Assessment of the SME Sector in Malawi in Preparation for a Development Credit Authority Loan Portfolio Guarantee

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ABBREVIATIONS AND ACRONYMS

ADB	African Development Bank
BAM	Bankers Association of Malawi
BAAC	Business Action Against Corruption
CAMAL	Coffee Association of Malawi
COMESA	Community of East and Southern Africa
DCA	Development Credit Authority
DEMAT	Development of Malawian Enterprise Trust
EDEP	Enterprise Development and Employment Generation Programme
EU	European Union
FDI	Foreign Direct Investment
FSJTF	Food Security Joint Task Force (in the Ministry of Agriculture)
GDP	Gross Domestic Product
GoM	Government of Malawi
GTPA	Grain Traders and Processors Association
IAS	International Accounting Standards
IDAF	Institutional Development across the Agri-Food Sector
IFC	International Finance Corporation
ICA	Investment Climate Assessment
ICoA	International Coffee Agreement
ICO	International Coffee Organisation
JICA	Japan International Cooperation Agency
KfW	KfW Bankengruppe
LPG	Loan Portfolio Guarantee
MBG	Milk Bulking Groups
MBS	Malawi Bureau of Standards
MCCCI	Malawi Confederated Chambers of Commerce and Industry
MEDI	Malawi Entrepreneurship Development Institute
MEPC	Malawi Export Promotion Council
MEGS	Malawi Economic Growth Strategy
MES	Medium Enterprise Survey
MGDS	Malawi Growth and Development Strategy
MIPA	Malawi Investment Promotion Agency
MITC	Malawi Investment and Trade Centre
MITPSD	Ministry of Industry, Trade and Private Sector Development

MK	Malawi Kwacha
MRA	Malawi Revenue Authority
MRDI	Multilateral Debt Relief Initiative
MSE	Micro and Small Enterprise/s
MSME	Micro, Small & Medium Enterprise/s
NBFIs	Non-Bank Financial Institutions
NPL	Non-Performing Loans
RATES	Regional Agricultural Trade Expansion Support
RBM	Reserve Bank of Malawi
RUTF	Ready to Use Therapeutic Foods
SADC	South African Development Community
SALES	Support to Agriculturally Linked Enterprises (Project)
SCFT	Mzuzu Smallholder Coffee Farmers Trust
SEDOM	Small Enterprise Development Organisation of Malawi
SHMPA	Shire Highlands Milk Producers Association
SME	Small & Medium Enterprise/s
T-Bills	Treasury Bills
UNDP	United Nations Development Program
USAID	U.S. Agency for International Development
VAT	Value-Added Tax
WRS	Warehouse Receipt Scheme

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SECTION I: INTRODUCTION AND BACKGROUND

A. Introduction

This assessment of the small and medium enterprise (SME) agribusiness sector in Malawi responds to the USAID/Malawi's interest in establishing a Development Credit Authority (DCA) Loan Portfolio Guarantee program. The report is based on secondary source information and in-country interviews. The final product will be incorporated into the DCA risk assessment of the program conducted by the Office of Development Credit.

The assessment analyzes relevant information on the targeted borrower group – agriculturally-linked SME – and its profile, creditworthiness, and needs. Despite the challenges of such a rapid assessment, data from several sources shows trends and can be triangulated with interviewee information to analyze key drivers of financial performance, factors that affect creditworthiness, and factors mitigating or exacerbating risk related to the debt repayment capacity of SMEs in Malawi. The information in this assessment was gathered from secondary sources (see Annex A, Bibliography) and interviews (see Annex B, Interviews). The conclusions and recommendations are drawn from these sources and the consultants' knowledge of Malawi and is offered to USAID in the structuring of the proposed DCA guarantee to better serve the intended market while reducing exposure risks.

B. Background

An outsider looking at Malawi today compared to even just three years ago might say that with a change in administration Malawi 'got religion'. Indeed, it is as if an old time tent revival passed through town, with the government's new administration preaching the gospel of moderation rather than over indulgence, of partnership and facilitation rather than domination and intervention. This period has witnessed a remarkable turnaround in Government of Malawi (GoM) finances and more recently a considerable improvement in macro-economic performance. But like anyone caught up in the moment, there is the temptation to backslide upon leaving the atmosphere of the tent. Similarly, the GoM has found it tempting at times to embrace the old ways – subsidizing agricultural inputs and setting floor prices on tobacco grades and cotton. With an election around the corner in 2009 and the Government in a minority – governing by its ability to pull opposition members to its agenda, point-by-point – the temptation to backslide will grow. Yet, the current administration has made real and considerable strides forward, efforts that donors have largely supported to date.

The USAID-funded Deepening Malawi's Microfinance Sector (DMS) Project operates, in this promising environment. The project name is a misnomer now, as DMS has spread its wings to encompass the broader finance sector. USAID, through DMS, completed an analysis of the possibilities for a DCA facility in August 2006. The report *Development Credit Authority Feasibility Assessment Increasing MSME Access to Private Sector Credit in Malawi* provides significant background to this borrower cohort report and proposes the basic structure of the proposed DCA Loan Portfolio Guarantee to enhance bank lending to agriculturally-linked SMEs – the targeted group.

The lack of credit from commercial banks to agriculturally-linked SMEs impedes this group's ability to develop and grow. However, the improving macro-economic environment has rekindled banks' interest in lending again beyond the comfort of Treasury Bills (T-Bills) and of a small and highly sought after corporate market. In this regard, a DCA Loan Portfolio Guarantee program is timely and, based on this analysis, will increase access to credit by SMEs for short, medium and long-term financing. Financing that will help these businesses to upgrade and increase on-farm production, increase purchases of local raw materials for processing, replace old machinery, and open opportunities in new markets, creating income through added value and export opportunities, further stimulating the economic revival occurring in Malawi right now.

SECTION II: INTRODUCTION AND BACKGROUND

A. Size & Structure of Economy

The Basics. Malawi is a low-income country in Central Southern Africa with a population of 12.17 million[1] of which over 60% is under 20 years old and 52.4% are below the official poverty line. The population growth rate is estimated at 2.1% for 1995-2003.[2]

Malawi is located in a relatively poor economic region, neighbored by Tanzania to the North, Zambia to the West and Mozambique to the West, South and East. Nearly 85% of the population lives in rural areas, with the remainder concentrated in the three urban centers of Lilongwe (Central Region), Blantyre (Southern Region) and Mzuzu (Northern Region). In 2005, Lilongwe was estimated to have a population of 660,000; Blantyre[3] 690,000 and Mzuzu in the North 130,000.[4] Lilongwe is the capital and seat for Government and much of the donor community. For historical reasons, the main business center including the banking sector is Blantyre though Malawi's largest business sector (tobacco) is headquartered in Lilongwe, closer to where the crop is predominantly grown.

Malawi is a relatively small country with a physical area of 118,480 square km, of which 24,400 (20.6%) is taken by Lakes. Lake Malawi is the largest Lake lying North-South and forming a natural border with Mozambique to the East.[5] The climate is sub-tropical, with one rainy season from November to April. Agriculture is the main livelihood source of the majority of the population and most agricultural production is rainfed, resulting in considerable vulnerability to drought, as witnessed in agricultural seasons 2003-4 and 2004-5. The main river is the Shire, running out of Lake Malawi to the South and feeding into the Zambezi River in Mozambique. Although vulnerable to drought, Malawi's climate, rainfall pattern, rivers and soils make it a potentially productive agricultural country.

Malawi has limited and mostly underdeveloped mineral resources including uranium, coal, heavy mineral sands and bauxite, with only coal and more recently mineral sands being mined commercially. However, approval has been given in 2007 for a major uranium-mining project that will contribute an additional 5-10% of Gross Domestic Product (GDP) from 2009. The only other significant natural resource is fish from Lake Malawi, some species of which are being rapidly depleted.

Transport Infrastructure. The main international airports are Lilongwe and Blantyre, with limited freight transport. The main roads between urban areas are paved and reasonably maintained, but most rural feeder roads are not paved resulting in poor access during the rainy season. Being landlocked, transport corridors are of particular importance as these link Malawi to the major ports of South East Africa. There are three important transport corridors to Durban (South Africa), via Mozambique and Zimbabwe, to Nacala and to Beira (both Mozambique) accounting for close to 60% of Malawi's export trade flows.[6] There is an operational railway line from Southern Malawi to Nacala, but the former route to Beira has not operated since the Mozambique civil war. Both are in need of investment to fully utilize their potential.

Both Nacala and Durban offer good deep-water ports, with Beira also used for trans-shipping to Durban to meet larger vessels. Durban functions well and is used for time critical imports and exports, but it is also the most expensive route. Nacala Port has recently been privatized to the company that

[1] 2005, Integrated Household Survey 2004-5.
[2] World Bank, World Development Indicators, 2004
[3] Including Limbe with which it is co-joined.
[4] National Statistical Office (NSO) – direct correspondence.
[5] Third largest in Africa.
[6] National Export Strategy, 2005

has the franchise for the Mozambique and Malawi railways. With planned donor and Governmental commitments to improve the Port and railways, this should result in improved times and lower cost haulage. There are also routes to the Tanzania and Kenyan Ports to the north but these are relatively underused due to the distances, except for tea, some of which is auctioned at Africa's largest tea auction in Mombassa, Kenya. Longer term, the GoM is keen to develop the Shire Zambezi Waterway that will provide barge transport to the Mozambique port of Chinde and from there to Beira.[7] High transport costs are considered to be one of the major inhibiting factors in the development of the economy by businesses.

Exhibit 1 Malawi Key Indicators 2006

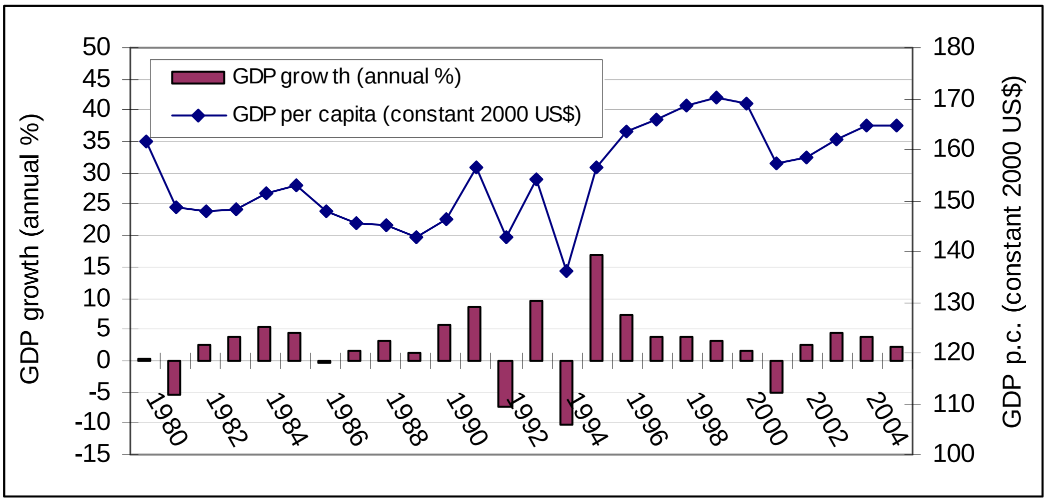
- Real GDP Growth: 8.5%
- GDP: US $2.1 billion
- GDP per Capita: $175
- Unemployment: N/A
- Inflation (Avg): 13.9%
- Gross Domestic Savings: 14.9% of GDP
- Gross Domestic Investment: 10.2% of GDP
- Exports and Imports: 71.6% of GDP (2005)
- Foreign Direct Investment Stock: 25% of GDP

Sources: Fitch Ratings, Reserve Bank of Malawi, Ministry of Economic Planning, Ministry of Finance, IMF, World Bank.

Size and structure of the economy. Malawi is a very poor country with GDP per capita in 2006 estimated at US$ 175/head. Per capita figures are difficult to obtain due to the lack of a recent population census[8], with estimates of the population ranging from 12.2m to 13.2m, but Malawi clearly falls into the low-income country and least developed country categories. Per capita income increased by an average of 0.8% in the period 1990-99 and due to slow economic growth in the 2000-04 period, it is estimated to have been static or marginally declining. As a result poverty rates have hardly changed over the last eight years, currently standing at 52.4% of the population. Only in 2005-06 has the high level of growth started to make a significantly positive impact on real GDP/capita.

Although Malawi's performance over the last two decades has been very poor with low growth, persistent fiscal deficits, high inflation, high interest rates and low savings and investment, there has been a significant change in its prospects since a new government was installed in mid 2004. The fiscal deficit has been significantly reduced to 2.2% of GDP (end FY 06), inflation has fallen to 8.6% (March 2007), growth in 2006 was the highest in the region at 8.5% and the Reserve Bank of Malawi (RBM) base rate has fallen from a peak of 45% to 20% with further falls expected by mid 2007. The GoM has also embarked on a series of modest taxation reform over the last two years and enabling reforms that are slowly beginning to have a positive impact. The pace of these reforms is expected to pick up over the coming year.

Exhibit 2 Malawi's GDP and GDP per Capita, 1980-2004



[7] There is talk of a corridor via Lake Malawi but it is not operating in any meaningful way. Nacala, Beira and Durban are the three that businesses want.
[8] Next survey is due in 2008.

Malawi is highly dependent on agriculture, with 84.5% of its population[9] recording farming as their main source of income. With very low levels of urbanization, the economy is still very dependent on weather conditions, and with only one rainy season (November to April) it is vulnerable to the impact of severe drought as occurred in 2003-04 and 2004-05 growing seasons. The latter had a significant impact on growth, inflation, trade balance and fiscal deficit as the GoM undertook to import significant amounts of maize, the main staple. Without these natural disasters, economic performance would have been considerably better in the period, though there has been a considerable rebound in 2005-06. With a good harvest in prospect for 2006-07, economic performance is likely to be good in the immediate future, though vulnerable to the vagaries of the weather.

The size of the economy and the private sector is relatively small, with a number of sectors dominating, particularly agriculture with 36-39% of GDP. Within agriculture, tobacco, tea and sugar represent close to 70% of the total exports,[10] though services particularly distribution (includes trading) are also significant at 21-23% of GDP. The trend for the last five years shows that there has been a decline in agriculture, mainly due to two successive poor harvests, with compensating increases in distribution/trading and more recently construction and mining. The latter has seen recent investments in mining heavy mineral sands and will see a dramatic increase in 2009 with the commencement of uranium mining. After declining rapidly from 17.7% of GDP in 1994, manufacturing has stabilized as a share of GDP at 11.5-12.0%.

