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Contract farming handbook

A practical guide for linking small-scale producers and buyers through business model innovation

Published by giz Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH

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Margret Will

List of Contents

List of boxes

List of figures

Abbreviations

ACA	African Cashew Alliance
ACi	African Cashew Initiative
AFD	Agence Française de Développement
AISP II	Agricultural Input Supply Project II
BDS	Business Development Services
BMZ	Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung
BoP	Bottom of the Pyramid
CAADP	Comprehensive African Agriculture Development Programme
CBZ	Cotton Board of Zambia
CF	Contract farming
CmiA	Cotton made in Africa
CoC	Code of Conduct
COMPACI	Competitive African Cotton Initiative
CoP	Code of Practice
CSR	Corporate Social Responsibility
CSV	Creating Shared Value
DCED	The Donor Committee for Enterprise Development
EABC	East African Business Council
EAGC	East African Grain Council
FA	Financial assistance
FAO	Food and Agriculture Organization of the United Nations
FBS	Farmer Business School
FPEAK	Fresh Produce Exporters Association of Kenya
GAP	Good Agricultural Practices
GGC	Ghana Grains Council
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH (now: GIZ)
HCDA	Horticultural Crops Development Authority
ICT	Information and Communication Technologies
IFAD	International Fund for Agricultural Development
IVLA	International ValueLinks Association e.V.
KENFAP	Kenya National Federation of Agricultural Producers
LDC	Least Developed Country
MFI	Micro finance institution
NGO	Non governmental institution
PPP	Public Private Partnership
RFLC	Rural Finance Learning Center
RoI	Return on Investment
SWOT	Strengths, Weaknesses, Opportunities and Threats
TA	Technical assistance
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development
VC	Value chain

Acknowledgements

This handbook is a joint product of three projects financed by the Federal Ministry for Economic Cooperation and Development (Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung/ BMZ) of the Federal Republic of Germany and implemented by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH; namely the Sector project Agricultural Policy and Food Security, the Competitive African Cotton Initiative (COMPACI) and the Agricultural Input Supply Project II (AISP II) in Zimbabwe. The author would like to thank the project managers, Mr Ingo Melchers, Mr Wolfgang Bertenbreiter and Dr Ulrich Weyl for having entrusted this highly interesting subject to her.

The touch with reality of this contract farming guide would not have been possible without the support of many people. The author expresses her gratitude to all interview partners who provided particularly valuable and interesting insights into on-going activities and future projects during the author's visit to Kenya, Zambia and Zimbabwe. It was a real pleasure and a great help to exchange ideas and learn from highly experienced company management and staff and committed representatives of public and private sector organisations and donor programmes.

Special thanks go to Frans Grey/ Cargill in Zambia; Charles Hayward and Graham Chilimina/ Dunavant in Zambia and the Dunavant lead farmers Mr. Kandesha, Mr. Muene and Mr. Chidenda; Dafulin Kaonga/ Cotton Board of Zambia; Dr Stephen Mbithi and Francis Wario/ Fresh Produce Exporters Association of Kenya (FPEAK); Boris Binnewerg/ Indu-Farm (EPZ) Ltd. in Kenya; Booker Owuor/ Kenya Small Scale Cereal Growers Association; Stanley Guantai/ ACDI VOCA Kenya Maize Development Programme; Harun N. Baiya/ SITE Enterprise Promotion in Kenya; Sean Johnson, Brendan Smith and Masimba Kanyepi/ Prime Seed and the contract farmer group in Mutasa District in Zimbabwe; Tafadzwa Madondo/ Consultant AISP II Zimbabwe; Theresa E. Makomva and Prince J.T. Kuipa/ Zimbabwe Farmers Union; Thomas Gardiner and Kudzai Mariga/ USAID Zimbabwe Agricultural Income & Employment Development Program; Helmut Anschuetz/ GIZ Advisor Zimbabwe Farmers Union; and Chris Masara/ SNV Zimbabwe.

The author especially appreciated the inspiring discussions on all aspects of contract farming with Dr Ulrich Weyl and Christoph Pannhausen during her stay in Zimbabwe, just like their recommendations for structuring this handbook. Furthermore, special acknowledgement goes to Max Baumann/ GIZ Environment and Rural Development (EnRD) Program Philippines, Christoph Pannhausen/ GIZ AISP II Zimbabwe, Till Rockenbauch/ GIZ Sector project Agricultural Policy and Food Security and Leonard Efison Munjanganja/ Zimbabwe for their constructive comments on the draft of this handbook.

Margret Will

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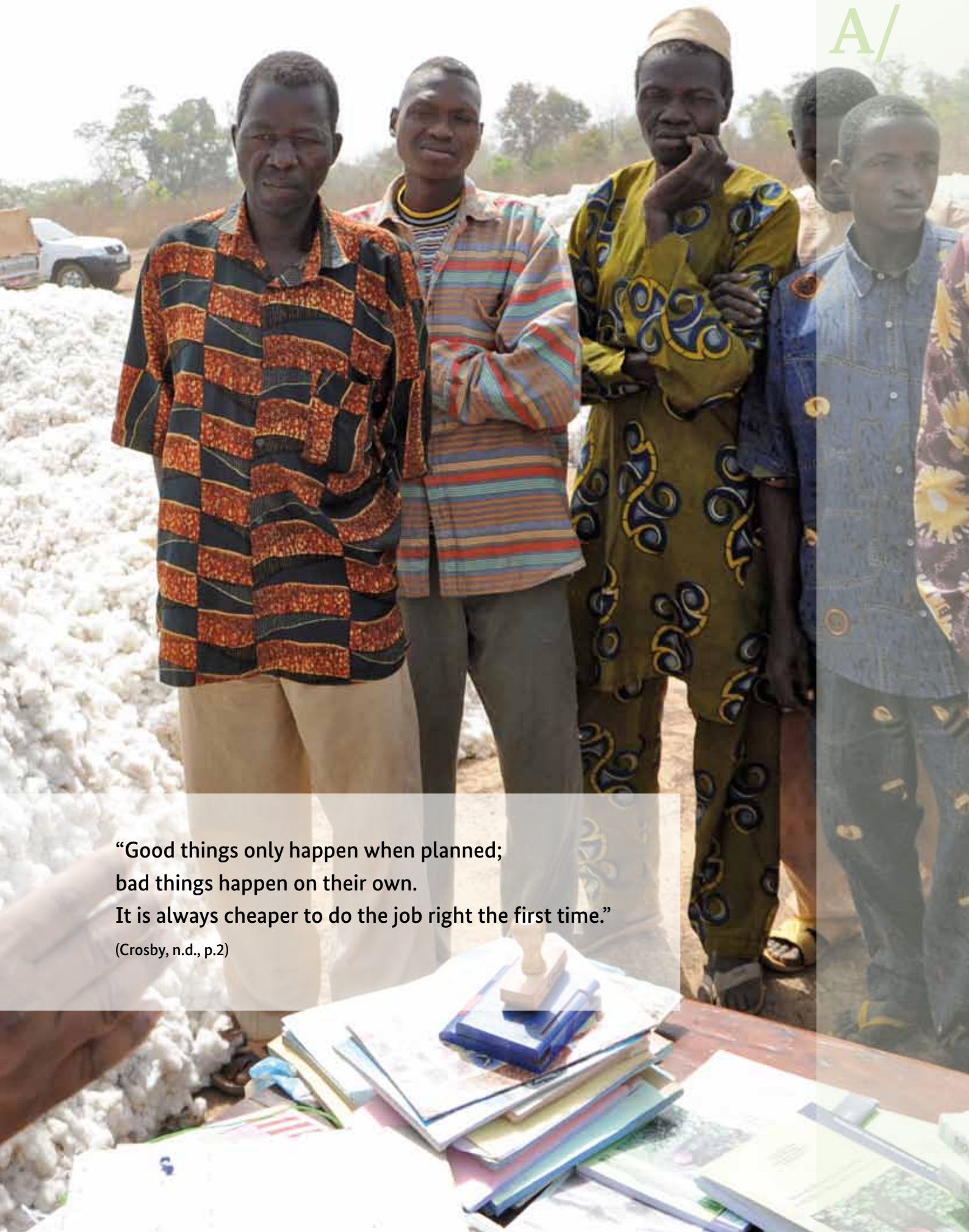


