agricultural rural enterprises had encountered problems with financing investments. These included limited investment support, short repayment periods for loans, high interest rates and low valuations of collateral. About 80% of the interviewed entrepreneurs were interested in financial instruments. Micro-financing was most often needed. Funding was mostly required for buildings, facilities, equipment, machinery and product development.

About 50% of the producer groups had encountered problems with financing for investments including a lack of collateral, high interest rates, high-risk rating and short repayment periods. Almost all surveyed producer groups (about 90%) were interested in financial instruments. Their investment requirements ranged mostly from EUR 100 000 to 500 000, but for some of them it was over EUR 5 million. Investments were mostly needed for fixed assets.

The ex-ante assessment suggested that an EAFRD co-funded financial instrument could help to modernise production, improve resource efficiency, and increase the competitiveness of the target groups. Thanks to leverage and revolving, the same budget could support more enterprises than grants. The ex-ante assessment estimated also that leverage of public funds could be as high as 3.5 times.

Off-the-shelf instruments, both SME risk-sharing loans and guarantees, were assessed as suitable for investment needs of agriculture, fisheries, food and beverage enterprises as well as agricultural wholesalers. However, taking into account all the pluses and minuses, in the end tailor-made financial instruments were selected, incorporating many elements of the off-the-shelf instruments in terms of governance and delivery.

In the context of the Rural Development Programme, the ex-ante assessment recommended the implementation of a financial instrument as a complement to non-refundable support (grants), rather than replacing it. In particular, the ex-ante assessment suggested that, if formulated to help beneficiaries of the grant to provide their own contribution, the financial instrument would likely increase the number of grant applicants and also the number of finalised projects, thus the performance of the relevant measures. The financial instrument was also seen as a way to extend the support available, since the budget for grants was limited.

The ex-ante assessment also analysed the interaction with other measures supporting the same objective, primarily under the Cohesion Fund. Such measures are implemented through the state foundations: Enterprise Estonia, KredEx and Environmental Investment Centre. KredEx, for example, provides state-backed guarantees, loans and venture capital. Finance provided by KredEx is suitable only for non-agricultural rural enterprises.

During the presentation of the draft final ex-ante assessment report in October 2014, the programme monitoring committee showed interest in the assessment conclusions. Most of the questions were related to technical aspects of the analysis e.g. whether target groups were analysed by sales revenue, or whether the microenterprises were analysed by the number of employees or by revenue.

The experience with the ex-ante assessment as a process showed how challenging it is for the managing authority because of the lack of previous experience with the implementation of EAFRD financial instruments and the lack of EAFRD-specific guidance material when the ex-ante assessment was started. Overall, the whole process took much longer than initially planned (about one year instead of three months). Further work was needed to verify whether some of the recommendations, e.g. those concerning the application of State aid rules, were compatible with the regulations. In addition the capacity of the implementing body suggested by the ex-ante assessment for the off-the-shelf schemes needed to be reviewed.

The managing authority was not fully satisfied with the ex-ante process, due to the difficulties mentioned above. However, it considered the assessment to be a good basis for making decisions on how to design and implement a financial instrument.[5]

3.2 Selection of the implementing body

The implementing body could be selected by means of a public procurement procedure, specifically through a negotiated procedure without prior publication of a contract notice, because the Government had transferred responsibility for (the administrative tasks of financial instrument) implementation from EMoRA to the foundation (MES) established by the Government.

MES was established by the Estonian Government in 1993 and its everyday tasks include providing loans, interest and capital support and guarantees to agricultural holdings, processors of agricultural products and SMEs in rural areas. So, financial instruments are very suitable within the overall activity of the organisation. MES also had experiences with financial instrument implementation from the EFF during the previous programming period. On this basis, the ex-ante assessment also recommended that the MES should be involved in the new financial instrument.

The whole selection process, from launch of the negotiated procedure to signing the funding agreement, took about four months, with no major delays. However, preliminary negotiations with the possible implementing body started already in January 2015, which facilitated the process.