Exhibit 3 Sector Share of GDP, 2002-6

Sector	2002 %	2003 %	2004 %	2005 %	2006 %
Agriculture	39.0	39.8	38.9	34.6	35.6
Small scale	*29.9*	*32.3*	*30.3*	*26.2*	*27.6*
Large scale	*9.2*	*7.5*	*8.6*	*8.3*	*8.0*
Mining and Quarrying	1.0	1.1	1.5	2.3	2.3
Manufacturing	11.3	11.2	11.4	12.0	11.7
Electricity and Water	1.4	1.4	1.5	1.6	1.5
Construction	2.4	2.6	2.8	3.1	3.2
Ownership of Dwellings	1.5	1.5	1.5	1.5	1.5
Services	43.4	42.4	42.5	45.1	44.2
Distribution	*21.9*	*21.0*	*21.3*	*23.5*	*23.3*
Transport and Communication	*5.0*	*5.2*	*5.3*	*5.7*	*5.5*
Financial and Professional Services	*8.5*	*8.6*	*9.0*	*9.5*	*9.0*
Private Social and Community Services	*2.2*	*2.2*	*2.2*	*2.2*	*2.1*
Producers of Government Services	*9.2*	*9.0*	*8.7*	*8.7*	*8.3*
Unallocable Finance Charges	*(3.4)*	*(3.6)*	*(4.0)*	*(4.6)*	*(4.1)*
GDP at Factor Cost	100.0	100.0	100.0	100.0	100.0

Source: RBM Economic and Financial Report 2006

One of the underlying problems for Malawi has been the low savings and investment rates, which stem in part from nearly five years of below inflation rate of return on short-term cash deposits, eroding the real value of any such deposits and making them unattractive to savers relative to other options. Gross national savings have been between 11-13% over the last five years, though the projection for 2006 shows a marginal improvement to 14.5%.[11]

Gross investment expenditure as a percent of GDP has remained in the 10-13% range for the last five years. Public investment, dropped from an average 14.9% in the 1990-99 period to 10-12.5% range in the last five years. This reflected the reduction in GoM expenditure and donor inflows for the public sector. Similarly private investment declined to a very low 2.4% of GDP in 2001 and has been less

[9] 1998 Population Census, GoM.
[10] Within that Tobacco is the most significant with between 50-60% of exports over the last 10 years.
[11] Reserve Bank of Malawi (RBM) Financial and Economic Review, Vol. 38 No. 4 2006

than 2% since 2002. The recent reduction in interest rates and expected further reductions in inflation should impact positively on private investment rates. However, the small domestic market, limited regional markets, and weak business-enabling environment, such as poorly performing utilities and poor infrastructure, mean private investment will continue to be constrained. It is also likely that most investment will come from the steady growth of existing investors who know Malawi and its opportunities, than from foreign direct investment. One exception is the uranium-mining project mentioned earlier accounting for a planned $134m of investment. Otherwise, the Malawi Investment Promotion Agency (MIPA) has facilitated Foreign Direct Investment (FDI) pledges of between $50-60m for the each of the last three years, excluding the uranium investment. This highlights the limited scale of new FDI coming into Malawi.

Currency. The currency is the Malawi Kwacha (MK), sub-divided into 100 Tambala. The exchange rate to the US$ is the most important rate and has been held steady in the MK 138-140 range since June 2006, but it has halved in value since 2001 when it was it was at $1: MK 72.[12] The currency is operated as a managed float, with partial liberalization of the external account. For much of the last five years the Kwacha has been overvalued resulting in a progressively deteriorating balance of trade with flat exports and increasing imports.[13]

Outside Influences: Malawi is a relatively open trading economy with the measure of trade openness at 71.6% of GDP, 2005.[14] Its main trading partners are South Africa, the European Union and the United States. It is a member of both the Southern Africa Development Community (SADC) and the Community of East and Southern Africa (COMESA). Due to the establishment of customs unions under both groupings, Malawi will very probably have to decide which grouping it will belong to within the next 12-18 months, which will have an important bearing on its future prospects.

Malawi is located in a relatively poor economic region, with economically poor neighbors as well as suffering from its land locked position with costly access to the ports. Transport costs are a significant factor making both exports and imports less competitive. This is due to many factors including the physical distances, the need to cross (multiple) borders, limited volumes, poor rail infrastructure, and highly seasonal imports and exports resulting in imbalances in the efficient use of vehicles. High duties on spare parts and fuel also add to the costs, as well as limited competitiveness in the transport sector.

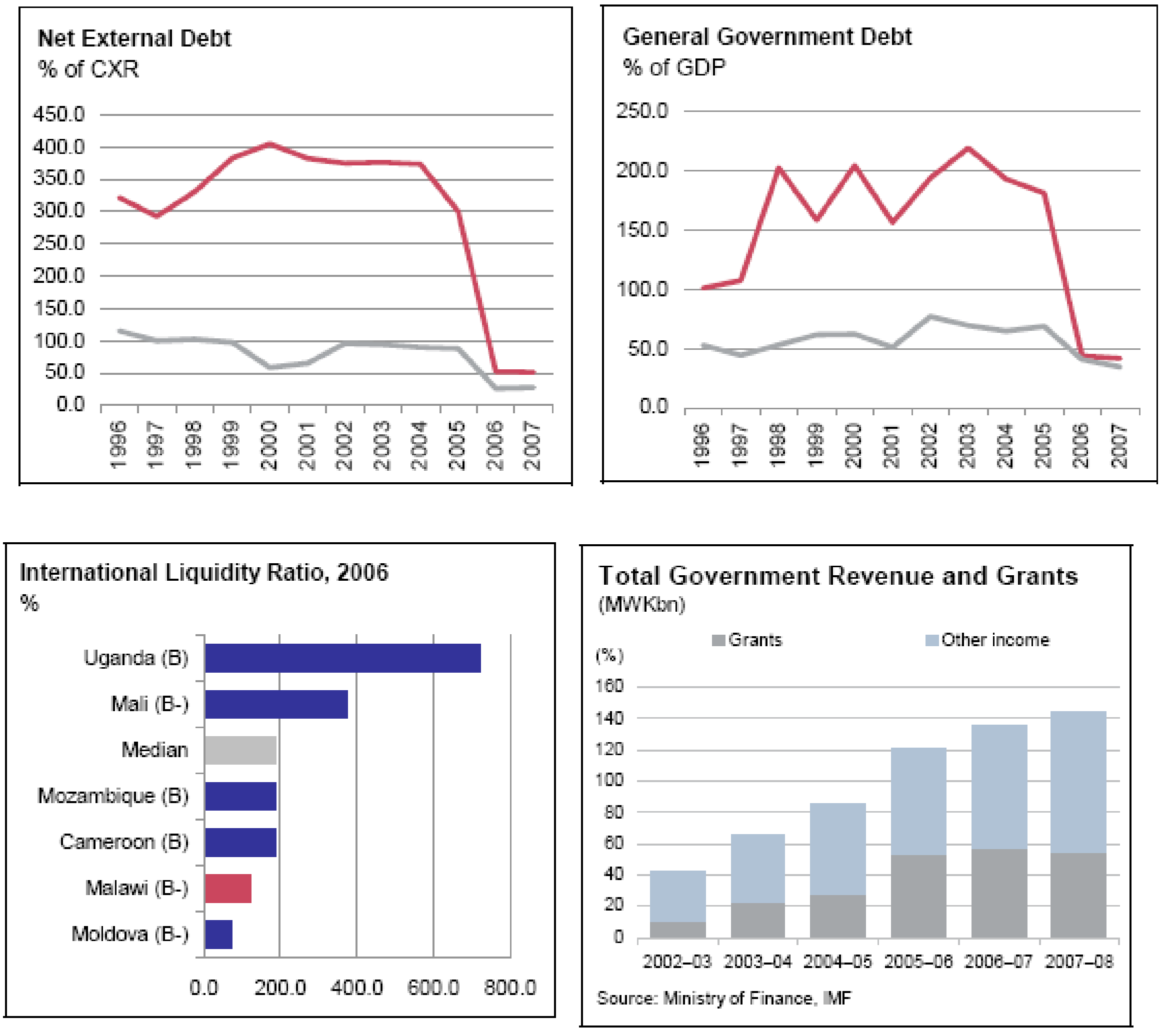
Because it is so heavily dependent on external development assistance, Malawi is subject to influence from its bi-lateral and multi-lateral development partners. Having gone 'off-track' with the IMF and therefore the rest of the donor community in 2002-04 and struggled hard to get back on-track in 2004-06, it is imperative that Malawi maintains its relations with its development partners.

Recent Progress: The most significant factor for Malawi has been the improvement in GoM's fiscal balance, from a peak of 12.5% in FY03 to 2.2% in FY06 and a projected to be 0.9% for FY07. Even if it is slightly higher as analysts expect, it is a remarkable turnaround through better control of expenditure, improved tax revenues and restoration of donor Budgetary support absent for much of the 2002-4 period due to poor fiscal management. Malawi finally qualified for debt forgiveness under the Multilateral Debt Relief Initiative (MRDI) in September 2006, enabling a reduction in its external interest payments by $110 million per year, saving around 5% of GDP. External debt servicing has now fallen to around $5m per year. The reduction in debt servicing has removed a major expenditure item from the Government's Budget allowing for allocation of resources to other priorities. For example, the government is investing more of its revenue on productive development capital expenditures, 13.4% in FY06 versus 7.9% in FY03. The reduction in debt servicing has also been an important factor in the improved credit ratings, including Fitch that announced a move from CCC to

[12] Stanbic Blueprint Malawi, January 2007.
[13] MCCCI and NASFAM budget submissions, 2006 and 2007.
[14] Consultant's calculations from IMF statistics.

B- in April 2007, with a forward outlook rated as "stable". Comparison information with Malawi's peer group from the Fitch Rating follows:

Exhibit 4 Government Performance, Selected Indicators



Source: Fitch Ratings.

Challenges: Malawi faces many challenges in its economic development and for growing the SME sector. The most significant has been achieving macro-economic stability as a platform for growth. For the last three years, the GoM has managed a considerable improvement in the Government finances that is now beginning to feed into growth of the economy and increased investment by existing domestic and foreign investors. The key challenges that remain are:

1. Continue improving the macro-economic performance, particularly bringing real interest rates down to levels that can support significant increases in investment thereby generating growth;
2. Providing macro-economic stability for the medium term, including over the period of the next election in 2009;
3. Improving the level of competitiveness in the banking sector, in particular reducing the spread between savings and lending rates;
4. Continuing the recent improvement in the performance of the utilities so that these support business growth;
5. Make the right decisions concerning its dual membership of SADC and COMESA, negotiation trade agreements and a customs union that supports Malawi's economic development;
6. Reduce the cost of domestic and international transportation;

7. Reduce agricultural vulnerability to weather (irrigation) and improve smallholder farmer productivity;
8. Continue tax reforms so that investors, particularly in agricultural production and processing, are sufficiently rewarded and the taxpayer base is significantly widened;
9. Accelerate the positive changes in the business-enabling environment to make trade flow faster.

As well as the economic-related challenges above, Malawi faces considerable social challenges, with over 52% of the population below the poverty line, an HIV and AIDS infection rate of 14.0% of the 15-49 age group,[15] poor education and health infrastructure and services, and weak governance in key institutions. The challenges are many and deeply entrenched. However, the GoM and key stakeholders have developed the Malawi Growth and Development Strategy (MGDS) that is being taken seriously by the Government and its development partners. This addresses both the economic and social challenges for the country, something that development partners have begun to support with new vigor. Central to this strategy is the desire to shift from a mainly consuming and importing nation to a producing and exporting one.

Malawi still has a significant domestic debt problem that was built up when the country went off track with the donors in 2002-04, reaching 25% of GDP and with interest payments accounting for 27.5% of GoM expenditure and 9.2% of GDP. However, the domestic debt was stabilized as a proportion of GDP and is now beginning to reduce in absolute and relative terms, with further savings on interest payments for the GoM. Net domestic debt is projected to be less than 15% of GDP in FY07.

Malawi has long had a poor trade balance, due to its weak production base and high dependency on imported capital goods, raw materials, agricultural inputs and consumer goods. In 1994 the exchange rate regime was liberalized but was immediately followed by the administrative fixing of the nominal rate from 1995 to mid-1998. This resulted in an appreciation build-up in the real effective exchange rate forcing a massive depreciation of 62% in 1998. Poor expenditure control has resulted in high inflation and pressure on the currency over the post 1998 period, with regular depreciation and devaluation.

The last five years has seen a progressive deterioration in this already weak position with the balance of goods and factor services falling from -18% in 2002 to -31% of GDP in 2006. This is due to the impact of two bad production years resulting in significant food imports and reduced production, the loss of donor budgetary support and a persistently over-valued exchange rate that resulted in regular foreign exchange shortages for private sector. Many of the imported goods have been for domestic consumption, which grew from 106.2% in 2002 to 122.6% in 2005, rather than for investment or production. However, with the restoration of donor budgetary support, better production (reduced food imports and increased export potential) and belated depreciation there is likely to be some improvement in the balance of trade.

B. Financial Sector and Credit Climate

B1. Private Financing Sector

At the beginning of 2004, Malawi's financial sector included 8 commercial banks, 2 discount houses, a building society, a savings bank and 2 leasing companies. Today, the sector has much the same look, though there are 9 commercial banks[16] (even with 57 branches and 64 agencies among the 9, banking services for most of Malawi's 12 million people remains difficult), 2 discount houses and 3 leasing companies, all subsidiaries of commercial banks. There is also a union of savings and credit cooperatives and numerous MFIs, five of which are profiled in the report *Development Credit*

[15] HIV and Syphilis sero-survey and national HIV prevalence estimates report, Ministry of Health and National Aids Commission, 2005 – 21.6% in urban and 12.1% in rural.
[16] First Merchant Bank, IndeBank, Loita, Malawi Savings Bank, National Bank of Malawi, NBS Bank, NED Bank, Opportunity International Bank of Malawi, and Stanbic. New Building Society converted to NBS Bank.

Authority Feasibility Assessment Increasing MSME Access to Private Sector Credit in Malawi. This assessment, dated August 2006, reported combined portfolio size of the five MFIs at nearly MK 395 million (or about US $2.8 million, at MK 140/US$) across 38,569 MFI loans (US $73/loan).

The Malawi Stock Exchange has 11 listings, though one new listing is expected by July of this year.[17] The Malawi All Shares Index closed 2006 at 2,123 versus 906 at the end of 2005. It was the fastest growing stock exchange (return) in Southern Africa, as investors that formerly invested in T-Bills seek better returns in the stock market. Market capitalization stood at MK 1,672 billion (US $11.9 bn) in December 2006 compared to MK 1,120 billion (US $8bn) at the end of 2005. While experiencing phenomenal growth, the exchange is not the place where SMEs will find capital.

However, the emergence of a nascent commodity exchange, Agricultural Commodity Exchange of Africa (ACE), through its price discovery mechanism and defined grades and standards, does enhance the possibility of establishing programs that could securitize commodities, such as a Warehouse Receipt Scheme (WRS) (see box). In the early 1990s, the exchange would not have been feasible, but with the relaxing of controls on the marketing of most agricultural commodities, liberalization of commodity marketing, and the emergence of agricultural industries the time is opportune. Integrity is critical to the success of any exchange and whether ACE will take root is uncertain, but its management team were instrumental in growing the Zimbabwe exchange that at its height, before government intervention, was an acknowledge powerhouse.

Trading Paper

A key factor in the success of ACE and a potential means for agricultural traders and processors to release capital will be the emergence of a warehouse receipt scheme (WRS). A WRS allows the depositor of agricultural produce to get a receipt that can be used to trade the certified product (through ACE or other means) or to borrow from commercial banks against it. There are several proposed WRSs in the pipeline, and it is expected that some donor-funded scheme will commence in the next 12 months, probably as a pilot.

B2. Banking Industry

The Players. The banking industry is heavily concentrated, with the two largest commercial banks – Stanbic[18] and National Bank of Malawi – controlling 58% of assets and 90% of bank credit in the economy[19] and with 26 branches and 12 agencies. Exhibit 5 categorizes the banks by size based on capital, as provided by the Bankers' Association of Malawi (BAM). Note, this is a notional classification, as the association did not have detailed capitalization figures.

Exhibit 5 Commercial Banks Defined by Assets

Classification	Commercial Banks
Large	National Bank, Stanbic
Medium	NBS Bank, First Merchant Bank
Small	IndeBank, Loita Bank, NED Bank, Malawi Savings Bank, Opportunity International Bank,

Source: Bankers Association of Malawi.

A commercial bank license requires a minimum of US $2 million in capital. By comparison, an exchange bureau requires US $100,000, though the GoM announced that all Forex Bureaus would have to close by 30th April 2007 unless they were under the ownership of a licensed bank.