**“Good things only happen when planned;
bad things happen on their own.
It is always cheaper to do the job right the first time.”**
(Crosby, n.d., p.2)

A/ About this guide: which purpose? for whom? and how to use it?

Seen as a powerful tool for linking farmers to buyers in an increasingly concentrated agri-food sector, and buyers to supply sources in ever-more competitive agricultural markets, contract farming experiences a new popularity. However, neither is contract farming a panacea for rural development nor does a blueprint exist for the design and operation of successful and sustainable contract farming arrangements. Rather, every single scheme calls for situation-specific design according to market opportunities, product features, suppliers' and buyers' capabilities, capacities of business development services as well as local, national, regional and international framework conditions for private investments into agri-food business development along the entire value chain (VC).

The history of contract farming, equally in developed and developing countries, shows quite mixed results. While in developed countries, contracts are more widely used with larger-scale farms, success stories in developing countries are also written with smallholders mainly in high-value product or commodity segments for exports and for overseas' or in-country processing. However, there are also hidden success stories in so called traditional markets linking small-scale farmers with village-level or small to medium-scale traders or processors through informal contractual agreements. Little is known about the scope and scale as well as the factors for success and failure of such arrangements. But the traditional ways of communication and coordination and the home-grown networks may well inform the design of new schemes or serve as starting point for upgrading and up-scaling existing ones.

On the other side, there are many reasons why quite a number of schemes collapsed in the past. In developing countries, it is often failure to adequately analyse the starting position, assess optional contract arrangements, design viable solutions, develop realistic and realisable business plans, competently manage contract relations and adapt external support to co-contractors' needs. Problems also arise when the promotion of contract farming is driven by third-party facilitators (governmental, non-governmental and development partners or consultants). Primarily pursuing development objectives, they often disregard that contract farming is first and foremost a business arrangement, in which farmers and buyers bear the risk of investments into land, labour and capital and have to take an independent informed decision whether to venture into such an innovative business model (see insert) or not. At the same time, farmers and buyers tend to rest on their laurels: buyers are readily willing to leave the difficult task of building capacities of large numbers of small-scale farmers to external agents; and farmers are thought not to be capable of defending their interests in contract negotiations without external support. In the end, none of the players assumes his or her distinct role and fails to concentrate on his or her core competencies in managing or supporting sustainable business linkages.

> A business model is characterised by the logic and the arrangements of how a company (farm or firm) creates, delivers and captures value.

It is obvious that lessons need to be learnt from past experiences to guide practitioners in the development of contract farming arrangements that are profitable for farmers and buyers thus justifying the risks taken in venturing into such a joint business. To furthermore legitimate assistance from government and development partners, the supported schemes also have to contribute to achieving overarching macro-economic development objectives (e.g. pro-poor growth, food security, protection of natural resources, and adaptation to climate change).

Which purpose does this handbook serve?

Against this background, the purpose of this guide is to provide a practical and process-oriented approach for a sound planning and implementation of contract farming (CF) schemes. Meant to assist practitioners to make such private business arrangements work, this guide provides answers and proposes tools for:

- the clarification of roles and responsibilities of farmers and buyers as business partners and governmental, non-governmental or development partners or others as third-party facilitators;
- the design of viable contract farming arrangements as part of an urgently required business model innovation based on a rapid but sound assessment of the starting situation;

A/

- the implementation of trust building and capacity development activities to support necessary change of attitudes and the adoption of relevant new technologies; and
- the reporting and monitoring systems required for managing CF schemes, giving feedback on performance and serving learning loops necessary for consolidating and up-scaling the scheme.

Who is this handbook for?

This guide has been developed to serve practitioners involved in starting up and managing or supporting the initiation and implementation of contract farming schemes:

- companies (buyers) interested to develop networks of small-scale farmers as competent and reliable preferred suppliers;
- farmers' organisations (farmer groups, associations, cooperatives) interested to service members (e.g. joint learning and possibly joint contract negotiation, input distribution, collection, marketing);
- sector organisations like national inter-professional bodies or regional federations interested to develop trade and exchange platforms or codes of conduct for contract farming; and
- third parties (governmental, non-governmental and development organisations or consultants) interested to promote CF as innovative business arrangement in a broader development context.

What coverage and limitations does this handbook feature?

As a generic guide, the proposed approaches are applicable for any type of product and situation, provided users are capable of using it in a flexible way and adapting the tools and recommendations to the specific local situation and the ever-faster changing production and market contexts in developing countries. With a view to facilitating this task, the handbook provides:

- the conceptual foundations of contract farming and its facilitation as basis for understanding the proposed phases and steps for contract farming development;
- a process-structure for CF development with three phases (initiate & plan, implement & learn, sustain & grow) and eight steps;
- a systematic description of the three phases and respective steps in a clearly structured and easy-to-capture format;
- specific guidance on selected key features of contract farming (e.g. contract terms, pricing mechanisms, causes of conflict and conflict resolution); and
- for each phase and step, references for literature on the subject.

In order not to further bloat this guide, the editors intend to provide detailed descriptions of proposed tools and case examples in a separate document. And, to make this guide usable for field agents and farmers, a shortened version will be prepared that focuses more on the farm-level and post farm-gate features of contract farming. It is also intended to develop a training course and training material.

How can this guide be used?