The main challenge was to understand how the regulatory implementation options and the general rules on public procurement apply to MES, given its nature of public foundation. The definition of the methodology for the calculation of management costs and fees was as well quite complex as a process. The latter includes a base fee (% p.a. on payments from the programme budget), plus a performance-based fee (% of loans disbursed or % of guarantees issued). After 1st January 2024 there will only be a performance-based fee, on the same basis.

The funding agreement defines *inter alia* the budget for the financial instrument and specifies the financial products to be provided. Other appropriate products can also be added, if required during implementation.

According to the funding agreement, MES is responsible for processing for loan and guarantee applications, assessing the credit capability of applicants, issuing loans, as well as monitoring

5 A general description of the financial instrument was included in the Rural Development Programme in February 2015. As of October 2016, a programme amendment including a more precise description of the financial instrument is under preparation.

and evaluating implementation. The funding agreement gives the end of the eligibility period as 31st December 2023. Funds repaid, interest and other income (including fees for amending contracts) are reinvested through the financial instrument.

3.3 Funding and governance

The financial instrument is financed through the Rural Development Programme budget (EUR 32.4 million from EAFRD and EUR 3.6 million from national public contribution) with the following split by sub-measure:

Sub-measure	Amount
M4.1 'Investments to improve the performance of agricultural enterprises'	EUR 17 million
M4.2 'Investments to process and market agricultural products'	EUR 6 million
M6.4 'Investments in the diversification of economic activities towards non-agricultural activity in rural area'	EUR 13 million

MES, as implementing body, must consult the managing authority on general aspects of implementation.

The managing authority will establish a supervising committee consisting of members from EMoRA, MES and the paying agency. The committee will be responsible for reviewing progress and on-going evaluation reports, and other issues related to implementation, and recommending amendments in the funding agreement, if needed.

MES will provide an annual report analysing performance and financial aspects of the financial instrument, which the managing authority will present to the programme monitoring committee. MES will also report on expected pay-outs to the paying agency.

MES must evaluate implementation once a year, according to requirements in the ex-ante assessment, and submit the results to the managing authority.

MES has not marketed the financial instrument specifically, but promotes it together with other products offered and assists potential applicants. The managing authority has also not made any special promotion of the financial instrument products, but details of these were given alongside the corresponding Rural Development Programme investment grants during information days for target groups. Awareness of the financial instrument is good and potential applicants are familiar with different options and the requirements, due to the long track-record of MES in the sector. Most applications are submitted electronically, but can also be sent by post to MES office in Tallinn.

4 Implementation

The financial instrument was launched in February 2016. A credit committee established within MES is making all decisions concerning individual loans. MES exchanges information with the paying agency to keep records of maximum support rates and any cumulation of aid. MES will also exchange information with any bank regarding co-lending.

As of September 2016, only loans are provided. Guarantees for producer groups and young farmers are not open for applications yet.

4.1 Financial products and terms

As of October 2016, the financial instrument provides two different types of loans: growth loans, and long-term investment loans for SMEs, as detailed in the table below.

	Growth loan of micro and small enterprises	Long-term investment loan
4-year target	EUR 14.2 million	EUR 16.1 million
Target group	micro and small enterprises	SMEs
Amount of loan	EUR 5 000 – 100 000 direct loan or co-lending	EUR 250 000 – 1 000 000 (EUR 250 000 – 3 000 000 for producer groups) co-lending at least 50%
Duration	up to 5 years (+ up to 3 years' grace period)	1 to 15 years (+ up to 5 years' grace period)
Collateral	at least 50%	at least 80% (30% for producer groups)
Interest	6% + ECB refinancing rate (lower than the market)	market conditions (bank interest)
Other conditions	lower interest for start-ups and microenterprises, disabled people, women (4% + ECB); young farmers and producer groups (2% + ECB)	lower interest for start-ups and microenterprises, handicapped people, women (2% + ECB); young farmers and producer groups (1% + ECB)

Source: EMoRA

The conditions described in the table show the most favourable conditions but depend on the State aid and Regulation (EU) No. 1305/2013 rules applicable to a particular case. Applicants can still receive loans, but under normal market conditions.