[17] NBS Bank Ltd.
[18] A wholly owned subsidiary of South Africa's Standard Chartered.
[19] *Malawi Investment Climate Assessment*, Etude Economique Conseil, June 2006

Performance. Exhibit highlights key financial performance indicators for the banking sector. As an industry, the liquidity ratio hovered around 45% at the end of 2006[20], suggesting the appropriateness of a partial credit guarantee program that seeks to put some of this liquidity to productive use through loans that otherwise might not be extended without the guarantee.

Exhibit 6 Bank Financial Soundness Indicators	
Capital adequacy ratio (Fitch)	23.5%
NPL ratio (NPL to gross loans/leases)	5.0%
Loan-deposit ratio	62%
Net open foreign position to capital	19.5%
Interest margin / total income	13.7%
Non-interest expense / total income	52.6%

Source: Finch Ratings – Republic of Malawi, March 2007 and interview with Reserve Bank of Malawi

Corporate Governance. As reported by the BAM, all commercial banks have annual independent audits. Commercial banks are more attuned to the need for high governance standards than many other sectors of the economy. The RBM has issued certain governance directives to the banking industry, including directives regarding:[21]

- New directors, audit committee members, and senior management officials. Among other points, all must be approved by the RBM in writing and one person cannot be a director of more than one licensed institution.
- Audit committee, annual independent audit, and publication of financial statements. Among other points, the directive addresses the need for board audit committee and its composition, the role of audit committee, requirement for an external auditor approved by RBM, submission of audited accounts to the RBM, and requirement to publish such.
- Transactions with related persons. Among other points, institutions must have a written policy and the policy should address the need for arms length transactions, prohibition on favorable treatment, and limits on exposure.

B3. Credit

Private Sector Borrowing. Year on year, 4th quarter 2005 to 2006, private sector deposits increased by nearly MK 6 billion to MK 45.8 billion and total commercial bank sources increased to MK 69.6 billion, up by almost MK 12 billion. Banks kept on a daily average MK 830 million in excess reserve requirements with the RBM.[22] Commercial bank gross domestic credit to the private sector was up more than MK 10 billion to MK 27.7 billion, reflecting reduced rates and a renewed interest on the part of commercial banks in lending versus buying T-bills. However caution is needed, these figures also include lending to private individuals as well as businesses. Credit to the private sector is fairly diversified too, with wholesale/retail lending accounting for 17%, agriculture 15%, manufacturing 13%, and personal accounts 15%.

Exhibit 7 Loans by Sector

SECTORS	TOTAL K000
AGRICULTURE	**4,593,935**
Of which: Tobacco	1,448,164
MINING	**56,834**
MANUFACTURING	**4,059,658**
Of which: food etc	1,482,182
Textile etc.	69,952
ELECTRICITY	**474,984**
CONSTRUCTION	**1,045,921**
WHOLESALE & RETAIL	**5,082,852**
Of which: Wholesale	2,553,918
Retail	2,528,934
TRANSPORT ETC	**1,951,432**
FINANCE ETC	**4,302,616**
COMMUNITY SOCIAL ETC	**4,108,045**
PERSONAL ACCOUNTS	**4,445,708**
TOTAL	**30,121,985**

Interest Rates. The RBM sets the base rate, from which the commercial banks take their signal for setting their own prime lending rates. Over the last three years RBM has moved the rates down in 5% steps, and this has fed through into lower T-Bill rates and to a lesser extent, commercial bank prime rates. The faster fall in T-Bill rates also reflects

[20] Reserve Bank of Malawi, *Financial and Economic Review, Volume 38 – Number 4, 2006.* At RBM requirement at the end of 2006 was 22.5% and in February 2007 was further lowered to 17.5%.
[21] Reserve Bank of Malawi
[22] Reserve Bank of Malawi, *Financial and Economic Review, Volume 38 – Number 4, 2006*

the reduced need for GoM borrowing. The commercial prime lending rate hit 56% in 2001, with the T-bill rate exceeding 40%.[23] It has declined significantly since then and, as seen in the Principal Interest Rates exhibit, continues to decline, nearly 8% from beginning to end of 2006.

Interest rate spreads (lending minus deposit rates) have exceeded 20% in recent years reflecting the GoM's competition for funds with the private sector and limited price competition by commercial banks. Exhibit 8 also highlights the rates at the beginning and the end of 2006 for both savings and base lending. The GoM has sought to further narrow the spread by reducing the Liquidity Reserve Ratio to 17.5% in February, 2007, down from 30% in 2005 and 22.5% in 2006. With improvements in the economy, more fiscal discipline and less government demand, T-Bill returns have also fallen to under 16%, as at April 2007[24]. The result has been a narrowing of the interest rate spread, but at 17-20% it is still very high.

Exhibit 8 Principal Interest Rates (%)
(nominal)

	Jan. '06	*Dec '06*
T Bills 91 days	24.12	16.44
Commercial Banks		
• Base lending (MK)	27.00	22.50
• Savings (MK)	7.75	4.67

Source*:* Reserve Bank of Malawi, *Financial and Economic Review, Volume 38 – Number 4, 2006*

Credit Risk Reduction. The banks' preferred means of lending risk reduction is **collateral**, which offers risk mitigation. The *2006 Malawi Investment Climate Assessment* notes that most firms pledge at least 100% of the value of their loans as collateral. Firms interviewed for this report all indicated collateral requirements in excess of 120-130%. Titled land and buildings are the collateral of choice, followed by immovable plant and machinery, which is impossible to offer in rural areas.

A **Commercial Court** should be operational by June or July. Four judges have been chosen and trained, premises leased, with equipment and furnishings, and a staff being selected. While the BAM noted that this is a very welcomed development, there is uncertainty surrounding the attitude and competency of the untested judges in commercial adjudication.

There is also on-going discussion surrounding a **Credit Bureau**, with interest to support it from the World Bank. A draft bill exists, though there is an on-going debate about the legal framework. There is no **Collateral Registry** and a **National I.D.** scheme is still under discussion and not making much progress.

Financial Products. Capped revolving lines of credit (overdrafts in Malawi) predominate, though some banks make term loans of two to four years, but these loans are less common. Leasing finance (standard, operating, and lease back) is available with terms that can be attractive (up to 5 years).[25] The use of Letters of Credit for export financing is also common, though the price is relatively high, at around 2%. More recently, many banks have started offering purchase order financing. The banks providing this service still look for some collateral, though they may require less and are essentially financing based on expected cashflow.

B4. SMEs as a Market

High historical T-bill rates pulled most commercial banks out of commercial lending and into buying T-bills. As a result, SMEs were an inconsequential market for banks. More recently, there appears to be renewed interest by commercial banks in refining and targeting the SME market as T-bill rates continue to fall. National Bank of Malawi (NBM) opened a Small Business Advisory Service Centre, the purpose of which was to nurture small businesses into bankable clients. They are now however closing the operation, though the reason is not clear. In 18 months of work the center saw

[23] *Malawi Investment Climate Assessment*, Etude Economique Conseil, June 2006
[24] Malawi Times, April 17, 2007
[25] Deepening Malawi's Microfinance Sector (DMS) Project, *Development Credit Authority Feasibility Assessment*, USAID Malawi, August 2006.

approximately 450 clients through the one office at the fair grounds in Blantyre, with less than 10 eventually receiving loans. While NBM closes its small business center, two other banks (Stanbic and NBS Bank) are putting finishing touches on new programs to target SMEs (see text box). However with the limited branch networks, commercial banks are mostly competing for the same SME market in the same locales. Stanbic's and NBS' programs are one way perhaps to gain some traction in the SME market ahead of the competition. A partial guarantee program could support these efforts.

Moving Down the Pyramid

Stanbic and NBS Bank are creating focused programs to seek out and cater to the SME market. Stanbic calls it the Branch Based Business Banker who will provide financial advisory services to SMEs. With assistance from a German-based organization, NBS Bank will train an officer in each of its branches in SME lending. NBS Bank will alter some of its lending criteria to attract more SMEs, for example, 3 rather than 6 months of banking with them to become eligible for a loan. While both banks feel that SME lending is more challenging, both feel that it is also potentially quite remunerative

But what is an SME for commercial banks[26]? Of seven banks surveyed in August 2006, five had no definition and one defined it simply as sole proprietorships or partnerships. Among the seven they reported over 7,200 micro and SME clients; however 95% of these clients resided with one bank specializing in micro and small loans – Opportunity International Bank of Malawi. SEDOM, a GoM owned micro-lender, indicated that of 10,570 clients in the first 9 months of its current fiscal year, about 40% (4,228) were small and medium, defined as loans in excess of MK 300,000 ($2,145). Defining businesses by their loan sizes is not very helpful in determining the size of the enterprise. Just as there is no one definition for SMEs among the banks, there likewise is no consensus on market potential. As noted, one bank closed a dedicated SME operation, while two others opened them.

The cost of finance remains a problem for medium and large businesses, which considers it a more serious issue (71%)[27] than access to finance (43%). Informal firms (micro) report access to finance (84%) a more serious impediment to growth than cost of finance (51%)[28] Whether it is access to or cost of credit that impedes SMEs from borrowing, excessive collateral requirements or a lack of financial products geared towards them or a lack of interest in the market by commercial banks, it is clear that only a small portion of the potential borrowing market is being serviced, as the sub-sector case studies suggest (see SECTION V: SELECTED SECTORS). A partial guarantee program should further attract participating banks into SME lending.

[26] See section A. SME Market Overview for a fuller discussion and definition of SMEs.
[27] Investment Climate Assessment, 2005.
[28] *Malawi Investment Climate Assessment*, Etude Economique Conseil, June 2006

SECTION III: BUSINESS ENVIRONMENT OVERVIEW

A. Legal & Regulatory

A.1 Rule of Law

The Malawi legal system is based on English Law, with Parliament as the legislature supplemented by case law precedents. The current GoM does not have a majority in Parliament and relies on independents and the opposition to get legislation through. This involves negotiation and compromise, which has slowed the legislative process in the last two years. There are several key business related pieces of legislation awaiting consideration, including updated Insurance and Employment Bills. Although the process of legislating can be hotly debated, the recent record is that even contentious bills, including the Budget and the Anti-Money Laundering Act have eventually been passed after discussion and compromise.

There are currently several donor-funded initiatives to support Parliamentarians and the Parliamentary Committees that consider all legislation before it is brought to Parliament. These will improve the capacity of the Parliamentarians to undertake an appropriate role of scrutinizing and passing better legislation more quickly. This support has established a process to identify key pieces of enabling legislation that need updating, and will lead to a set process for consultation, drafting and ultimately submission of the most important pieces. With a more effective business lobby than in the past, there is a better prospect of legislative progress.

As well as legislation, there are other regulatory requirements that can be determined by Ministers and key public agencies, such as the RBM. These powers have their basis in statute and changes are published in the official Government Gazette. The effect of regulations is hard to objectively quantify and compare. Malawi generally performs poorly in comparative surveys, such as the World Bank's Doing Business and the World Economic Forum's Global Competitiveness Reports. These have recently shown that Malawi is slipping in the rankings in most cases, not because the environment has worsened, but more because other countries are reforming faster. There is also a time lag in the capturing of changes recently made.

The Minister of Industry, Trade and Private Sector has announced[29] three important sets of reforms that are being implemented in the second quarter of 2007. First is the formation of a Commercial Courts Division within the judicial system, dedicated to the resolution of commercial disputes, which were previously dealt with slowly through the normal courts due to the proliferation of political disputes. Second, the Ministry will collapse eight separate licensing processes into a single business license and, third, the revenue authority will pilot fast tracking procedures for custom's compliant businesses.

These initiatives will assist the private sector, though they do not yet address the relatively high cost of legal services with a set of scale charges applied across the profession. This has resulted in a high cost of debt recovery, amounting to 136.5% of the cost of the debt.[30]

The private sector has noted that there is a different application of the rule of law to Government compared to the private sector. For example, GoM is estimated to owe over MK 5 billion[31] in court judgments with accumulated interest, mostly to the private sector, judgments that appear not to be enforceable through the normal Sheriff system that enables seizure and forfeiture of goods. The GoM did not defend all the cases brought against it and the Minister of Finance has recently stated his

[29] April 4th 2007, at the Public-Private Dialogue Forum, Blantyre.
[30] World Bank, Doing Business 2006
[31] MCCCI, Pre-Budget presentation, 2007

intention to pay those contested judgments it lost and appeal on those it did not defend, due to lack of lawyers in the government at the time. This will be an important test of how the rule of law is applied and for the enforceability of contracts against Government and its agencies.

Commercial disputes between large formal entities tend to be resolved through the legal system even if the cost is high and the time long. However, disputes between smaller businesses or informal entities rarely get resolved through the legal process, as the cost is too high.

A2. Commercial Law

Land. In 2002 a new land policy was introduced covering a range of land related matters. Of significance for foreign investors is that only citizens or companies majority owned by citizens can hold freehold title, while non-citizens can take a 50-year lease. It is not entirely clear how much of the new policy has been translated into the legislation, though this provision appears to be being implemented progressively, with the exception of those non-citizens that already held title prior to the new policy.

Banks are able to, and commonly do, take land title (freehold or leasehold) as collateral and are able to enforce this through the courts. However, using land title is problematic for businesses to secure their loans as the value of the title may be far in excess of the loan needed, yet it cannot be sub-divided for collateral purposes. As in other African countries there is also considerable sensitivity about land and its ownership, making it less attractive to the lenders, more particularly in rural rather than urban areas.

All land transactions still require the Minister of Lands to give personal permission for the transfer, which can lead to considerable delays, as the number of transactions is increasing. The Ministry of Lands is currently considering a proposal to delegate these powers to a technical committee, so that transactions become purely a technical matter of meeting the necessary criteria. This will bring Malawi into line with practice in most other countries and bring speed and greater certainty to the process.

Creditor Rights. Creditors are able to pursue their debts through the courts. This is a relatively straightforward process requiring the creditor to present evidence of the debt in court, where if judgment is given in the creditors favor this is then enforced by the Sheriffs, once the deadline to pay has expired, through seizure and sale of movable assets. In practice the judgments are carried out.

Foreign Investors. Foreign investors are guaranteed the same rights as domestic investors, under the Investment Promotion Act 1991, though there is still some debate about whether there would be measures to favor indigenous investors. The GoM has so far reinforced its position that Malawi is open to foreign investors and does not want to give concessionary support based on indigenous status, as GoM wants both categories of investors. An Economic Empowerment Policy was developed in 2004 and consulted on, but has yet to be adopted by Cabinet. A process to develop a revised National Investment Policy has been underway since 2006 and there has been a consultation process to consider a reserved list of sectors for citizen (as opposed to indigenous) investors under the COMESA Common Investment Area (CCIA). These are still ongoing.

Bankruptcy. Under the Companies Act 1984, winding up, liquidation and bankruptcy has not been widely used because of the cost of enforcement, but more recently several financial institutions have been using this to pursue debtors. Part of the problem in the past was that certain individuals and their companies benefited from a degree of political protection under the previous government; however this has now gone with the change of government, encouraging several financial organizations to pursue old debts against these individuals. This is a positive change and reflects a growing application of the law, regardless of whom the other party is.

Shareholder rights. Shareholder rights are protected in the Companies Act 1984. Within family/owner-managed enterprises, shareholder issues are resolved within the 'closed' structure as there are rarely outside shareholders. For companies with non-family ownership, shareholder rights are mainly exercised at the annual general meeting, though as is normal, if there is a significant shareholder then this person or entity may seek and be accorded board representation. It is relatively uncommon for smaller businesses to have non-family shareholders, as this does not fit well with the prevailing attitudes to involving outsiders in a 'family' business. For larger corporations, or other businesses with minority shareholders, the mechanism for dispute settlement is through the courts if it cannot be resolved through discussion, negotiation and compromise. This is not reported to be a problematic area.