The main thrust of this guide is to provide a hands-on and process-oriented approach for the development of contract farming schemes. Following the logic stages of starting up a business, the overall structure is easy to capture. And, while giving orientation for a focussed approach, the guide remains flexible leaving the selection of tools and sequencing of activities to the discretion of users according to the reality on the ground.

B/B.1/

"While it is conceivable that exogenous change in education, literacy and awareness would assist transition to contract-based relationships, it is unlikely that court-aided enforcement would ever render trust irrelevant, as has been pointed out repeatedly even in developed countries."

(Narayanan, 2012, p.13)

B/Conceptual foundations

B/1 Contract farming (CF): the basics at a glance

1.1 Definition, contract farming models and contract types

Contract farming (CF) is defined as forward agreements specifying the obligations of farmers and buyers as partners in business. Legally, farming contracts entail the sellers' (farmers') obligation to supply the volumes and qualities as specified, and the buyers' (processors'/ traders') obligation to off-take the goods and realise payments as agreed. Furthermore, the buyers normally provide embedded services (see insert) such as (for more details see section C.2):

- upfront delivery of inputs (e.g. seeds, fertilizers, plant protection products);
- pre-financing of input delivery on credit (explicit rates not always charged; see insert); and
- other non-financial services (e.g. extension, training, transport and logistics).

With regard to substance, form and the process of concluding such arrangements, farming contracts are quite variable (for more details see sections C.2 and C.3):

- agreements may be established informally or formally, in verbal or written form;
- contracts may be concluded with individual farmers or farmer groups;
- description of obligations may remain quite vague or be reasonably specific;
- contracts may be renewed each season or cover long-term agreements;
- specifications may be based on case by case negotiations or on a sub-sector code of practice.

Whatever process applied or contents itemised, to be successful and sustainable, contract farming arrangements have to be designed in a way that promises benefits to both co-contractors (see section B.1.3).

Given the diversity of produce features and geo-climatic situations, existing forms of transaction and business development services (BDS), business cultures and entrepreneurial capacities, socio-economic structures (e.g. farmer organisations) and attitudes (e.g. business attitudes, opportunistic behaviour) and investment climate, it is obvious that there is no one-size-fits-all blueprint for designing contract farming arrangements. Rather, there are various forms in the continuum from spot market exchange to full vertical integration within a firm. For designing the best possible contract farming arrangement under given local conditions, there is hence a need to analyse the opportunities and limitations for building trustful, reliable and sustainable coordination and cooperation linkages between farmers and buyers.

According to Eaton and Shepherd (2001, p.44f), "Contract farming usually follows one of five broad models, depending on the product, the resources of the sponsor [the buyer] and the intensity of the relationship between farmer and sponsor that is necessary." While CF schemes may take various forms and involve different actors, a formal contract concluded between the farm and an agribusiness firm is common to all types of schemes, thus forming a distinctive difference

Embedded services are financial or non-financial services provided by the off-taking company as integral part of the business transaction. Service charges are usually deducted from the farmers' final sales revenue.

Interest rates for pre-financing of input delivery are not always transparently specified in contracts either to avoid discussions or they are not charged if intended to incentivise farmers.

Contract farming and outgrower schemes: While some authors use the terms synonymously, there is a difference: an outgrower scheme is a particular contract farming model. Typical characteristics are a high degree of service provision on the side of the buyer in exchange for land and labour provided by smallholders (see nucleus estate model in Box 1 and Figure 1).

Business Development Services (BDS) "are services that improve the performance of the enterprise, its access to markets, and its ability to compete." (DCED, 2001).

Vertical integration relates to a merger of two or several nodes of the value chain within one company (e.g. backward integration of processors into farming or forward integration of farmers into trading and/ or processing).

Spot markets are characterised by one-off sales transactions without prior agreement.

B.1/

to spot-market/ arms-length marketing relations. The following provides an overview on different **contract farming models** and their respective features (Box 1 and Figure 1) and on **contract types** (Box 2).

Box 1/ **Contract farming business models**

(adapted/ complemented by the author from Eaton & Shepherd, 2001, p. 44f; van Gent, n.d., p.4f)

Informal model

"This model is the most transient and speculative of all contract farming models, with a risk of default by both the promoter and the farmer" (van Gent, n.d., p.5). However, this depends on the situation: interdependence of contract parties or long-term trustful relationships may reduce the risk of opportunistic behaviour.

Special features of this CF model are:

- Small firms conclude simple, informal seasonal production contracts with smallholders.
- The success often depends on the availability and quality of external extension services.
- Embedded services, if at all provided, are limited to the delivery of basic inputs, occasionally on credit; advice is usually limited to grading and quality control.
- Typical products: requiring minimal processing/ packaging, vertical coordination; e.g. fresh fruit/ vegetables for local markets, sometimes also staple crops.

Intermediary model

In this model, the buyer subcontracts an intermediary (collector, aggregator or farmer organisation) who formally or informally contracts farmers (combination of the centralised/ informal models).

Special characteristics of this CF model are:

- The intermediary provides embedded services (usually passing through services provided by buyers against service charges) and purchases the crop.
- This model can work, if well-designed and if incentive-structures are adequate and control mechanisms are in place.
- This model can bear disadvantages for vertical coordination and for providing incentives to farmers (buyers may lose control of production processes, quality assurance and regularity of supplies; farmers may not benefit from technology transfer; there is also a risk of price distortion and reduced incomes for farmers).

Multipartite model

This model can develop from the centralised or nucleus estate models, e.g. following the privatisation of parastatals. It involves various organisations such as governmental statutory bodies alongside private companies and sometimes financial institutions. Special features:

- This model may feature as joint ventures of parastatals/ community companies with domestic/ foreign investors for processing. The vertical coordination depends on the discretion of the firm. Due attention has to be paid to possible political interferences.
- This model may also feature as farm-firm arrangement complemented by agreements with 3rd party service providers (e.g. extension, training, credits, inputs, logistics).
- Separate organisations (e.g. cooperatives) may organise farmers and provide embedded services (e.g. credits, extension, marketing, sometimes also processing).
- This model may involve equity share schemes for producers.

Centralized model

In this model, the buyers' involvement may vary from minimal input provision (e.g. specific varieties) to control of most production aspects (e.g. from land preparation to harvesting).
This is the most common CF model, which can be characterised as follows:

- The buyer sources products from and provides services to large numbers of small, medium or large farmers.
- The relation/ coordination between farmers and contractor is strictly vertically organised.
- The quantities (quota), qualities and delivery conditions are determined at the beginning of the season.
- The production and harvesting processes and qualities are tightly controlled, sometimes directly implemented by the buyer's staff.
- Typical products: large volumes of uniform quality usually for processing; e.g. sugar cane, tobacco, tea, coffee, cotton, tree crops, vegetables, dairy, poultry.