Up to 30% of a loan can be used to finance working capital that is linked to a new investment. Financing of working capital must be convincingly justified and related to development or expansion activities. Existing loans cannot be re-financed.

A loan may be used to cover own contribution of the beneficiary to the relevant Rural Development Programme measures if the gross grant equivalent[6] of the grant and loan together does not exceed the maximum amounts established in Annex II of Regulation (EU) No. 1305/2013 or the grant ceiling set out in conditions of the respective measure. A financial instrument loan cannot pre-finance a grant.

6 Gross grant equivalent in a loan is the amount of the principal multiplied by the difference between the rate charged and the market rate that should have been charged, and discounted to the point in time that the loan is granted.

Advice related to the financial instrument is provided by MES from the overall budget of the organisation, no special budget is anticipated for these activities.

4.2 State aid

Support may include State aid or *de minimis* aid to the final recipient, depending on the type of investment. This particularly concerns investments under measures 6.4 (diversification) and 4.2 (processing), as loans can have an interest rate which is lower than the normal market interest rate and may require less collateral. For each loan the gross grant equivalent is calculated, irrespective of the type of investment, taking into account the risks of the project, including the value of collateral and the financial rating of final beneficiary, in compliance with State aid rules.

For operations falling outside the scope of Annex I of the Treaty, the financial instrument complies with the State aid and *de minimis* requirements of Regulation (EU) No. 1407/2013 and Regulation (EU) No. 651/2014.

This procedure involves an exchange of information with the paying agency, to check for any other support received by the final recipient.

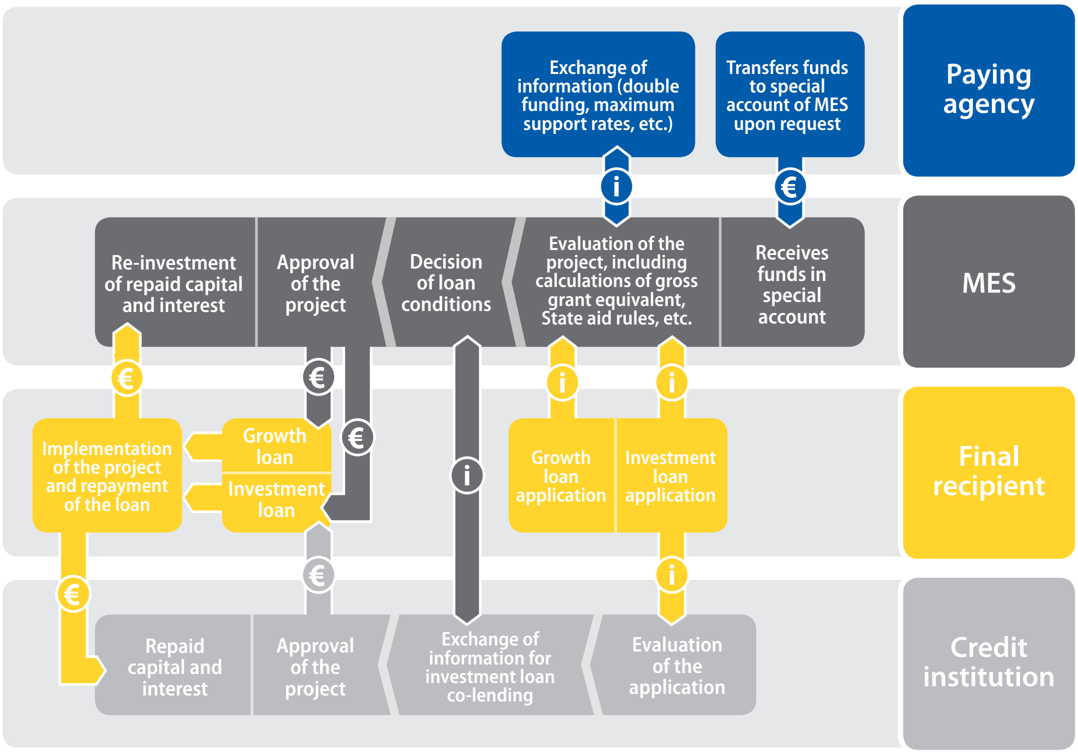
4.3 Financial flow and appraisal process

At first, MES submits a phased payment application to the paying agency which transfers the funds to a separate sub-account of MES in the state treasury.[7]

The applicant submits a loan application to MES and MES checks whether the applicant and the project meet the requirements set out in the funding agreement. MES consults with the paying agency to check for any double funding and ensure compliance with maximum support rates and State aid requirements.