B. Corporate Governance

B1. Profile/Management Capacity

Models of corporate governance are based on the English corporate law, with the separation of owners (shareholders) and the employed executive (managers). A key weakness in the past has been the lack of a body to regulate and supervise Directors. However, there are currently moves to establish an Institute of Directors, initiated by the accounting regulatory and professional bodies. This would be a welcome move, as it would assist in the training and educating of Directors. Smaller companies in particular tend to have Directors with very limited understanding of their roles and responsibilities.

The biggest concern and focus of corporate governance initiatives has been around the area of corruption. In this area, a number of private sector companies have been working with Business Action Against Corruption (BAAC) to develop a code of conduct, which has been finalized and will be launched by the President once sufficient companies have signed up. Signatory companies commit themselves to implementing its measures within six months of signing. These primarily relate to establishing policies, procedures and systems that seek to eliminate corruption, reporting and prosecution of cases and setting the incentives and the culture within the companies to drive out corruption.

B2. Accounting Principles

Many of the large international auditing firms operate in Malawi, including Deloitte, PriceWaterhouseCoopers and KPMG, along with regional and local firms. Businesses are required to operate to international accounting standards, with the recent adoption of the revised international accounting standards following the lead from the United States. All companies, partnerships and sole traders are required to submit audited accounts using an external auditor to the Malawi Revenue Authority (MRA) within six months of their year-end.

SECTION IV: SMEs IN MALAWI

A. SME Market Overview

Although on the face of it the pre-1994 Malawi was a market economy, much of the economy was controlled by the then Life President and his party through state-owned monopolies/oligopolies, protected from imports, as well as through quotas, licensing and other restrictions on who could operate businesses in almost every sector of the economy. Foreign businesses were monitored and separately licensed, and certain communities, such as the Asians were restricted to operating only in certain parts of the urban areas and not at all in rural areas. Under the surface, Malawi was more akin to a planned than a market economy, and that was also true of the Micro, Small and Medium Enterprises (MSMEs) sector of the business community that was generally discouraged and contained.

Since the advent of multi-party democracy in 1994, there has been a significantly increased interest in MSMEs as a key component of the economy and potential driver of growth, with Malawi's first Micro and Small Enterprise (MSE)[32] policy adopted in 1998. Subsequently, the Ministry of Commerce and Industry taking responsibility for SMEs and Co-operatives, a role that it still holds though it is now the Ministry of Industry, Trade and Private Sector Development (MITPSD), as of 2006. There were a number of key liberalizing measures in the post 1994 election period, including removal of many restrictions, simplification of the licensing regime and opening up of previously restricted sectors, most notably allowing smallholder farmers to grow burley tobacco, with at least 180,000 taking up the opportunity. These reforms did stimulate the economy in the mid 1990s but petered out in the late 1990s with little reform in the 2000-04 period.

During the period from 1994, the number of MSMEs exploded once the restrictions were removed,[33] particularly very small scale vending and hawking in urban areas and trading centers. The previous state monopolies and oligopolies that existed in most sectors of the economy also began to break down, with new entrants in many areas, particularly trading and to some extent manufacturing. In addition, the privatization program that began in 1996 also resulted in the creation of private sector entities, in all areas of the economy, including manufacturing and trade. The program has also created new MSME opportunities, such as concessions for new tourist facilities in the national parks.

Although foreign investment in SMEs has been relatively low, the competitive landscape has changed considerably in the last 13 years, with most sectors having several competing firms, many of which are SMEs. The missing middle so commonly referred to in Africa, is progressively being filled in Malawi as micro and small enterprises grow into small and medium sized businesses respectively.

Definition of MSMEs. In the MSE policy, GoM defined MSMEs by a combination of employment and turnover, having drop its capital investment criteria in 1998, as follows:

Exhibit 9 Enterprise Definitions

Type	Employment	Annual Turnover (MK)
Micro	1-4	Up to 120,000
Small	5-20	120,001 to 4 million
Medium	21-100	Above 4 million to 10 million
Large	Above 100	Above 10 million

Source: Ministry of Industry, Trade and Private Sector Development

[32] Although termed MSE, it also covers medium scale businesses and therefore it is more accurately an MSME policy.
[33] Up to 1994 vendors had to have a party card to set up in a market and no selling outside the designated markets was allowed.

The Directorate of SMEs currently only uses the employment criteria when defining MSMEs as the turnover figures have been rendered meaningless due to inflation over the period, with the Malawi Kwacha currently trading at 2.33 times the rate to the US$ in 2007 compared to 1998. Using an employment criterion, particularly in a low wage economy, can be difficult to apply in practice, as businesses in Malawi typically employ a lot of low waged staff because they are so low cost, when in other economies the roles may be automated or out-sourced. In addition, because of the predominance of agriculture that is highly seasonal, there are also relatively high levels of seasonal workers in many agriculturally-linked enterprises that may overstate the relative size of these businesses. Nevertheless, in the absence of more useful criteria that are easily measurable, the use of employment as a defining criterion is the most robust method of categorizing businesses, as long as the potential distortions are understood.

Sector size. Using the employment criterion, two surveys have identified the number of non-farm MSMEs in the economy. The 2000 Gemini[34] study used a definition of MSEs to "include those businesses that employ 50 or fewer employees including working owners." This does not cover the whole of the Medium Sector according to the GoM definition, but was based on the Gemini methodology to allow for international comparisons. In 2000, there were an estimated 747,396 enterprises with up to 50 employees, of which 8.5% (63,500) were in the 5-20 employee range and 0.2% (1,500) were in the 21-50 employee range.

Exhibit 10 MSEs by Sector (2000)

		Number of MSEs	% of Total
Agriculture, Mining and Natural Resources	Crops	160,805	21.5
	Livestock	7,286	1.0
	Forestry	9,571	1.5
	Fishing	10,997	1.5
	Mining	888	0.1
	Subtotal	*189,548*	*25.4*
Manufacturing, Commerce and Services	Manufacturing	206,397	27.6
	Construction	6,475	0.9
	Commerce and Trade, Hotels	306,682	41.0
	ransport	4,701	0.6
	Services	33,594	4.5
	Subtotal	*557,848*	*74.6*
Total		747,396	100.0

Source: Gemini, 2000

The 1998 Medium Enterprise Survey (MES) used a definition of 5-99[35] employees for 'medium enterprises' even though this spans the GoM definition of small and medium enterprises. A total of 22,361 enterprises in this size range were identified, which was an increase of 109% on the 1994 level of 10,698. Of the two studies, the Gemini survey adopted a more comprehensive survey method for MSEs and is likely to be more accurate for smaller businesses. However, the Gemini study did not identify firms in the 51-100 employee range and notes that the MES is more accurate for medium and large firms due to the different focus of enumerators. The MES identified 3,400 firms with 21-100

[34] Growth and Equity through Micro-Enterprise Investments and Institutions, Results of a Nationwide Survey on Micro, Small and Medium Enterprises in Malawi, Technical Report 53, DAI.
[35] 5-10 employees (52.9%), 11-20 employees (28.3%) and 20+ employees (15.2%).

employees, which combined with the Gemini data suggests 66,900 enterprises in the 5-100 employee range.

There has been no further survey of enterprise numbers since these studies, making it difficult to give up to date totals for the MSME sector. With relatively limited growth rates in the 2000-06 period, there are likely to be no more than an additional 25% more businesses, giving a probably range of 66,900-83,625 enterprises with 5-100 employees and of these, 3,400-4,250 enterprises with 21-100 employees.

In terms of agriculturally-linked businesses, the Gemini survey suggests that 22.5% of enterprises are in agricultural production (crops and livestock). Of these, 15.7% of all enterprises are tobacco related[36], leaving 5.8% (43,544) non-tobacco related agricultural production enterprises. In addition, the Gemini study found 21.6% of all enterprises were in the food and drink sector (processing and retail), amounting to 161,966 enterprises. There are other agricultural linked sectors, including machinery, transport, services etc, but these are not separately identified so cannot be included in the estimate of agriculturally linked enterprises.

Therefore, there were an estimated 205,510 MSMEs in agricultural production and food/beverage processors/distributors in 2000 representing 27.5% of all enterprises. Given the growth in the economy since 2000, there are likely to be up to an additional 50,000 by 2006. Combining the data for the number of enterprises in the 5-100 employee range and the data for agriculturally linked enterprises, **it is estimated that there are at least 18,400 agriculturally linked enterprises employing 5-100 employees, the likely main target group for this DCA**.

Informal sector. Any analysis should also note that there is a considerable 'informal' sector of the economy that is for this purpose defined as enterprises and enterprise activity not registered or paying enterprise related taxes. The methodology for the Gemini was designed to capture this group, most of which fell into the micro-enterprise category of 0-4 employees amounting to 682,373 enterprises. Not all of these micro-enterprises were informal and not all of those in the 5+ employee range will be formal, but it is a reasonable proxy to suggest that the majority of those in the 0-4 employee range will be informal and therefore ineligible for commercial bank loans. While there should not be any restriction on the minimum size of borrowers, in practice it is likely that the main target group for the DCA guaranteed loans would be the 5-100 employee group identified in the previous section.

Government & Development Partner Roles. The GoM policy on MSEs is long established and pro development of MSEs as an integral part of economic development. MSEs are also seen as important to the economy because most of these are Malawian run, providing additional political reasons to see this sector grow. Of particular relevance, within the MSE Policy, there is a key statement of policy that Government "shall establish a loan guarantee scheme in favor of MSEs".[37] There was a UNDP funded loan guarantee scheme established in 1997 under the Enterprise Development and Employment Generation Programme (EDEP), that was implemented by the parastatal Development of Malawian Enterprise Trust (DEMAT) and two commercial banks. But due to poor design[38] the scheme failed and ended in April 2000. Although the EDEP was a failure, the implementation of a loan guarantee scheme fits within the GoM policy framework and from discussions with the relevant Ministry there is acceptance that this should be implemented through the commercial banks.

There are several government agencies that operate to regulate and support enterprises of all sizes, notably the Malawi Bureau of Standards, Malawi Revenue Authority, Malawi Investment Promotion Agency (MIPA) and Malawi Export Promotion Council (MEPC). These organizations have differing levels of resources and function accordingly, with both MIPA and MEPC consistently less well

[36] These would not be potential borrowers under DCA.
[37] Point 5.1, page 5.
[38] Notably that the banks carried only a 5% share of the risk, poor screening, no clear responsibility for collection etc. See Terminal Evaluation Report, April 2002.

resourced. The performance of all four agencies has been criticized by the private sector, partly because they perform regulatory and revenue collections functions which are inevitably unpopular, but also for their inefficiencies and bureaucracy.[39]

GoM also funds several MSE support agencies, including DEMAT, Small Enterprise Development Organisation of Malawi (SEDOM) and Malawi Entrepreneurs Development Institute (MEDI). These three provide a mixture of credit, vocational and business training to micro and small enterprises, but are of limited reach and effectiveness in the business community in practical terms. There is a proposed[40] facility for $18.5m under the Business Environment Strengthening Technical Assistance Project that will have a number of components that support MSME development such as support to the commercial courts, Registrar General and Lands Registry; streamlining regulations; creation of the Malawi Investment and Trade Centre (MITC); establishing the framework for Public Private Partnerships; support for Public Private Dialogue; establishment of an SME venture finance fund; and a matching grant scheme for improving enterprise productivity. Approval is very likely and there are a number of elements that would support the MSME sector's developments, if well implemented.

There is a project in the Ministry of Agriculture, Institutional Development across the Agri-Food Sector (IDAF) that is providing support to a range of agri-businesses, including developing institutions and support systems to promote agri-food trade and realizing access to export markets through commercial partnerships between the public and private sectors. The mandate is wide-ranging and relevant to agriculturally linked enterprises. There are two sector focused programs that are of interest – Land O' Lakes (LoL) and USAID's Regional Aricultural Trade Expansion Support (RATES). LoL recently commenced a Malawi Dairy Development Alliance program that includes support to private enterprises in the dairy sector. There has also been assistance from the RATES project[41] based in Nairobi that has supported a number of initiatives in the grain trading and processing, dairy and cotton sectors. Finally, United Nations Development Programme (UNDP) has recently commenced the Growing Sustainable Businesses program that seeks to broker private sector investment, with agri-business a key focal sector, including technical support to MIPA.

In addition to the above, there are a number of small grants programs for micro-enterprises from several embassies and donors, which are of limited scope and relevance to this analysis. There are also a myriad of NGO programs and projects that target micro and rural enterprises that are not of significance to the sector's development as they are mostly focused at the level of livelihood and community interventions.[42]

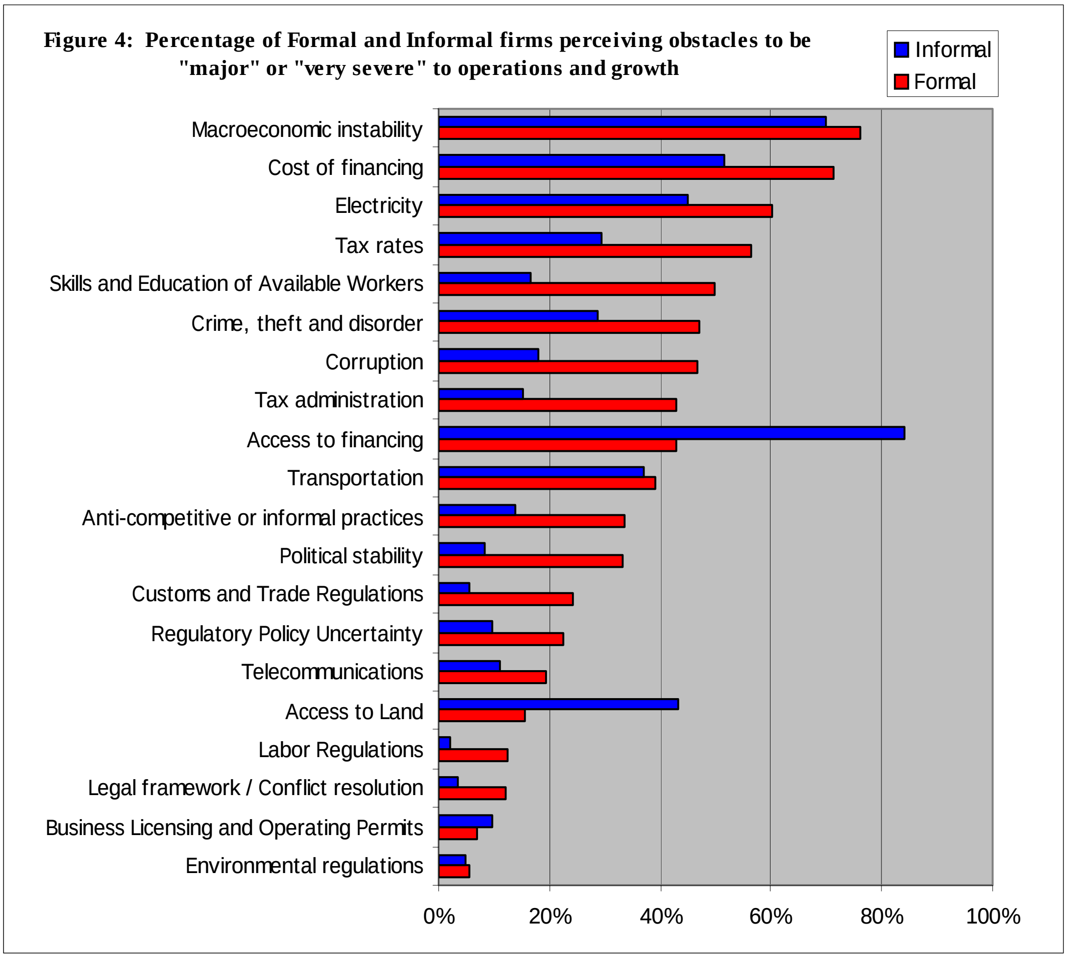
B. Common SME Sector Constraints and Responses

The constraints facing the private sector as whole were well articulated in the GoM's Malawi Economic Growth Strategy (2003) and subsequently reiterated in the Malawi Growth and Development Strategy (2006). These fell into five main areas: Macro-economic conditions and instability; weaknesses in the legal and regulatory framework; weaknesses in infrastructure (particularly transport related and utilities); poor dialogue and co-operation between government; and private sectors and weak human resource base.