Nucleus estate model

In this model, the buyer sources both from own estates/ plantations and from contracted farmers. The estate system involves significant investments by the buyer into land, machines, staff and management. This CF model can be characterised as follows:

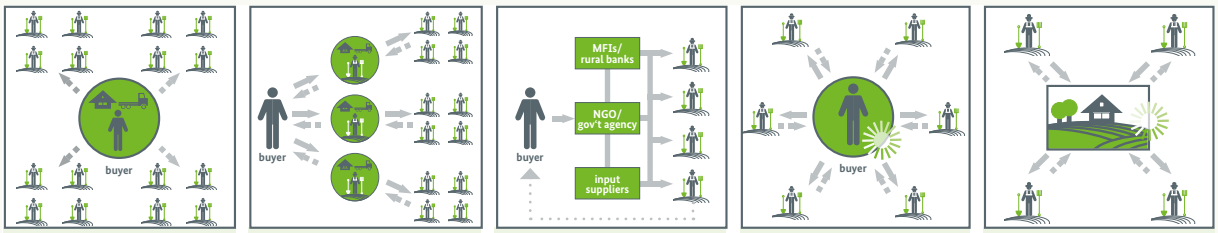
- The nucleus estate usually guarantees supplies to assure cost-efficient utilisation of installed processing capacities and to satisfy firm sales obligations respectively.
- In some cases, the nucleus estate is used for research, breeding or piloting and demonstration purposes and/ or as collection point.
- The farmers are at times called 'satellite farmers' illustrating their link to the nucleus farm.
- This model was in the past often used for state owned farms that re-allocated land to former workers. It is nowadays also used by the private sector as one type of CF.
- This model is often referred to as "outgrower model".
- Typical products: perennials

B.1/

The following illustration gives an insightful idea of the five basic models that can guide the selection of appropriate CF arrangements based on a sound analysis of the specific situation on the ground.

Figure 1/ **Contract farming models and defining characteristics**

(Technoserve and IFAD, 2011, p.3)



	Informal model	Intermediary model	Multipartite model	Centralized model	Nucleus estate model
Increasing buyer investment					
Increasing risk of inconsistent supply					
Input/credit	○	◔	◔	◑	◑
Extension services	○	◑	●	◑	◑
Use of contracts	○	◑	●	●	◑
Farmer grouping	○	◑	◑	◑	◑
Grower management	○	◔	●	◑	◕
Centralized production/processing	◑	◑	◑	◑	●
Post-harvest logistics (packaging, transport)	◑	◔	◔	◕	●
Summary:	speculative, seasonal sourcing on an ad-hoc or semi-formal basis and spot-market transactions; few if any inputs/services provided to farmers; minimal firm/farmer coordination; little to no product specification by buyer	semi-formal to formal subcontracting by buyers to partner intermediaries (e.g. lead farmers, farmer groups, buying agents) who manage outgrowers & provide services; limited direct firm/ farmer interaction; enhanced but limited product specification	buyer sources from farmers & farmer groups; technical assistance/ input/credit provision & grower management via 3rd parties; limited firm/ farmer coordination; higher level of product specification necessitates close monitoring/supervision of production	buyer provides technical assistance/inputs directly, purchases crop, handles many post-harvest activities; farmers provide land & labor; high degree of firm/farmer coordination; strict product specifications monitored by inhouse technical staff; often linked to processing	buyer operates centralized production and processing (estate), supplementing throughput via direct contracting with outgrowers; buyers often own/control land used by farmers who supply labor; buyer provides technical assistance/ inputs/ credit; close monitoring/ supervision
Pros:	little to no buyer investment in technical/ financial support; low operational costs; high level of sourcing flexibility	reduced risk, assuming effective management; minimal buyer investment in technical/financial support; marginally improved supply chain management; low cost of switching to new partners	limited investment & reduced costs due to partner cost-sharing; reduced risks (vs commercial production) due to geo-dispersal of outgrowers	enables high level of control over product quality & volumes; frequent interaction with farmer inhibits side-selling	high level of control over supply chain; simplified technical assistance/extension/farmer oversight; reduced risk of supply rupture
Cons:	limited control over production (i.e. prod-ucts, varieties, quality, etc.); high risk of supply ruptures; strong buyer competition	lower buyer visibility among farmers; marginal control over production (volumes, quality)	greater risk of side-selling; no core production, reliant on smallholder production; high transport costs	high level of investment for in-house technical assistance and pre- and post-harvest logistics and related infrastructure	requires heavy investments (land, labor) in production; higher crop-related risks; limited flexibility/options in selecting outgrowers

Inputs Outputs Processing ○ Never ◔ Rarely ◑ Sometimes ◕ Often ● Always

With respect to the description of the different CF models in the preceding illustration it should be noted that:

- the boundaries between one model and the other are fluid with regard to organisational structures and operational arrangements;
- the models chosen for starting up a scheme may (usually do) change over time through the integration of lessons learnt ('trial & error'), changing attitudes and adoption of new technologies; and
- a model that proves to be appropriate for the start-up phase may need to be adapted and perhaps changed for the consolidation and scaling up phase respectively.

As regards contract types, Bijman (2008, p.5) mentions: "A classical typology of agricultural contracts has been made by Mighell and Jones (1963), who distinguish between market-specification contracts, production-management contracts, and resource-providing contracts. These contracts differ in their main objectives, in the transfer of decision-rights (from the farmer to the contractor), and in the transfer of risks." The specific features of the different contract types are explained in the following box.

Box 2/ **Contract types**

(Bijman, 2008)

Market specification (or marketing) contract

- Pre-harvest farmer-contractor agreement on terms of delivery (e.g. varieties, qualities, quantities/ quota, time of delivery) that are crucial for farmers' production decisions.
- The farmers maintain most of the decision rights over farming activities and farm assets.
- The farmers bear the production risk; the marketing risk is partly transferred to the buyer.

Production management contract

- The farmers delegate a substantial part of decision rights over production/ harvesting practices to buyers by agreeing to follow contractor's farming specifications.
- The contractor specifies and inspects production processes and bears most of the marketing risk.

Resource providing contract

- The contractor provides inputs as in-kind credits with costs being recovered upon product delivery.
- The level of transfer of decision-making and risks from farmers to buyers ranges from production management by farmers up to full production management by contractors.

1.2 Drivers and trends

As the citation of Mighell and Jones (1963; cited in Bijman, 2008, p.5) in the preceding section illustrates, **contract farming is not a new concept.** On the contrary, there is evidence of use in the 19th century already in Asia and Latin America. In the 20th century, the concept spread in the United States and Europe and was introduced into North and Sub-Sahara Africa. According to da Silva (n.d., slide 5), interest and adoption rates have increased in the recent past as the following examples illustrate:

- in the United States, CF rose from 12% of agricultural production in 1969 to 36% in 2004;
- in Brazil, 75% of poultry production are under contracts; and
- in India, Vietnam, Morocco, Thailand and others, policies have been developed for promoting CF.