7 The first payment to the financial instrument was made by the paying agency in February 2016 (EUR 7.6 million).

Figure 1: Financial flow and project appraisal



After that, the MES credit committee decides on the loan and pays out as agreed with the applicant. MES is responsible for verifying implementation of the project and takes all necessary steps to recover the finance if the applicant does not fulfil its obligations. The interest and repaid capital are reused in the financial instrument.

For an investment loan, where co-investment by a bank is required, the applicant takes the offer from a bank and MES proceeds with the loan application for the remaining part of the loan. Conditions and interest rates can differ between funding from the bank and MES. If the bank is not interested in co-lending, there is no loan from the financial instrument, but the enterprise can still apply for a grant under the Rural Development Programme measure.

5 Output

The first detailed information on output will be available in the yearly report to be published in 2017. Taking into account that the financial instrument is in its early phase of implementation, the following preliminary information, as of September 2016, could be provided:

- 46 submitted applications (EUR 13.2 million), 26 for growth loans (approx. EUR 2 million) and 20 for investment loans (approx. EUR 11 million);
- 30 approved applications (EUR 6.5 million, or 18% of the EUR 36 million allocation);
- 9.4% (EUR 3.4 million) of the whole budget disbursed;
- EUR 5.5 million private co-investment.

Most of the loans disbursed (19) are targeted to Rural Development Programme measure M4.1 'investments to improve the performance of agricultural enterprises'.

Grain farm supported by the financial instrument

Under the financial instrument, a growth loan has been provided to farmer Ando Mägi[8] to increase the capacity of its farm's grain dryer with equipment and facilities such as loading systems, grain silos and storage.

Approval given for photograph to be used in fi-compass publications

Total investment was approximately EUR 150 000. EUR 50 000 was provided by a Rural Development Programme grant for investments to improve the performance of agricultural enterprises, EUR 85 000 were covered by a financial instrument loan, and the remaining part from own funds. With this investment, farmer Ando Mägi could substantially improve the storage conditions for his grain and build a basis for increasing grain production from the current 300 hectares.

The loan from the financial instrument provided much better conditions, especially regarding collateral. Bank requirements for collateral were much stricter and without MES, Ando would not get a loan. Additionally, as a young farmer, Ando could benefit from a lower than the market interest rate through the financial instrument.

Although there were some difficulties with the application at first, as for example the forms were changed, the whole process was very well supported by MES and the project is about to finish soon.

8 Name changed for data protection purposes.

6 Lessons learned

Without any previous experience of EAFRD financial instruments and with very limited guidance available at the time (2013-2014), conducting the ex-ante assessment was challenging for the managing authority and the results did not fully meet initial expectations. However, it was a useful exercise, which provided new insights and a good basis for implementing the financial instrument.

The main challenge in selecting the implementing body was to understand how the regulatory implementation options and the general rules on public procurement applied to MES, given its status as a public state foundation. Nevertheless, there were no major delays before signing the funding agreement.

Proper organisation and the implementing body's previous experience with similar instruments was a very good starting point for setting-up and launching the financial instrument. In addition, MES and its services are well known and trusted by agricultural and rural entrepreneurs.

The first months of implementation already show that final recipients clearly need such an instrument. The conditions are generally suitable for agricultural and rural entrepreneurs helping to overcome the existing market gap and enabling them to make needed investments.

Both the managing authority and the implementing body very much welcome changes by the proposed 'Omnibus Regulation', which aims to simplify the rules of financial instruments. The managing authority believes that the flexibility of financial instruments is increased substantially if the only condition for the use of loan funds is that they improve the performance of the enterprise.

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