In relation to MSMEs, the Investment Climate Assessment (ICA) provides a recent review of constraints facing formal and informal firms:

[39] MCCCI presentation to the Minister of Finance, 16 April 2007.
[40] To be presented for approval to the World Bank Board on 24th May 2007.
[41] Both Land O' Lakes and RATES receive USAID support.
[42] NGOs operating rural micro-enterprise related programs include Oxfam, CARE, World Vision, CADECOM, Concern Universal, Blantyre Synod, GOAL and others

Exhibit 11 Private Sector Perceptions of Obstacles to Growth



Source: ICA, 2005

Of particular relevance, over 40% of formal firms stated that access to finance was a major or severe constraint to the operations and growth of their business and cost of finance was ranked the second concern with over 70% of firms rating it as a constraint. Since the time of the survey in 2005, the cost of finance, and the macro-environment have seen considerable improvements, with the RBM base rate falling to 20% and expectations of further falls. However, in terms of access to finance, the most commonly repeated issue in the survey for this study is the banks' stringent collateral requirements, often at levels in excess of 120% of the loan. This can be very restrictive if the level of the loan is well below the value of the asset pledge, such as a property, as this asset cannot then be used for collateral for another loan.

There has been considerable tax reform implemented since the ICA survey was conducted, and the business community has generally welcomed these changes that were in line with proposals from the private sector.[43] For example this has seen the removal of the Minimum Turnover Tax that was payable even if a business made a loss, with the effects falling most heavily on SMEs due to the structure of the tax bandings. The pressure from private sector has also resulted in the establishment of separate commercial courts, with one particular objective being for allowing appeals on tax matters, due to ongoing concerns about the fairness and quality of tax administration. According to the Ministry of Industry, Trade and Private Sector Development, the courts will be operational in the 2nd

[43] Final submission for the 2006/7 Budget by Bankers Association of Malawi, Economics Association of Malawi, Society of Accountants in Malawi and the Malawi Confederated Chambers of Commerce and Industry.

Quarter of 2007. Further pressure from private sector[44] has also resulted in improvements in the operation of the electricity utility, which had severe operating problems in the 2002-5 period.

Although there are still considerable improvements needed to the enabling environment, the existence of a dialogue process and the improved access to GoM for the private sector, suggests that there will continue to be improvements at least until the next election in 2009. With improved macro-economic performance and stability, the prospects for MSMEs are better than for many years, as evidenced in the improving outlook in Malawi Confederated Chambers of Commerce and Industry (MCCCI) Business Expectations Survey 2006 compared to the 2005 Survey.

[44] There has been an effective process for high level Public-Private Dialogue since 2001, through the National Action Group Forum that is now being taken on by the Public-Private Dialogue Forum, with commitment from Ministers and business leaders.

SECTION V: SELECTED SECTORS

The consultants reviewed a range of possible agriculturally-linked sectors as illustrative of the potential for the DCA. Despite its importance to the economy, the tobacco sector was specifically excluded from consideration due to USAID regulations. Three sectors were selected – coffee, dairy, and dry goods processing. These three were chosen because they provided a cross section of an export oriented sub-sector (coffee), a domestic oriented sub-sector with considerable added value processing (dairy) and a sector that covered several sub-sectors with both domestic and export markets and a range of added value content (dry goods, principally maize, rice and groundnuts).

A. Coffee

A considerable amount of information is available on the Malawi coffee sector from two recent studies conducted by one of the consultants for this current DCA assignment. The first study in 2005 ('Coffee Sector Report') funded by the Support to Agricultural Linked Enterprises (SALES) Project, undertook a coffee value-chain analysis providing comprehensive data on the producers, their production and sales. The second study in late 2006, built on the first study by specifically analyzing the credit demand and supply for the coffee sector ('Credit and Demand Report') and was funded by the DMS Project[45] and the European Union's Food Security Joint Task Force (FSJTF). The latter in particular gives considerable detail on the financing needs of the sector. In addition, the Coffee Association of Malawi (CAMAL) was interviewed to gather the latest information on the sector.

A1. Sector Overview

Context. Coffee is produced in more than 50 countries and according to the International Coffee Organization (ICO), 2004 world annual production was 115 million 60kg bags (6-7 million tonnes) with an export value of US$ 5-6 billion. Three countries, Brazil, Colombia and Vietnam account for almost 60% of world production. From 1975 to 1989, though prices fluctuated significantly, they remained relatively high and rarely fell below the International Coffee Agreement (ICoA) price floor of US$1.20/lb. However, with the entry of more countries and increases in production it became more difficult to sustain the manipulation of supply. In 2001 and then 2002, the average price of mild Arabica recorded fell to all time lows of 62.28 and then 61.52 US$ cents/lb. It has since recovered to an average of 122.03 US$ cents/lb according to the ICO as at Feb 2007.[46]

Malawi is a very minor coffee producer with less than 0.02% of world production, though coffee is still a significant foreign exchange earner for Malawi, due to the relatively small size of the economy. Malawi's production declined in the period 1989 to 2004 due to the steep decline in world prices following the collapse of the ICoA, escalating input costs, frequent droughts and progressive reductions in hectarage as growers switched to other crops.

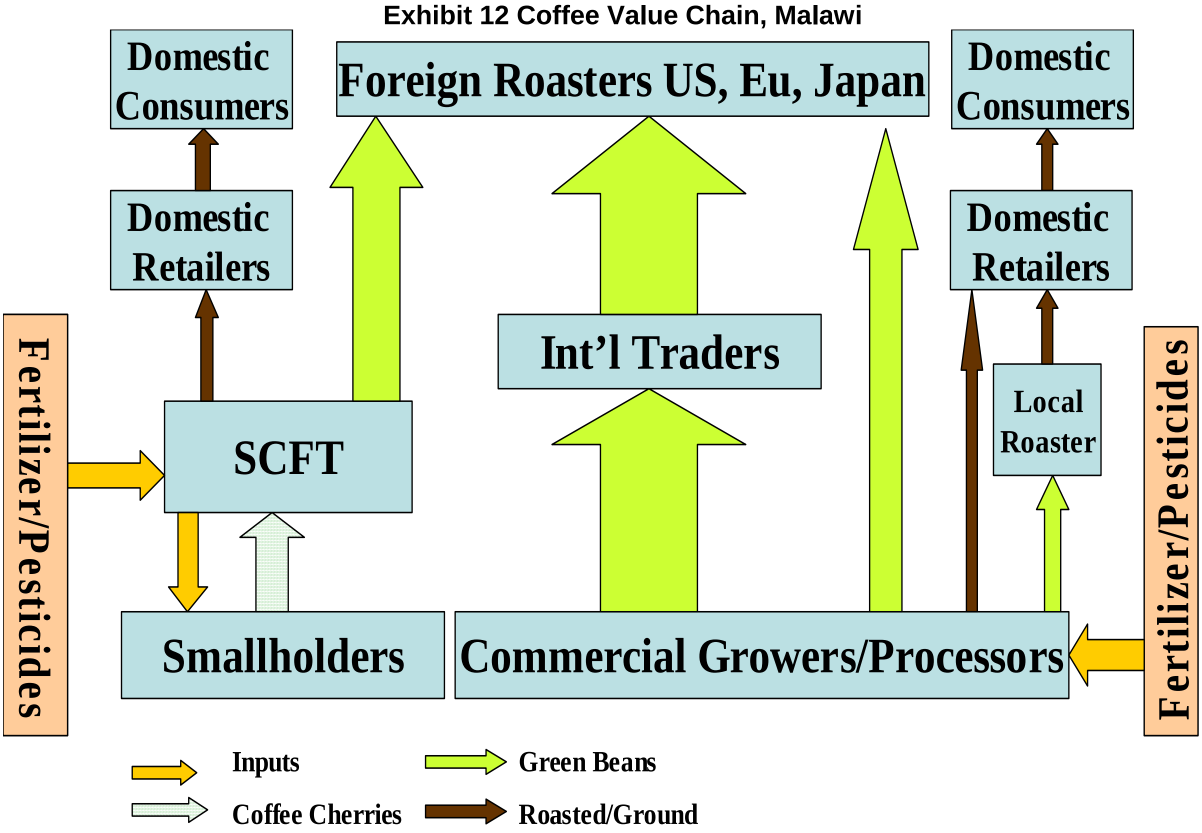
Malawi coffee is 100% Arabica and grows at an elevation above 950 metres, with most in the range of 1,050 metres or higher. Coffee is grown mainly in the north and in the south of the country. In the south, coffee is grown by commercial farms and estates centered around Thyolo and Zomba, with no smallholder growers at all. In the north it is predominantly grown by smallholders in associations affiliated with the Mzuzu Smallholder Coffee Farmers Trust (SCFT) and two small farms around Mzuzu. The profile of the coffee sector is therefore completely different between north and south.

Sector Composition and Trends. There are currently fifteen organizations active in coffee growing, all of which are estates/commercial farms, except Mzuzu SCFT, which comprises five smallholder associations. Due to the nature of coffee, it needs to be processed at the point of harvesting, resulting

[45] Both SALES and DMS are USAID funded.
[46] www.ico.org

in integrated grower-processors through to at least the green bean stage. Two estate processors (Sable and Makandi)[47] and the smallholder processor (Mzuzu SCFT) accounted for more than 75% of production (2005-06).

Exhibit 12 Coffee Value Chain, Malawi



Source: Consultants adaptation of Value Chain, Coffee Report 2005, Kadale Consultants.

The ***estates and commercial farms*** part of the sector accounted for 82.5% of estimated production in 2005-6, with Sable, Makandi and Press being the biggest estate producers. Among the group are several smaller family owned commercial farms/estates including Satemwa, Zoa, Kapno, Naming'omba and RWJ Wallace. Most of the coffee growers/processors also grow other commodities, most notably tea and macadamia nuts, which have complimentary demands for seasonal labor, and in the case of macadamia, can share the initial processing facilities.

A number of the estates/farms are part irrigated depending on availability of year round streams, ensuring more consistent production levels. All producers treat their crops differently, but on average fertilizers need to be applied 8-12 times per year and pesticides sprayed every 21 days. In Malawi, all coffee is handpicked with several passes through the fields in every season, which is in accordance with recommendations for harvesting of quality beans. Most estates draw their labor force from a pool of local people who have picked before.

The main stages of the post-harvesting process include: pulping, washing, soaking/fermentation, drying, sorting, conditioning, hulled, polished and graded. Due to the low world prices, there has been relatively limited investment by the remaining coffee processors, as it has not been profitable to do so. Now that prices have recovered with the best AAA grades reaching US$ 2.85/lb, there is more interest in investing in growing and processing

In relation to ***smallholder coffee***, the Mzuzu SCFT operates as a farmer-member owned business, with 3,100 coffee farmers grouped in five geographic associations. Each association is further

[47] Both Sable and Makandi are owned by Global, but operate independently in financial terms.

divided into business zones with each zone subdivided into business centers, with 10-30 farmers. Two or more business centers (farmer groups) form one business zone, with a pulpery at each business zone. Farmers bring their coffee cherries to their business zone's pulpery for initial sorting, weighing and first stage processing.

Pulped coffee is collected by the SCFT and transferred to its facilities in Mzuzu where secondary processing is completed (green beans) and where tertiary processing of some green beans (grinding/roasting and packaging) is undertaken for domestic retail sale and export. For the last seven years since the transition from government ownership to its current Trust status, SCFT has received donor funding from the European Union to support the smallholder coffee sector, including extension services, coffee expansion and operations. This ended in December 2005 and so SCFT now meets its financing needs through self-financing supplemented by local commercial bank loans.

It is important to realize that smallholder coffee in Malawi is still in a developmental stage. Over the last several years the SCFT has made a major effort to replant smallholder coffee removing the low yielding local variety (Geisha) and replacing it with a higher yielding variety (Catimor). Of the 3.6 million bushes currently planted, only 1.3 million are mature and producing (two years and older). As a result the 2004-05 production level of 234 tonnes is expected to double by 2007-08 and triple by 2009-10.

The mainstream coffee market has developed into a relatively low value high volume market. Many coffees are used only for blending or processing into neutral or anonymous end products. These coffees are bought from many sources as green beans to be blended and roasted elsewhere. This is not to preclude the sale of roasted bean or ground coffee products originating from Malawi, but the main specialty markets in the USA and Japan are more interested in green beans than origin roasted and ground coffees. Although there is a market for a roasted bean and ground coffee retail product in Malawi, this is very small compared to the opportunity for green bean sales, less than 2% of volume.

Economic Impact. Malawi has predominantly supplied into the high-volume coffee market and has suffered considerably from the low world market prices since 1989. The result was a progressive decline in production with growers leaving the industry or reducing hectarage with production falling from 7,720 tonnes in 1991/92 to a low of 1,590 tonnes in 2004/05. However, a combination of improving international prices and recent efforts by the industry with support from the USAID Support to Agriculturally-Linked Enterprises (SALES) project, resulted in an increase in production in 2005-6 to 1,767 tonnes and expectations of higher production in 2006-7, estimated at 2,100 tonnes by the Coffee Association of Malawi (CAMAL). As a result of improved prices and production levels, coffee has regained its position as the fourth most important agricultural export, accounting for 4.4% of exports in 2005-06, based on Free On-Board US $Values.

Challenges. According to the 2005 Coffee Report, the increasing consumption of specialty coffee worldwide suggests that there are opportunities to producers who are willing to invest in their coffees. However, the specialty market is difficult to break into, as it requires considerable attention to quality from growing through harvesting, grading and processing beyond the methods that have historically evolved in Malawi. Even if there is a high quality coffee, it also requires good marketing to differentiate the product in the supply chain to attract the specialty premium.

Coffee is an input intensive crop, requiring multiple applications of fertilizer and several pesticides. There is a significant need to employ temporary labor for weeding, spraying and plucking. Unfortunately low world coffee prices for many years have reduced the returns for coffee farmers and, as a result, the cash available for labor and fertilizer inputs. Many estates lowered the use of inorganic chemical inputs and sometimes used organic alternatives such as chicken manure. This adversely affected production and quality, which is now only being reversed in the last two years.

Some practices that compromise quality are made by some producers to produce lower cost coffee, for example using recycled water for washing. Generally, the estates have focused on bulk production, perhaps due to limited awareness of the potential for their coffees in the quality specialty market. However, to take advantage of the market opportunity will probably require a shift in thinking from lowest cost processing to quality oriented processing, at least for part of the production. This will require investment in equipment for processing and testing, higher operating costs, additional training and a re-orientation of processing attitudes from low cost to quality.

A2. Financing Opportunities

Borrower Profile. The following table gives a summary of the lending to the coffee sector.