It should however be noted, that even in industrialised countries, CF is not as common as may be assumed given its real or perceived advantages over spot market conditions, apart from some commodities that are largely governed by contracts (e.g. sugar beets, feedstock for biofuels, raw materials for baby food). The main reasons are lack of trust between potential business partners and the possibility to achieve similar prices through other distribution channels in usually quite stable markets.

The rising interest of private investors, policy makers and development partners in CF arrangements in developing countries is driven by the following **recent changes in the agri-food systems:**

- high agri-food prices and improving terms of trade open opportunities for the long-time neglected farm sector; provided the positive effects trickle down to farming and trading to incentivise investments into technologies for increasing yields, improving quality and reducing post-harvest losses;
- worldwide population growth, shifting urban consumption patterns, increasing purchasing power of emergent middle income segments in emerging economies and developing countries and the related market growth and structural transformation of agri-food markets (supermarkets, fast food);
- negative effects of market failure that can possibly be mitigated through CF arrangements (e.g. input supplies, non-financial services such as extension, training, information and access to markets and financial services such as bank transfer systems, savings, credits and insurance);
- growing disputes over large-scale land acquisitions by (global, regional or local) investors (catchword „land grabbing“) and the search for politically and socially sound and economically viable alternatives such as formalised cooperation with smallholder farmers (e.g. in the form of contract farming);
- increasing requirements for compliance with food safety/ quality standards and traceability needs in international mainstream markets but increasingly also in local and regional markets (e.g. fresh produce supplies to supermarkets or staple food channelled through commodity exchanges);
- increasing demand for sustainability certification (social and environmental standards) of cash crops such as palm oil, rubber, coffee, tea, cocoa and for specialty products (organic certification; origin labelling; etc.), not necessarily triggering premiums for certification;
- peak oil prices and the effects on transport costs (local, export, import) for the procurement of inputs and distribution of produce and on production costs for inputs (fertilizers, packaging material);
- urgent need to adopt appropriate technologies to adapt to or mitigate climate change in order to prevent/ minimise the damage climate change can cause or to take advantage of opportunities that may arise;
- recent droughts in the Horn of Africa and the Sahel leading to efforts to achieve national autarchy or to develop food reserves at the level of Regional Economic Communities respectively;
- emerging discussions on the role of the private sector in improving food security through the upgrading of value chains to better link production surplus with consumption deficit areas;

- diverse challenges: the need to achieve food security without increasing the pressure on natural resources; the need to balance required foreign and domestic direct investments into agriculture with the rights of smallholders (competition for scarce land resources usually referred to as 'land grabbing'); and finally the need to restore the reputation of agriculture to attract future generations to venturing into farming or accepting employment opportunities in rural areas given rural-urban migration of young people and the resulting ageing farmer population in many developing countries.

In this setting, **access to ever-scarcer production assets** (in the first instance land and qualified and affordable labour; only in the second place capital) turns out to be **a decisive aspect of competitiveness** of processing and trading firms, be they small, medium or large, national or global players. At the same time and for diverse products destined to local, regional or the international market, **smallholders can become a source of competitive advantages** (e.g. providing access to ever scarcer land resources; assuring dedicated family labour for more diligent crop husbandry; providing family labour for more cost-effective production; having location-specific traditional knowledge required for e.g. adaptation to climate change).

To become and remain competitive in increasingly globalised agri-food markets is a special challenge for value chain actors in the (large majority of) net food importing countries in Sub-Sahara Africa, since otherwise, farmers, traders and processors risk of being crowded out of national and regional markets by price and quality-wise more competitive imports. Against this background, awareness increases among off-taking companies that better cooperation with smallholder farmers is required for assuring sustainable access to agricultural produce. If in the past, linkages of global players and home-grown champions with local communities were largely inspired by 'corporate social responsibility' (CSR) this now gradually shifts to the paradigm of **'creating shared value'** (CSV). This concept highlights that business partnerships will only succeed and sustain if both partners, farmers and buyers, benefit. Porter and Kramer (2011), the most prominent proponents of this concept, see a real opportunity in CSV contributing to "unleash a wave of innovation and growth", two objectives that are also encouraging the renaissance of contract farming.

It is in this context that the still largely untapped market potential at the **Bottom of the Pyramid (BoP)** is increasingly recognised: poor consumers offer opportunities on the demand-side and resource-poor farmers offer opportunities on the supply-side. As a consequence, awareness is growing among downstream traders and processors and upstream input dealers that **inclusive business models** can open attractive business prospects in ever more competitive and demanding markets. At the same time, national governments and development partners start to recognise inclusive business models as engine for socially inclusive economic growth. Unlike CSR, which primarily aims at improving the company's reputation through societal contributions and philanthropy, the main objective of inclusive business models is to integrate poor sections of the population either as customers or as suppliers into viable business models and, by doing so, to increase the economic and social benefit for all business partners involved (see Step 2, Activity 2.1 for the selection of farmers/ farmer groups).

1.3 Incentives (benefits) and disincentives (disadvantages) for contract farming

For planning viable and sustainable CF schemes, it is necessary to understand the motivation of farmers and buyers to conclude or not to conclude farming agreements. **While in the end mutual trust is the basic and critical reason why contracts succeed or fail, a realistic and realisable cost-benefit-'plus' (profit) is crucial for creating a viable business that can sustain itself.** This cost-benefit-'plus' that constitutes an incentive (benefit) motivating farmers and buyers to conclude contracts can be quite diverse and is largely different in the perspectives of farmers and buyers.

Incentives (or benefits) are defined as "... factors that motivate human behaviour. They can be positive and foster certain behaviour, but they can also act as disincentives and deter people from doing something." (Fischer et.al., 2004, p.9). The success of efforts aimed at promoting contract farming depends to a large extent on the

willingness and preparedness of stakeholders to commit resources, develop their capacities and join forces. It is often argued that the resource-poor are not capable of investing in new ventures. However, this depends on (Will, 2008, p.97; verbatim citation):

- the type of capital that needs to be invested, which is not necessarily financial (e.g. savings, access to credits) but may as well be human capital (e.g. indigenous knowledge, skills and the ability to work), natural (e.g. access to land for production), physical (e.g. access to transport, water, energy) or social (e.g. networks, trust, access to service institutions); and

- the possibility of reducing the risks of investments in new ventures in order to minimise any adverse effects on their livelihoods and to overcome the widespread risk adversity of small-scale farmers, by identifying realistic and realisable benefits from any commitment of resources.

This calls for a solid analysis of the livelihood framework and the concrete benefits, prior to embarking on any CF project. In the light of the crucial role business linkages play in ensuring market access for farmers, benefits also have to accrue at the up- and downstream stages of the value chain (VC) to assure the collective commitment of all business partners. The simple reason is that investments into inputs, farming, wholesale trading, processing and retailing will only translate into income for VC operators if the final product is marketable and competitive enough to be sold.

The main **reasons for smallholders** to enter farming contracts are: higher and more stable incomes, access to markets, access to more affordable credits and inputs, access to new technologies, extension, training and information and reduction of production and marketing risks. With respect to the **advantages for buyers** to work with smallholders, Prowse comes to the conclusion that: "Small farms are frequently the most efficient agricultural producers, and have advantages over large farms in terms of labour-related transaction costs, in particular supervision and motivation."

However, contracting smallholders also bears risks, since "small farm production often suffers from capital constraints, and a lack of capacity to adopt technological innovations. Moreover, ..., smallholders often lack the ability to meet exacting standards from actors further down the value chain. Contract farming can overcome these limitations: it can deliver the scale benefits typically associated with large-farm production systems. Economies of scale through the firm decrease the cost of inputs and transport. In addition, firms have a comparative advantage in marketing and technical knowledge, and product traceability and quality. In terms of poverty reduction, contracting with smallholders can reap large dividends: small farms are generally owned and operated by the poor, often using locally-hired labour, and often spend income within nearby locales, creating multipliers (Hazell et al., 2006). Overall, there are good reasons why contract farming with smallholders can succeed" (Prowse, 2012, p.23). The following box gives an overview of possible incentives and disincentives that may play a role in decision-making of farmers and buyers.

Transaction costs are associated with the exchange of goods at every stage of the value chain: e.g. search costs for suppliers or buyers, for market and price information; costs for monitoring of producers and quality control, for logistics and distribution, for security services for cash payments, for bribery and for dealing with contract breach.

Box 3/ **Incentives and disincentives of contract farming for farmers and buyers**

Potential incentives
in the ideal case of well-designed/ well-managed CF schemes and mutually beneficial contract terms

For Farmers

Monetary incentives

- better/ more stable income through higher yields, reduced losses, possible premiums
- improved access to inputs through buyer credits or direct provision by buyers
- reduced input costs due to procurement in bulk by buyers
- improved liquidity (e.g. through pre-financing of inputs or adequate terms of payment)
- reduced credit risk in case banks accept forward contracts as collateral
- financial support for standard compliance/ certification to satisfy market requirements

Non-monetary incentives

- reliable and stable market access (traditional and new markets)
- improved access to non-financial services (e.g. technologies, extension, training)
- reduced market risk through forward contracting/ market-oriented production planning
- reduced production risk through longer term farm planning/ better utilisation of capacities
- reduced production risk through access to inputs, extension and new technologies
- lower barrier to produce higher-risk crops, which resource-poor farmers usually avoid
- improved overall farm system performance through spill-over of technologies and skills
- improved food security/ better nutrition through increased diversification

For Buyers

Monetary incentives

- lower investments/ operational costs for own production (land, machinery, staff)
- reduced staff costs through outsourcing production/ subcontracting intermediaries
- reduced transaction costs for (i) coordination due to agreed arrangements for regular and stable supplies; and (ii) procurement owing to scale economies, higher productivity
- reduced post-harvest losses due to more efficient post-harvest transport and logistics
- reduced investment risk thanks to more efficient utilisation of installed capacities

Non-monetary incentives

- sustainable supply of required volumes and qualities at required delivery dates
- solution for buyers' problems in access to land and labour
- reduced supply risks compared to spot market procurement
- reduced disease/ weather induced supply risks through geographical diversification
- reduced marketing risk owing to better alignment of supplies and customer requirements
- more consistent supplies through better control over production processes and quality
- more flexible response to growing/ depressing markets thanks to fewer fixed assets
- improved reputation and public relations owing to inclusiveness of CF business model

For both

Monetary incentives

- reduced transaction costs thanks to direct linkages (e.g. reduced screening and default costs)
- reduced price risk for agreed quota based on pre-agreed prices or price calculation formula

Non-monetary incentives

- specific crop characteristics (e.g. perishability requiring efficient collection and delivery)
- better access to up-market segments requiring compliance with (local/ global) standards

Potential disincentives
in the negative case of ill-designed CF arrangements, intransparent relations and deceptive practices

For Farmers

- increased risk of loss of decision-making autonomy
- increased production, marketing and investment/ credit risk if the CF business model is not viable
- over-indebtedness in case of insufficient consideration of the livelihood framework/ farm assets
- weak negotiation power resulting in depressed prices if the buyer exercises monopsony market power
- weak claiming position in case of buyer default (unduly high rejection rates, late or non-payment)
- non-understanding of contract terms if not available in vernacular resulting in mistrust/ default
- mismatch between long-term investment requirements and short-term purchase commitments
- mismanagement of production quota/ output manipulation by the buyer or corrupted staff
- disregard of the required farm household cash crop-food balance (competition/ opportunity costs for land and labour)

For Buyers

- high infrastructure and transaction costs and high risks in organising supply from dispersed producers
- insufficient and inadequate farm management skills and technologies leading to inconsistent supplies
- reduced yields due to diversion of inputs provided by buyers
- unreliable business attitudes of farmers leading to high credit default rates
- poaching by competitors and side-selling by farmers leading to undersupply of buyers' capacities/ needs

However, the above compilation of incentives and disincentives is a mere theoretical review of motivations, while the real incentives and disincentives depend on the CF arrangement, on contract terms, on the commitment of co-contractors, on their business attitudes and last but not least on the trust or mistrust which governs the behaviour of the contracting parties.

1.4 Conditions for success and failure

As said at the onset of these guidelines, there is no blueprint for the design and operation of successful and sustainable contract farming arrangements. Rather, every single scheme calls for situation-specific design according to market opportunities, product features, suppliers' and buyers' capacities, existing business development services and the overall local, national, regional and international framework conditions for agricultural and agri-food business development and private investments. Accordingly, there is a **vast range of conditions for success and failure that need to be taken into consideration when analysing the situation on the ground and planning CF arrangements**. And, equally important, right from the beginning, monitoring of performance and feedback loops have to be built in for early identification of problems and of appropriate solutions for the necessary modification of CF arrangements.

In the same line of thinking, Vermeulen and Cotula come to the conclusion that "Among the different business models reviewed here, no single model emerges as the best possible option ... in all circumstances. Rather, what works best for smallholders while still being attractive to investors is very much context-specific, and is contin-

gent on tenure, policy, culture, history as well as on biophysical and demographic considerations. Also, none of the arrangements reviewed here can be said to be perfectly fair, nor a holistic solution to rural development at local or national levels. By their very nature, these arrangements link two sets of players – agribusiness and smallholders – with very different negotiating power, which has direct implications for the design and implementation of the arrangements. Finally, the devil is often in the detail: in defining the extent to which an investment shares value with local smallholders, the detailed arrangements of the scheme may be more important than the abstract model." (Vermeulen and Cotula, 2010, p.6).