Exhibit 13 Summary of Lending to the Coffee Sector for 2005-06 Season

	Approx Aggregate Values	
Type of Loan	**As Reported By Local Commercial Banks**	**As Reported By Growers Surveyed**
Short-Term Loans (Overdrafts/Seasonal Loans)	$575,000	$448,000
Medium-Term Loans		$1,300
Local Commercial Banks SUBTOTAL	**$575,000**	**$449,300**
Medium-Term Loans	NA	$14,700
Foreign Commercial Banks SUBTOTAL	**NA**	**$14,700**
TOTAL LENDING	**$575,000**	**$464,000**

Source: Credit Demand and Supply Report, Kadale Consultants, 2006

In general, the industry is quite conservative in its borrowing because of its past experience of high interest rates, volatile pricing and low profitability. Most estates have cut their working capital budgets (for fertilizer/inputs) than over-extend themselves when production may not fund loan repayment. The larger estates and those with external parent companies manage their working capital needs through self-financing topped up by short-term overdraft facilities. When in need of working capital, producers/processors access such normally from the commercial banking sector. The reported constraint is more the cost of short-term financing than the availability of such financing.

Demand for Financing. Although additional working capital would be beneficial, commercial growers/processors have been reluctant to increase their credit facilities in light of volatility in the Kwacha exchange rate and their own low profit margins. This attitude may be changing with the change in emphasis on quality for a better return. The small to medium estates/farms have more difficulties securing financing as they are constrained by provision of the necessary collateral guarantees. They could benefit from more working capital but once again the cost of capital versus the returns from additional capital has made it not viable up to now.

Accessing longer term asset financing is a major constraint that limits development of the sector. All respondents to the 2006 Credit Demand and Supply study reported that the lack of longer-term asset financing was their primary unfulfilled financing need. This included replanting, irrigation, major upgrades/replacement of factory, development of new factories, replacement of transport fleets, etc.

The SCFT, in particular, has substantial capital expenditure needs that are currently unmet. As it was owned and managed by government for many years prior to its current Trust structure insufficient equipment rehabilitation and replacement took place. For example, much its pulpery machinery is more than 50 years old. Therefore, the Trust requires a significant injection of capital for replacement and rehabilitation of pulpery machinery, transport vehicles, new warehousing, additional new huller equipment, new automated packaging equipment, etc. However, as it is still in a developmental stage, the Trust is reluctant to take on more commercial bank financing to support its capital improvement and development goals until its smallholder growers level of production has increased and become operationally self-sufficient.

It also lends through a Savings and Credit Union to around 1,800 smallholders to finance their input application, to the tune of MK 22.3m in 2005-06.

The study respondents wanted US dollar loan terms of between five to twelve years with annual payments that coincide with the annual coffee sales. Due to the export nature of the coffee business, the grower processors have nearly all their earnings in US dollars and so they are ideally looking for US dollar loans to hedge exchange rate risks of long-term financing.

Other Related Coffee Linkages. Due to limitations of time, the focus of this study was on the grower processors. However, there are potential other SMEs that supply into or are connected with the coffee value chain, notably equipment suppliers, input suppliers (fertilizer, herbicides, pesticides), packaging suppliers, freight forwarders and transporters.

A3. Strengths, Weaknesses, Opportunities, Threats (SWOT) Analysis

By way of summary of the analysis of the Malawi coffee sector, the following Strengths, Weaknesses, Opportunities and Threats have been adapted and added to from the Coffee Sector Report, 2005.

SWOT Summary – Coffee Sector	
Strengths: • Good environment for coffee growing, supported by irrigation in many cases; • Small number of committed growers/ processors well organized through CAMAL; • CAMAL has been revitalized and is now resourced to help re-establish coffee production and access to markets; • Specialty potential coffee, though only partially realized; • Smallholder production set to double following past planting; • Selective investment in planting and processing now occurring after years of neglect;	*Opportunities*: • Complete the repositioning of Malawi as a source of specialty Arabica grades; • Increase the proportion of coffee produced and marketed as specialty grades; • Improve the average quality and sector's appreciation of its non-specialty grade coffees; • Increase domestic market base of consumption of Malawi coffee at retail and catering levels;
Weaknesses: • Insufficient application of inputs to get right yield/ quality balance due to past low prices; • Under investment in processing over many years by growers due to the past low prices; • Limited attention to, and facilities for QC and grading, especially for specialty • Limited specialty marketing experience in the sector, aside from Smallholders Trust	*Threats*: • Volatile World Coffee markets; • Malawi is vulnerable to drought and pests; • Specialty market is increasingly competitive and may lose its current growing interest in Malawi's coffees;

B. Dairy

The consultants drew on several documents related to the dairy sub-sector. Two of note are the RATES 2004 report *Review of the Dairy Industry in Malawi* and the Volunteers in Service Overseas 2006 analysis *Milk Enterprise Development in Malawi*. In addition, the consultants interviewed two existing processors, a dairy association, an donor assistance project, and one perspective dairy processing investor.

B1. Sector Overview

Context: The dairy sector is poised either for a leap forward or a steady crawl ahead, but all indicators are that it is moving. The ingredients are there to leap forward, to expand market penetration, and even export at the margins. Which way it goes will depend largely on attitude, vision, and capital.

> ***Got Milk?***
>
> *The country is in short supply of milk because we are producing half of the required amount…"*
>
> Deputy Director, Livestock Development, Ministry of Agriculture and Food Security, noting that local demand is for 80-90,000 tonnes of milk equivalent. (The Daily Times, April 18, 2007).

The market for milk in Malawi is currently domestic and urban focused, with some possibilities of regional export with the introduction of locally produced UHT by one firm (with another contemplating it). Average per capita milk consumption is only 6 liters/year compared to the Africa-wide average in 2004 of 15 liters/year, equating to about 72 million liters/year. Roughly half of the country's dairy needs are imported, with an estimated 2006 value of $4 million. For the formal dairy processing sector, consumption is heavily skewed to the top 3% of the population that are targeted by the three largest dairy processors. At this end of the market, demand is relatively inelastic and able to absorb increasing prices. Margins for processors and retailers are attractive. Based on a retail price of MK 250/500ml, they are estimated to be 15-30% on sales price for processors and 22-30% for retailers.

The informal urban and rural market is undeveloped,[48] with limited unprocessed milk sales from farmer to consumer and some availability of milk powders in bigger trading centers used for reconstitution. In other countries – e.g., India, Kenya – the informal urban market has proven quite attractive through efficient distribution of large volume, low margin semi-processed milk in affordable unit sizes priced correctly. With the introduction of locally produced UHT milk, competitively priced it may be possible to expand the formal processed milk market to at least 10% of the population (mainly urban and trading centre based), though this would also take a change in approach (see below Composition).

About 66% of marketed milk goes through the formal processing sector with the remaining third sold unprocessed and informally to neighbors and traders. The dairy processing industry is 81% dependent for its supply on 5,100 smallholders, with a dairy herd of 7,700 cows, 75% of whom are in the Southern Region. In additional, there are eight commercial dairy herds with around 420 cows, representing the remaining 19% of formal supply. This production concentration has lead to shortages for milk processors in the Central and Northern regions, which prompts imports of powdered milk[49] and more recently trucking milk from the Southern Region, where there are seasonal surpluses. Production levels are affected by seasonal rains, but also by prices paid for raw milk by processors. In 2006 this ranged from MK 35/ltr to MK 40/ltr from formal processors, compared to an informal sales price of up to MK 60/ltr if sold directly to consumer or up to MK 50/ltr if sold to a trader. There is evidence that the smallholder can increase or decrease production in response to prices and most are

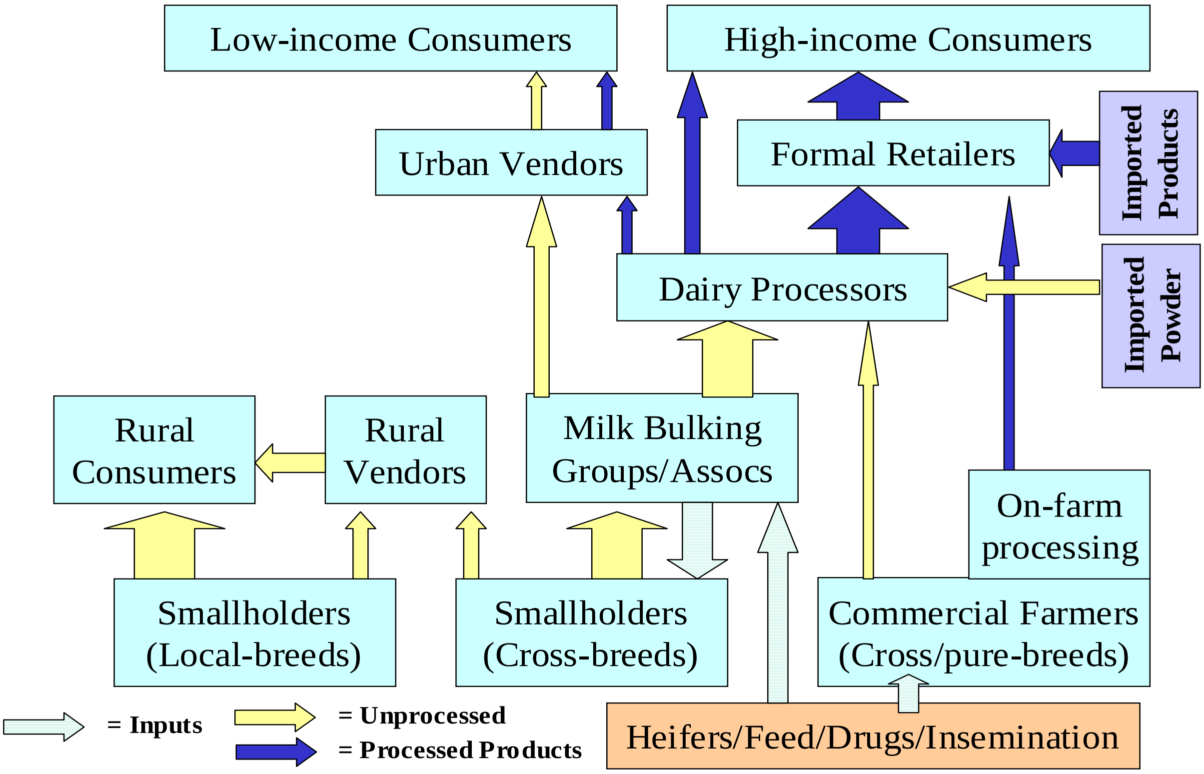
[48] Milk produced by local Zebu cattle is not included as this is almost all consumed by the producers rather than enter the marketing system. According to SHMPA, this probably accounts for about 66,000 ltrs/day, compared to 37,000/ltrs/day that is marketed formally and informally.
[49] 33-50% more expensive compared to local unprocessed milk bought from smallholders.

not yet producing at optimal levels. For example, additional feeding with cheap bran[50] would increase profitability by increasing production greater than the additional cost of the feed.

Milk Bulking Groups (MBGs) in production areas are a key element of the value chain, making it feasible for processors to collect milk from smallholders. Formal milk processors facilities are inspected four times a year. However, quality control of the raw milk moving throughout the value chain, from producer to informal trade to formal milk processors is still not good enough in the south, though Land O Lakes reports that the quality is good in central region according to the processors.

To grow the industry, increase consumption and production will take: a more competitive and risk taking approach, greater industry-wide organization, more efficient and competitive distribution, product right-sizing and pricing and subsequent marketing, as well as additional short and medium term capital. A depiction of the value chain follows in Exhibit . Investment opportunities exist throughout, though not all such opportunities can support current commercial lending rates of 22.5%[51] and more.

Exhibit 14 Dairy Value Chain Malawi



Source: Consultants based on interviews and secondary sources.

Economic Impact: More than 5,100 smallholders can earn on average more than $300/year[52] from milk sales, providing regular and for Malawi, a relatively high income,[53] as well as a diversification of farming risk. Importantly, this income reaches some of the more disadvantaged households, particularly women-headed that are the main beneficiaries of the work of the Shire Highlands Milk Producers Association (SHMPA) in Southern Region and LoL in Central and Northern Regions. In the formal processing sector dairy represents approximately 350 to 400 jobs at all levels, not including

[50] A bi-product of wheat and other cereal flour production.
[51] Commercial banks prime rate.
[52] The 3,800 members of the SHMPA grossed MK 170 million in 2006, or $320 at MF 140/$. Another report estimates on average more than $420/smallholder (*Milk Enterprise Development in Malawi*, 2006) as follows: MK 300 million / 5100 smallholders / MK140: $1.
[53] Per capita income is around $175.

jobs created by small processors in outlying areas. Given that most processors are operating at less than 40% of their installed capacity, there is considerable scope for employment increases without considerable capital investment. There are no formal exports presently, though the possibility exists, especially along the borders with Mozambique and Zambia, particularly for the newly introduced UHT milk, which is already reported to be crossing the border informally.

Sector Composition and Trends: The formal dairy industry in Malawi is a paradox. In many respects it is a mature industry, with formal processing around since the 1970s, and under government control until 1997. In other respects, it is an industry still experiencing teething problems in terms of the efficiency of its value chain. Since 1997, the sector has seen a considerable expansion and over the last few years a subsequent contraction in the number of formal processors. Today, there are three operating medium-scale processors – Lilongwe Dairy, Dairibord, and Suncrest – with a fourth in receivership (New Capital Dairy) and likely to be purchased and re-opened in time. There is also a smaller dairy in Mzuzu (Northern Dairies) and some estate production, such as Satemwa Estates, that produce a range of dairy products.

Each of the three operating medium processors is reportedly profitable while running at only 20-35% capacity utilization. This is possible because they target the top 3% (375,000) of the population with the highest disposable income that are relatively price insensitive. This conservative approach removes a good portion of the risk, but it does limit growth and volumes. Informed parties, suggest that it is possible to reach perhaps 10% (1.2 million) of the population through greater efficiency in distribution, lower margins (made up in additional volume), and innovative approaches.

All the processors use outside auditors. The board of directors for two of the processors is composed of family members, and the third is owned by Zimbabwe's Dairibord, while the company in liquidation had a mixture of shareholders including producer associations. Labor does not seem to be a problem at any level of the operation. While the formal processing level is highly concentrated, it appears to be reasonably competitive. The production level is fairly well organized through associations and MBGs. Milk moves from source to processor and consumer fairly effectively, if not always efficiently, though it is not uncommon for tankers of milk to be lost from non-collection due to poor roads and breakdowns.

The Malawi Bureau of Standards regulations appear to be fairly applied at the processor level. The duty and Value Added Tax (VAT) status, VAT exempt in most cases, plus the relative overvaluation of the currency in recent years, means that imported dairy products are relatively cheaper than they should be to the disadvantage of domestic production. Sale of unprocessed milk in urban areas is still illegal, but partly flouted. This law was originally intended to encourage milk processing, which at the time was a government monopoly, and based on developed country perspectives of what is necessary. The smallholder organizations say this antiquated law limits their opportunity to sell semi-processed milk to urban and peri-urban consumers the majority of who cannot afford processed (and packaged) milk products. This deprives a larger segment of the population of an important dietary source and limits market options for milk producers.

Challenges: The primary challenge and opportunity is attaining greater market penetration. This is entirely within the reach of the sector if it communicates and coordinates, and if at least one medium milk processor takes up the challenge to innovate more radically with competitively priced 'economy' products. Alternatively, or in tandem, the smallholder producer associations extend their marketing initiative and are not stifled by the regulators.