Overall, contract farming is a way of doing business, in which both contract partners aspire to make profit through improved security of access to supplies and markets. The setting in many developing countries, however, is difficult for developing and maintaining viable, fair and equitable business relations between firms and small-scale farmers. The main reason is that developing countries are characterised by ample **market imperfections** resulting in prohibitive business start-up and transaction costs. Fragmented production, trading and largely also processing structures as well as fragile vertical linkages along the value chains result in high production and marketing risks for producers and high supply and sales risks for buyers. In this challenging environment it is hardly astonishing that professional relations are further complicated by low levels of trust. Moreover, road and market infrastructure are often inadequate, transport means and logistic facilities (e.g. grading, packaging and storage) are outdated and inefficiently organised. And, low volumes supplied by a multitude of dispersed small-scale farmers result in power imbalances between suppliers and buyers and are one of the root causes for unstable markets.

Furthermore, prices are highly volatile due to seasonal and annual supply fluctuations, speculation and frequent government interferences, especially in staple food markets. Also, the lack of harvest forecast and market information systems impede a more efficient balancing between production surplus and demand deficit regions as well as more transparency in price setting mechanisms.

Failure to access to rural finance services, necessary investments for upgrading technologies from inputs through farming and processing up to trading remain negligible. And the usually weak rule of law makes business relations and investments, also from the enforcement perspective, a risky venture. Last but not least, unfavourable macro-economic framework conditions (e.g. inflation, terms of trade, fiscal policies) and an often inappropriate investment/ business climate (first and foremost land tenure rights, but also economic and social context, business start-up and development conditions, private sector financing, economic and social infrastructure) impede the private sector from making the essential changes happen towards better functioning of markets.

In this setting, **contract farming can serve to mitigating market imperfections**. Depending on the arrangements, contract farming can equally make a change in the physical input and output markets, in the required rural finance and advisory service markets as well as in business attitudes.

B.1/

To mitigate market imperfections, **six key conditions for successful contract farming** have been identified, that integrate the criteria of Vermeulen and Cotula (2010) for assessing the ways of value sharing between partners in different types of business models (see insert) while adopting a broader view of the requirements for developing successful contract farming arrangements (the criteria of Vermeulen and Cotula are written in *italic)*:

- **trust and scope of negotiation:** appreciation that trustful relations are the foundation for success and that trust builds on fair give-and-take relations and equal *voice* in contract negotiations and conflict settlement;
- **economic viability and incentives:** recognition that farming contracts are clear-cut commercial agreements that can only be viable and sustainable if farmers and buyers equally realise a cost-benefit-'plus' (profit/ *reward*) that incentivises both parties to fulfil their commitments (see section B.1.3);
- **contract farming arrangements and risks:** realisation that contract farming bears risks requiring arrangements for sharing *ownership* as well as distributing and minimising *risks* of conjoint investments according to the quite divergent capabilities of contract partners;
- **technology transfer and innovation:** appreciation that the adoption of appropriate technologies and innovations can stimulate increased farm productivity and chain efficiency, provided embedded or external services contribute to building required capacities;
- **investment climate and 3rd party support:** awareness that conducive political, legal, administrative and infrastructure framework conditions are decisive for building CF schemes that can compete in national, regional and international markets;
- **sound analysis and planning:** recognition that sound analysis and situation-specific design are a prerequisite for success since CF arrangements have to be adapted to market opportunities, product features, farmers' and buyers' capacities, existing services and framework conditions.

The four criteria of Vermeulen and Cotula (2010, p.5) for assessing value sharing between the business partners (partly verbatim citation):
Ownership: includes ownership of the business (equity shares), and of key assets such as land and processing facilities.
Voice: concerns the ability to influence key business decisions, including weight in decision-making, arrangements for review, and mechanisms for dealing with asymmetries in information access.
Risk: includes commercial (i.e. production, supply and market) risk, but also wider risks such as political and reputational risks.
Reward: concerns the sharing of costs and benefits, price setting and finance arrangements.

Investment climate: involves the regulatory environment and rule of law; the quality of infrastructure, health and education system; political stability and security; functioning financial markets; trade liberalisation, international rules and standards. The investment climate represents the "location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs, and expand (World Bank, 2004)" (adapted from UNIDO and GTZ, 2008, p.6f)

The following table provides a list of success factors related to each of these key conditions for successful contract farming. Just like the CF arrangements are as diverse as the specific conditions on the ground require, the list of success factors is neither relevant in all its details for all CF cases nor is the list exhaustive. Approaches and tools for translating the sought success factors into CF-reality will be discussed in part C of this guide.

Box 4/ **Six key conditions for successful CF and selected related success factors**

Trust and scope of negotiation

Successful contract farming (CF) arrangements provide conditions that contribute to:

- Building trust based on a common purpose, mutual benefits ('win-win'), recognition of mutual interdependency, fair contracts and commitment to honour the contract.
- Providing sufficient time to build trust in the course of business dealings based on efficient management, open communication and direct interaction in the field.
- Assuring a fair scope of negotiation for farmers in decision-making (e.g. price-setting) built on unbiased information sharing, transparent communication, participatory negotiations.
- Incorporating chain-wide approaches to self-regulation of CF practices (e.g. sector-wide agreement on seasonal minimum prices; code of practice for contracting).

Economic viability and incentives (see section B.1.3)

Successful CF arrangements provide conditions that contribute to:

- Meeting end-market requirements (volume, quality, price, time of delivery).
- Increasing farm productivity/ reducing unit production costs through capacity building.
- Increasing market shares through improved competitiveness.
- Providing better returns on investments/ stabilising incomes of farmers and buyers.
- Assuring reliable and timely access to markets, credits, inputs, etc. for farmers.
- Assuring reliable supply of required volumes/ qualities at agreed dates for buyers.
- Enabling buyers to utilise logistics/ processing facilities more efficiently.
- Reducing VC inefficiencies and hence unit transaction costs (e.g. coordination, logistics).
- Reducing unduly high post-harvest losses thus contributing to reducing unit costs.
- Introducing new remunerative crops through technology transfer and innovation.
- Facilitating fast adaptation to changing consumer preferences/ customer requirements (e.g. food safety/ sustainability standards; shift to supermarkets).

Contract farming arrangements and risks

Successful CF arrangements provide conditions that contribute to:

- Agreeing on clear contract terms and transparent pricing mechanisms.
- Agreeing prices/ payment terms beneficial for both (fair margins, financial liquidity).
- Reducing production, supply, marketing and credit risks (including case of force majeure).
- Motivating farmers to form farmer groups/ associations/ cooperatives to realise scale economies and joint investments (e.g. collection centre) and develop mutual risk sharing.
- Reducing risks of farmer default (e.g. input diversion, poaching and side-selling).
- Reducing risks of buyer default (e.g. late or non-payment, unduly high rejection).
- Sharing ownership of CF assets according to partner capabilities (e.g. shares for smallholders in the logistics centre or the off-taking company as partial payment for supplies).
- Involve neutral 3rd party individuals/ organisations for brokering linkages (e.g. facilitation of trust-building between co-contractors, control of contract observance of farmers and firms).
- Establishing equally accessible and mutually recognised dispute settlement mechanisms.