B2. Financing Opportunities

Borrower Profile: The three operating medium processors say they are making profits at low levels of utilization. They appear to be sophisticated if not aggressive business operators. The processors interviewed indicated total working capital needs of $1 million or more on a more or less permanent basis. The operating dairies have limited immediate need to replace current equipment, though in the next two years may have to start selective upgrading. One dairy recently invested in a UHT line; a welcome and bold move. Others may contemplate the same. A UHT line costs at least US $500,000 depending on capacity, plus the need for working capital for importing packaging and increased milk purchases. Other potential investments within the sector include improved collection centers, new products, increased raw milk purchases, and vehicles for collection and distribution. Loans, where obtained, are for relatively short-term needs and collateralized by buildings or personal property. The level of collateral is high and with the high commercial rates of interest, this has deterred additional investment, with the companies generally relying on parent company or family capital and accumulated profits for their investment capital.

Demand for Financing: Based on interviews with two of the three formal processors estimates of annual working capital needs unmet are at least $500,000 between them. Equipment needs over the next year amount to $800,000 to $1 million, if capital was available, affordable, and did not tie up collateral. There are two investors reportedly interested in a commercial scale dairy farms of 300 and 40 plus heifers (at a minimum imported price of US $1,000/head). The DCA feasibility study identified another US$ 2 million in investment possibilities in dairy – breeding farm and commercial dairy farm with on-site processing.

Other Related Dairy Linkages. This rapid analysis focused significantly on dairy processing. However, there are potential other businesses that supply into or are connected with the dairy value chain, notably equipment suppliers, feed suppliers, animal husbandry and veterinary services, cold transport and storage, input suppliers, packaging suppliers, freight forwarders and transporters.

B3. Strengths, Weaknesses, Opportunities, Threats (SWOT) Analysis

By way of a brief summary of the foregoing analysis of the Malawi dairy industry, the following summarizes the Strengths, Weaknesses, Opportunities and Threats.

SWOT Summary – Dairy Sector	
Strengths: • Existing dairy processors are profitable at low throughput; • Deeper market penetration need not require large capital investments; • Well defined and understood value chain, with generally functioning and effective system for raw milk collection; • Production of milk by smallholders is progressively increasing year on year without additional investment	*Opportunities*: • Formal milk market expansion to 10% or more from 3 % possible through product innovation and market penetration pricing; • UHT can extend market penetration to market centers areas without electricity; • Development of informal distribution network for semi-processed milk to poor urban consumers; • Donor and international NGO interest is high and Associations can access development funds
Weaknesses: • Lack of an effective industry-wide (producer to processor to retailer) representative body that can unite sector; • Quality control at pre-processing level is variable and creates problems later on; • Low average yield per cow relative to potential, due to limited feeding and poor disease control; • Collection of milk is difficult in the rainy season due to rural roads, resulting in losses	*Threats*: • Local market open to imported higher value products; • Uninformed policy and regulations that restrict innovative developments; • Fluctuations in world market prices for dairy powders causing sudden shifts in profitability

C. Dry Goods Processing

The consultants drew on current knowledge and information gathered from interviews with six processing firms of various sizes in drawing conclusions regarding the dry goods sub-sector.

C1. Sector Overview

Context: The formal dry goods processing sub-sector refers to a range of basic food commodities that are grown for self-consumption and trade, notably maize, rice, beans and groundnuts. The sub-sector has a handful of national medium to large processors processing for consumer sales and export and numerous local smaller millers that process (maize and rice) that farmers and consumers bring to them. The formal processors sub-sector is fragmented depending on the commodity and fairly competitive.

Cash Needed

"*As we are talking now, farmers all over the country have started trekking to us to sell their produce and to the disappointment of many we can only manage* [to purchase] *30 tonnes at a time…due to the current shortfall in working capital*."

Mid-size dry goods processor, April, 2007.

There should be a symbiotic relationship between smallholders and processors. To encourage further intensification of smallholder production, it is important to have ready domestic and export market[54] opportunities for crops produced, such as those presented by the dry goods processors. In turn, the dry goods processors are dependent on smallholders for raw material, as there are relatively few commercial farms. Given this landscape, intensifying production using sound crop husbandry practices is a must, and it is in the interest of processors to play a catalytic role where possible.

Much of the dry goods production is consumed by the producing household. This effectively takes many of the 'survivalist' smallholders out of the market system for processed dry goods. At the urban level, the poor buy commodities such as maize (chimanga) from traders and pay small hammer mills to process it into flour (ufa), further reducing the potential market. Even moderately well to do urban families, will transform some commodities, rather than buying it pre-processed. All told, the general domestic market for most dry goods is less than 10% of the population.

Though no figures were available, the government institutional market and the donor/NGO markets are important and relatively competitive, offering an additional outlet and a source of capacity utilization at breakeven or better prices. GoM and donors have been regular buyers of unmilled maize in years when there is a relative shortfall in production, sourced from within Malawi or commonly imported. In most cases, this is supplied by tenders, but the demand is unpredictable from year- to-year, and when there is a need, then by definition local supply tends to be constrained. In the 2006-07 production season there have been no major tenders.

Of more interest to the processors is the supply of a range of food products to donors and NGOs, contracts to schools, the Army and other government institutions, and contracts for private sector buyers, such as estates for feeding workers and so on. These mostly include demand for maize flour, rice, beans and some pulses. In addition, for nutritional feeding programs which are very common in poor countries like Malawi, there is increasing demand for special feeds for infants and malnourished people, such as Likuni Phale (maize, soya, sugar, salt and vitamins and minerals), and for energy-dense groundnut and sugar pastes (Sibusiso) that are used to target HIV/AIDS patients, particularly those who are weakened and entering anti-retro-viral therapy. This category of ready to use therapeutic foods (RUTF) is growing, rapidly, relatively profitable and local producers are beginning to substitute (costly) imported products.

[54] A recent study: Fresh produce into South Africa: An analysis of Supply Gaps, ABT Associates/CARANA Corporation for USAID Southern Africa, highlighted potential for fresh produce and a range of dry processed products that Malawi produces.

There is export potential for several commodities such as beans and groundnuts that have an export history. Groundnuts enjoy a strong internal market and were once a major export earner (50,000 metric tons/annually). Malawi used to be renowned as the home of the Chalimbana groundnut, which is very suited to packet nuts. However, due to the introduction of the CG 7 variety, which has much higher productivity than the Chalimbana variety, but is not as good for processing, the Chalimbana nut almost disappeared and with it much of Malawi's exports, undermined further by failure to assure afla-toxin compliance. More recently, a new Chalimbana variety has been reintroduced with similar levels of productivity as the CG 7, which should assure its wide re-adoption. This would also help to resurrect the export market for groundnuts from Malawi, though most of these would be unprocessed beyond sorting and grading. In terms of beans, there is reported to be considerable unfilled demand in South Africa in particular.[55]

Maize would have a ready regional market in surplus years, but GoM has banned its export in processed and unprocessed form, lifting it too late in the 2006-07season to make much difference for commercial processors and traders, though there is considerable demand (400,000 tonnes, Zimbabwe) and another 80,000 tonnes elsewhere in 2006-07. Lifting the ban should encourage production as it keeps farm gate prices potentially buoyant and remunerative for the smallholder, but the unpredictability of the imposing and lifting of bans is a deterrent to commercial production and processing

Though many processing plants report they are running at or well above break-even utilization, many require financing to purchase additional volumes of the basic commodities, which would allow them to increase their throughput, lower unit costs, penetrate further the domestic market and realizing the potential of the neighboring export markets.

Exhibit 15, next page, illustrates the dry goods processing value chain. Investment opportunities exist throughout, though most opportunities cannot support current lending rates of 22.5% and more.

Economic Impact: Nearly 9 out of 10 people are engaged in agriculture, which accounts for 35-39% of GDP according to how good the season is. Agriculture is critical to Malawi's present and future state of well-being, especially maize. More than 95% of smallholders grow maize, nearly 25% grow other cereals (e.g. rice), nearly 70% grow pulses (such as groundnuts), and more than 35% grow root crops (e.g. cassava).[56] The dry goods processing sub-sector offers a small, but important alternative market to traders who source from the smallholders, in effect giving the smallholders access to a wider market.

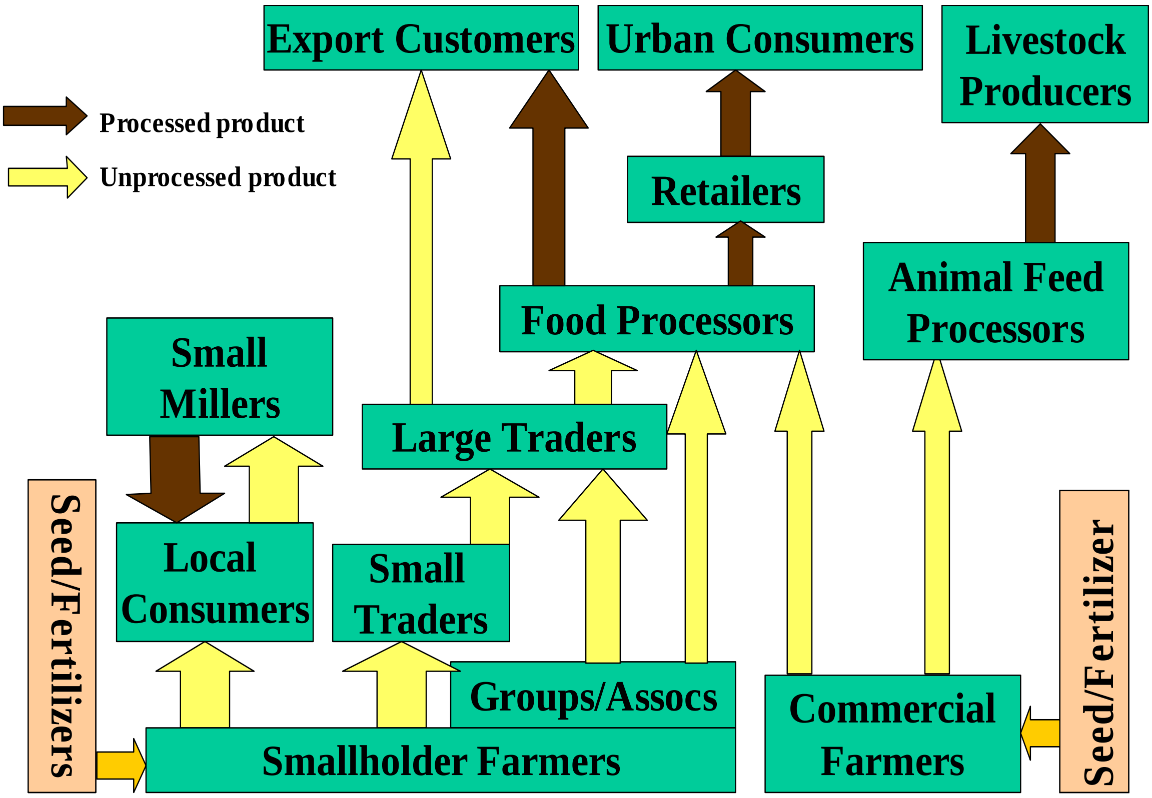
Select commodities and area under production (2006) are shown in Exhibit 16. The GoM reported[57] that for 2005-6 season, groundnuts and sweet potato were the most profitable crops, reflecting a strong domestic market. Maize however remains king, as it is very deeply entrenched as the national staple food of choice.

Exhibit 16 Hectares in Production (2006)[58]

Maize –	1,620,000	Cassava –	163,000
Groundnuts –	230,000	Pigeon peas –	150,000
Beans –	192,000	Rice –	51,000

[55] Fresh produce into South Africa: An analysis of Supply Gaps, ABT Associates/CARANA Corporation for USAID S. Africa.
[56] Report of an Internal Assessment Team: USAID's Activities on Agriculture and Food Security in Malawi (4th Consolidated Draft), November 2006
[57] USAID, Report of an Internal Assessment Team: USAID's Activities on Agriculture and Food Security in Malawi (4th Consolidated Draft), November 2006
[58] Ibid.

Exhibit 15 Dry Goods Processing Value Chain, Malawi



Source: Consultants based on interviews and secondary sources.

The 'Kilombera' rice produced in Malawi is regarded as aromatic compared to other varieties grown in the region, according to processors, and has qualities that are preferred on the local market, even compared to lower priced imports. Rice is not a staple, but a special occasion choice e.g. at Christmas, with one company noting that 35% of its rice sales come around the holidays. Pigeon peas and beans are important supplementary crops to maize as, both products have promising domestic and export markets. Cassava offers a drought resistant commodity and one with interesting processing possibilities given the growing demand for industrial starch. One plant, with support from the International Institute for Tropical Agriculture, is processing up to 150 tonnes/month (wet weight) providing a final (dry weight) output of 15 tonnes/month.

Sector Composition and Trends: The formal dry goods processor sub-sector in Malawi is fairly mature. A few medium to large companies have been around for awhile and have a diversified product mix, offering a range of products at different price points and even extending into other processing activities such as drinks. As lending rates come down, they will expand and others may look to invest in the sub-sector. For purposes of this assessment, six dry goods processors were interviewed – Rice Milling and Commodities Processors (same ownership), Tambala Foods, Karu Foods, NASFAM Commercial, and Countryside Products Ltd. It is estimated that together they represent more than 50% of the processed goods capacity and market share.

Maize, rice, groundnuts, etc. move fairly effectively from farm gate to processor. As depicted in the value-chain, most use middlemen though one company is considering establishing their own purchasing points to better control supply. This approach has been taken in the past and proven expensive for some companies to maintain and manage such a network of buying points, including moving the money around and controlling the activities of their own buyers. NASFAM Commercial seeks to buy direct from the associations and the companies also buy direct from the various associations and the rice schemes. The supply of commodities is complicated by harvest seasons that over lap (maize, rice, groundnuts are all within a three month window May – July) and there is only one opportunity to buy these commodities as, unlike maize, the farmers and associations do not generally store these products for later sale in the season. This puts additional financial pressure on the processors, who have to accurately estimate and buy their full year needs in one narrow window. This is also why a Warehouse Receipt Scheme would be welcome to the as it would provide the opportunity for processors, allowing them to borrow against their own stocks, or allowing others to hold stock and sell it later in the season, as working capital is the main restriction on expanding volumes of sales.

As a group, all but one of the processors are running at or above 50% utilization, with a couple likely near optimal utilization on a one shift a day basis. The age of machinery and equipment varies; but many are operating older equipment that is at or nearing its depreciable life. Some have newer equipment and one has a computerized "state-of-the-art" processing line. Sales figures for five of the six firms showed a combined turnover in 2006 (fiscal years differ) of MK 1.1 billion. All but one company showed a profit in 2006. Employment across the companies totals more than 430 full-time equivalent employees with seasonal jobs adding at least another 125.

As they compete domestically for the same niche markets (top 5-8% of the population with some disposable income, expatriates, and institutional sales), their products tend to be of good quality and widely accepted. If the increase in real per capita income is maintained, then the demand for their products will increase. Of the six, Rice Milling, Commodities Processors, NASFAM, and Tambala are also keen on developing their export markets.

Five of the six firms engage an outside auditor, with the one exception considering such. All of the companies are under 'closed' ownership, mostly families; though one has three different owners and a board that includes another three outsiders. NASFAM Commercial is a company limited by guarantee, wholly owned by NASFAM, but set up as a separate company to encourage a strong market orientation, that is distinct from NASFAM's development work. Labor does not seem to be a problem at any level of the operation, except for Rice Milling and Commodity Processors.[59]

Malawi Bureau of Standards (MBS) product standards appear to be fairly and evenly applied, and are not an issue, though there are concerns about the testing capacity of MBS and the application of unnecessary levies on imported products for processing. The Malawi Revenue Authority (MRA) is different however, as the MRA officers are paid a commission on total assessed tax collected, which encourages over-assessing and subsequent "negotiation" of the assessment.

Challenges: The primary challenge and opportunity is attaining greater domestic market penetration and realizing export potential. Both are possible provided the processors can access financing to purchase greater product volumes, increasing throughput and utilization, reducing unit costs, and making the final product more affordable domestically and more competitive regionally.

The other major challenge is improving the supply and quality of produce from the producers, as it is currently erratic and of mixed quality. This type of supply system allows for spot exports, but is not conducive to medium and long-term export contracts or the development of branded consumer products, if supply of the basic commodities is not sufficiently certain.

C2. Financing Opportunities

Borrower Profile: The dry goods processors interviewed are medium firms with relatively fixed labor and capital overheads. Smaller operators have an advantage in that they can simply shut down, when

[59] The rice milling line is ultra modern, and requires a degree of computer and machinery skill not readily available. Commodity Processing's labor issue is on the other extreme. The production of dahl from pigeon pies is as much an art as wine making. Dahl specialists apprentice for years and finding this talent in Malawi is impossible. In both cases, work permits for foreign nationals have been difficult to obtain.

product for processing is not available, as their fixed carrying costs are lower. Micro-processors, those most likely operating a small hammer-mill facility, often do not even buy product outright but operate the mill on a use-charge basis, though some do buy on their own account for sales in scarce periods.

The six processors interviewed appear to range from ultra sophisticated to moderately so. All appeared to have a strategic plan (written or otherwise) and all but one were able to provide clear information on their financial situation and needs. Again, this is not likely reflective of the micro processor. All but one indicated they are profitable. The potential for these medium dry goods processor is one of deeper domestic market penetration and export market expansion. Both paths, to varying degrees depending on the processor, are dependent in part on financing.

Demand for Financing: The six firms vary in their financing needs. All reported immediate need for working capital ranging from $500,000 up to $3 million for raw material purchases. Three firms identified medium term financing needs collectively of just under $1.3 million. This of course does not account for the myriad of smaller and micro processors. In addition, as noted in the DCA feasibility study, some portion of a proposed starch processing facility would likely be eligible under the facility.

Other Related Dry Goods Processing Linkages. This rapid analysis focused on small and medium processors. However, there are potential other businesses that supply into or are connected with the dry goods processing value chain, notably equipment suppliers, transporters, packaging suppliers, equipment repair services, storage facilities, village-level micro millers, and others.

C3. Strengths, Weaknesses, Opportunities, Threats (SWOT) Analysis

By way of a brief summary of the foregoing analysis of the Malawi dry goods processors sub-sector, the following summarizes the Strengths, Weaknesses, Opportunities and Threats.

SWOT Summary– Dry Goods Processing Sub-Sector	
Strengths: • Raw material is locally available, though not always in sufficient supply; • Considerable development partner interest and initiatives to increase smallholder productivity and production levels; • Stable and growing domestic demand for processed products; • Emergence of the Grain Traders and Processors Association - GTPA pressure helped lift the ban on maize exports; • Relatively high levels of utilization ensuring most firms are profitable with resources to re-invest; • Trading network does bring commodities from the rural areas to the urban centers where the processors are; • Agricultural land rents relatively low; • General plentiful labor availability	*Opportunities*: • Investment in systems to improve yields/returns for smallholders that will produce a surplus for marketing; • Potential to increase the sale of packaged processed goods, such as groundnuts, rice and other commodities to a growing domestic market; • Increasing demand for Ready to Use Therapeutic Foods; • Regional export markets, particularly South Africa for commodities other than maize • Re-establishment of the Chalimbana export markets;
Weaknesses: • Coinciding harvest seasons for maize, rice, groundnuts stretches working capital; • Insufficient working capital available and high cost of borrowing to supplement own sources; • Need to import most packaging; • Road network is problematic especially during rainy season, making buying difficult at certain times and from isolated areas; • Shortages of skilled labor may constrain value-addition potential; • Some traders exploit smallholders, resulting in lack of resources for re-investment by many farmers;	*Threats*: • Mixed signals for the GoM of liberalizing markets yet intervening on prices, buying via ADMARC and subsidies for inputs, • Poor weather conditions risk for every harvest; • Commodity price volatility and generally low prices make investing in production riskier; • Agricultural commodity trade may be subject to worsening protection, particularly in the light of the failure of the WTO, Doha Development Round.

SECTION V: BRIEF CONCLUSIONS AND RECOMMENDATIONS

The purpose of this report was to provide an analysis on the creditworthiness of the SME sector in Malawi as part of a broader feasibility assessment of utilizing a DCA Loan Portfolio Guarantee undertaken by USAID/Malawi, with analysis based on interviews conducted in Blantyre and Lilongwe, as well as secondary source information. The analysis examines the economic performance of Malawi and its outlook, the business environment, the role of SMEs in the economy, challenges and opportunities confronting business, and in some more detail three agriculturally-linked sectors.

Following is a summary of the real and (bank) perceived risks of lending to Malawian SMEs that could contribute to borrower delinquency or default. Along with these potential risk factors, thoughts are offered regarding risk mitigating factors, both real and potential.

- **Weather Dependence**: Malawi's agriculture is largely dependent on the vagaries of the weather. For the last two production seasons, including 2006-7, the rains have been good and agriculture and agriculturally-linked businesses have flourished, but the two seasons previous to this saw considerable production shortfalls for many commodities. Irrigation is relatively limited (approximately 40,000 hectares out of a potential of 500,000 ha); though there are a range of governmental, development partner and commercial initiatives to extend irrigation that would provide a more reliable supply of produce for processing. Crop insurance programs would also offer some protection. Although none currently exists, there is a trial being undertaken by NASFAM and the World Bank in a limited number of sites around weather stations.

- **Volatility**: Malawi's export crops, such as coffee and tea, and generally speaking any unprocessed commodity, are vulnerable to the swings in commodity prices. Coffee in particular suffered from world oversupply for many years and prices for producers and processors have only recently improved, further mitigated by Malawi beginning to target the specialty market. Processed products are by their nature, less volatile than un-processed/semi-processed commodities, which would include a number of Malawi's non-traditional export crops. The existence of a partial guarantee that expands access to financing for traders and processors could reduce price volatility by increasing the volume of commodities purchased by traders and processors which encourages steady production levels rather than wild swings. Likewise, the rapid economic development in Mozambique, Tanzania, and Zambia is expanding regional markets, which should have a further dampening effect on volatility.

- **High Transaction Costs**: High transaction costs due to infrastructure constraints, poor technology and high cost of inputs, reduces value added potential for SME products reducing profit levels. However, with the fall in interest rates there are increased opportunities for the introduction of new technologies that will substitute for imported processed products, as has happened with long life milk in the dairy sector. Moreover, the GoM has shown greater focus on investment in productive infrastructure, which in time will reduce transaction costs.

- **SMEs**: There is an inherent perception of risk by commercial banks in the targeted agriculturally-linked SME borrower group due to their size, typical ownership and business acumen. This perception is exacerbated by commercial banks' lack of knowledge of SMEs, their limited understanding of the relative risks within agricultural sectors[60] their conservative

[60] Different crops have different return profiles – for example coffee is a once a year harvest, whereas tea is cropped bi-weekly and payments flow more regularly. However, coffee bushes start to yield within 2 years, whereas tea only yields after 3-4 years.

lending policies, and the lack of financial product innovation. Possible factors mitigating such SME risk include:

- Donor initiatives (See Annex C, Donor and Private Foundation Activities) targeting SMEs and the agriculture sector that can boost production, help secure markets, improve market infrastructure, enhance business acumen, etc. all reducing the risk of lending to agriculturally-linked SMEs.
- Opportunity to pair a DCA Loan Portfolio Guarantee (should such be determined to be an appropriate mechanism to address the financial impediments to the development of the SME sector in Malawi) with technical assistance and capacity building to complement both the lender(s) and borrower(s), which will mitigate the risk of lending to SME agribusinesses.
- Opportunity to develop new loan products that match needs and cashflows. Some lenders see this possibility. For example, as noted, a few banks are offering purchase order financing though still requiring collateral rather than securing the loan with the purchase order. A partial guarantee program could enhance these efforts by eliminating the need for collateral.

- **Low Investment-Low Return Cycle:** Competition for funds by the GoM for a long time meant that banks flocked to high yielding and relatively safe T-bills. This complicated credit accessibility by SMEs and raised the cost of funds to a point where an SME with an otherwise profitable business could not afford to borrow to invest. The safer decision in that situation was not to borrow but to invest out of cashflow and profits, thus limiting growth to current profitability rather than the profitability level that could be attained from higher investment. With interest rates decreasing and expected to fall further from the current 22.5%, investments that were not profitable at 40+% interest are now viable, offering opportunities for company returns commensurate with the investment and risk.

- **Sources and Uses Mismatch:** The lack of long-term credit products can mean that short-term borrowing is being used in some cases to finance long-term (more than 12 months) needs. This is relatively costly for the business and places a burden on their cash flow, which also increases risk to the lending bank. This reflects in part the low level of product innovation by the banking sector and in part the lack of awareness by businesses of alternative methods of financing their businesses that have emerged, such as forex lines of credit. As the market becomes more competitive, banks will innovate and promote their existing products more aggressively, helping to close the information and product gaps.

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ANNEX A: REFERENCES

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ANNEX B: Interviews

ANNEX B: INTERVIEWS

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ANNEX C: Donor and Private Foundation Activities

ANNEX C: DONOR AND PRIVATE FOUNDATION ACTIVITIES

Outside Efforts Related to Agriculture[61]

Donors:
JICA: 800 ha irrigation rehabilitation scheme; processing and marketing of agricultural products at the village level; appropriate processing and technology; volunteer dairy technicians with NGOs.

DFID: major emphasis is input subsidy program and more recently looking at public-private partnerships in agriculture and other sectors that promote social development.

NORAD: Norway is supporting agricultural research, small scale irrigation and NASFAM, among other efforts.

The United Nations System: There are eight agencies operating in Malawi, including, UNICEF, FAO (focused on small scale irrigation, water harvesting and improving soil fertility), WFP and UNIDO. Latter has been working on investment promotion with Malawi Investment Promotion Agency (MIPA) and there is the Growing Sustainable Businesses (GSB) project to find equity venture partners to invest in Malawian businesses.

European Union: Agriculture-related programs work through the Ministry of Agriculture and emphasize soil conservation and water management, crop and livestock production, building the capacity of farmer organizations, and marketing. They are also working within the Ministry of Agriculture on institutional change and support to agri-businesses through the IDAF project. Previously they supported farmer input lending through the Agricultural Productivity Improvement Programme (APIP).

World Bank. The World Bank activities in agriculture focus on developing a land market, irrigation rehabilitation, resettlement and infrastructure development. The Bank is rehabilitating five large irrigation schemes and supporting the development of water user associations to manage the schemes. Infrastructure activities involve rural roads, power, telephone and water projects. Other agriculture related activities include working with NASFAM on grain banks, possible support to warehouse receipts programs and the agriculture commodity exchange. The Bank is also supporting the establishment of a Commercial Court and a program of private sector development, including institutional capacity building, support for Business Development Services and support for public-private dialogue.

Private Foundations:
The Millennium Village Project promoted by Jeffery Sachs with a UN Fund is operating in Malawi in a few pilot villages seeking to prove that intensive support can radically change the economic and social outcomes for people.

The Alliance for a Green Revolution in Africa (AGRA) is a partnership between the Bill & Melinda Gates Foundation and the Rockefeller Foundation. The foundation is considering Malawi for selection.

The Raising Income of Smallholders Farmers in the Developing World by Improving Value Chains project funded by the Gates Foundation is considering committing a total of $30 million to between five and fifteen grantees. NASFAM has presented a concept paper and is well positioned to receive one of the grants. Practical Action (UK) also presented a concept paper for dairy development in four countries including Malawi, and it may be funded in the next round through the master grantee, Heifer International.

[61] All material in this annex is taken from *Report of an Internal Assessment Team: USAID's Activities on Agriculture and Food Security in Malawi* (4th Consolidated Draft), November, 2006.

The Clinton-Hunter Development Initiative (CHDI) has selected Malawi and Rwanda to launch this initiative. CHDI will be a government-led effort in which the Clinton Foundation plays a critical supportive and catalytic role. CHDI will work to address the continuum of problems facing African agriculture today through: the application of new technologies and techniques to achieve greater food productivity and sustainable agriculture; changing the economics of agriculture inputs; and the creation of sustainable market mechanism for surplus agricultural productions.

Non-governmental Organizations:
There are numerous NGOs working at the community level in various agriculture sub-sectors on such things as improving productivity, access to markets, use of inputs, etc. Among these are World Vision, Concern Worldwide, Concern Universal, Oxfam, GOAL, CADECOM and many others.

The following table compares Donor and Private Foundation development programs in Malawi with the 11 priorities in Malawi's Agricultural Sector Policy Framework.

Programs of Major Donors Matched Against the 11 Priorities

Priority	Donor & Activity
1. Land tenure	*EU* – support for implementing Malawi's land reform program *World Bank* – assistance in developing a land market and resettlement
2. Sustainable Mgt. of Nat. Res.	*EU* – land care under food and nutrition security work *EU* – farm income diversification project focuses on soil conservation *EU* – improved forestry management for sustainable livelihoods *USAID* – COMPASS - improved management of natural resources *USAID* – CHIA Lagoon sustainable use
3. Adaptive Research	*NORAD* – agricultural research at Bunda College of Agriculture *EU* – tea propagation and plant breeding *Rockefeller and Gates* – developing appropriate seeds *USAID* – CGIAR centers and Bean/cowpeas CRSP
4. Extension	*EU* – training and credit for coffee production *Rockefeller and Gates* – delivering high-quality seeds to farmers
5. Irrigation	*JICA* – Bwanje Valley irrigation scheme *NORAD* – small scale irrigation *FAO* – small scale irrigation *EU* – irrigation under food and nutrition security work *EU* – safety net activities providing treadle pumps *World Bank* – irrigation rehabilitation *USAID* – I-LIFE small scale irrigation activities, WSU/Total Land Care programs on gravity systems and treadle pumps
6. Credit for Inputs	*NORAD* – Malawi Savings and Credit Unions with SIDA *EU* – loans to farmers' organizations to provide inputs to smallholders (APIP) *USAID* – microfinance for underserved poor *USAID* – expand access to capital by MSMEs
7. Quality Control	*EU* – ensure quality of agri-food exports with international standards
8. Conducive Environment for Increased Smallholder Productivity	*DFID* – fertilizer subsidy *EU* – support to GOM on agricultural trade issues *EU* – smallholder seed multiplication action group *EU* – marketing of diversified agricultural products *World Bank* – cereal banks, warehouse receipts, and agricultural commodity exchange, reforms at ADMARC *Rockefeller and Gates* – expansion of seed and fertilizer distribution networks *USAID* – promoting private sector input provision *USAID* – I-LIFE livelihood activities
9. Livestock, Fisheries, and Agroforestry	*EU* – smallholder dairy under food and nutrition security work *EU* – safety net activities in sustainable fuel wood and timber supplies *USAID* – dairy development
10. Farmers' Organizations	*EU* – cooperatives under food and nutrition security work and under farm income diversification project *EU* – support to take advantage of market opportunities *EU* – support for Paprika Farmers Association

Priority	Donor & Activity
	USAID **–** promoting smallholder farmers' associations
11. Value-Addition and Agribusiness	*JICA* – processing and marketing of ag products at the village level *EU* – production of locally made corn soya blend for supplementary feeding *EU* – enabling environment for growth across the agri-food chain *Rockefeller and Gates* – improving value chains for smallholders *USAID* **–** support for both output input marketing chains, cassava starch processing, processing and marketing of forest products