B.1/

Technology transfer and innovation
Successful CF arrangements provide conditions that contribute to:

- Speeding up the adoption of new technologies and innovations through embedded/ external services to stimulate increased farm productivity and VC efficiency.
- Combining financial services with other embedded/ external services to facilitate the adoption of innovations and to build capacities for using credits successfully.
- Aligning VC processes to improve quality assurance/ introduce standards and certification with a view of accessing more lucrative markets.

Investment climate and 3rd party support
Successful CF arrangements require governments/ development partners/ NGOs to:

- Recognising CF as a private sector driven and owned business arrangement that may nevertheless require 3rd party (external) technical assistance, incentives for kick-starting innovative businesses and, if necessary, smart subsidies.
- Addressing sovereign tasks that are at the origin of market failures and constitute risks for the viability and sustainability of CF.
- Avoiding any measures that may create political risks for private sector investments (e.g. undue market interferences).
- Acting as honest brokers/ ethical agents if need arises to assist in reducing risks of exploitative behaviour of buyers or deceptive practices of farmers respectively.

Sound analysis, planning and monitoring
Successful CF arrangements require a solid analysis, planning and monitoring regarding:

- The initial position for starting up a CF scheme (VC analysis; livelihood framework of farm/ household systems; cost and benefits/ incentives for farmers/ buyers).
- The existing financial/ non-financial and operational services and overall framework conditions (policies, legislation, public infrastructure).
- The suitability of agro-ecological conditions and farming systems in potential production areas.
- The social capital (e.g. trust) and structures (e.g. existing networks), on which CF arrangements can build or which may have adverse effects on the CF success.
- The possibilities of and the measures to countervail a trade-off between household food security and CF crops (e.g. due to competition for land, labour, capital).
- The establishment of systems for monitoring/ feedback for learning lessons (good practices, problems) to modify CF arrangements and operations if necessary.

Altogether, everybody involved has to get straight that starting up a contract farming scheme requires all partners to be serious about their commitments regarding required time, efforts and resources to make the joint undertaking a success. It has to be clearly understood that CF schemes usually do not achieve break-even in the first year and quite frequently they will only do so after three to five or even more years.

Sufficient time and resources for the formation, start-up and up-scaling of CF schemes (including necessary investments into capacity development, the establishment of CF management structures and systems, logistics facilities and operations, etc.) have hence to be built into the feasibility study, the risk assessment and finally the CF business planning.

Furthermore, since resource-poor smallholders have to be paid for their supplies from the very onset, appropriate measures have to be built into the CF arrangements **to bridge the financing gap between short-term payments for supplies and investments into qualification and infrastructure and medium to long-term return on investments.** Otherwise, smallholders will not be able to honour their contracts.

The following illustration provides an easy to recall overview of similar ideas of key success factors for inclusive business models and CF arrangements respectively.

Figure 2/ **The new business model principles**

(Lundy et.al., 2012, p.83)

1. Chain wide collaboration	2. New market linkages	3. Fair and transparent governance	4. Equitable access to services	5. Inclusive innovation	6. Measurement of outcomes
The resolution of problems in both, the commercial and social performance of new business models requires all or most chain actors to **set shared goals for collaboration.** The development of a systemic view of the chain recognizes and values the interdependence of the actors. Reaching and implementing agreements often involves **identifying** one or more **champions** along the chain to lead the process.	For farmers and their organizations, market linkages should provide a **stable market** with clear quality, volume and price signals as well as access to key services (Principle 4). These linkages must contribute to improved livelihoods. For buyers, solutions must provide **consistent supply** of safe and quality products at a competitive price. The achievement of both, producers' and buyer's goals requires the delivery of social and commercial value up and down the chain.	Fair and transparent governance refers to the establishment and enforcement of **clear and consistent grades and standards, clear commitments** to buy and sell certain volumes of certain grades at certain times, and processes of equitable **risk management.** Mutually **recognized interdependency** between chain actors is a key criteria. Shared commercial risk and insurance against failure are frequently cited as the cement of successful relationships.	One of the special challenges faced by small-scale producers is access to services such as finance, market information, and best agronomic practices that could improve quality, yields, food safety, and environmental performance. Successful solutions enable smallholders to **access credits, knowledge, technology,** and develop incentives that encourage producers to invest in their own production based on market needs.	New business models **promote innovation** by multiple actors along the chain in **products** and **services** as well as the **processes** that underpin both. Innovations should be done **'with' smallholder farmers,** rather than 'for' them. Inclusive access to innovation provides a means to remain competitive in dynamic markets; build the commercial value of goods and services; and, share innovation gains among partners, all of which building business durability.	The business axiom states that you cannot manage what you do not measure. Our sixth principle is to incorporate **tailored indicators and monitoring plans** to assess the health of the on-going trading relationship as a for-profit business and also its effectiveness as a vehicle for community development. Constant monitoring of the health of the trading relationship reduces the risk that minor problems will destroy the business.

In a reverse deduction, it can be concluded that contract farming fails where key success conditions or success factors do not exist. The **most frequent reasons for failure** are:

- absence of informed investment decision-making both on buyers' and farmers' sides due to an ill-informed interest to create quick-wins and lack of awareness on the high risks entailed with a hasty start-up of a joint CF venture without sound analysis and proper business planning;
- governments/ development partners/ NGOs promoting CF for development objectives without looking at the viability of the business proposition, the required capacities, the risk-aversion of farmers, the investment/ management capacities of buyers or the specificities of crops/ locations;
- buyers relying on government/ development partners/ NGOs for the selection of locations and farmers without considering that the criteria need to be guided by business reasoning and not by location decisions and development objectives of 3rd parties;
- low productivity and trade-offs between household food security and CF crops especially regarding competition for scarce smallholder farm assets (opportunity costs for the use of land, labour and capital assets for CF production; even labour is frequently more scarce than many may think);
- lack of scope of negotiation/ voice of farmers in designing CF arrangements and deciding on contract terms due to uneven balance of power (lack of farmer organisation and information on markets, prices, technologies), intransparent communication by buyers or lack of 3rd party mediation;
- contract default either by buyers (delayed or non-payment, unjustified rejection) or farmers (side-selling, supply of low qualities) due to lack of trust, intransparent contract terms, opportunistic behaviour and short-sighted preference for short-term benefits over long-term advantages (e.g. side-selling by farmers when other buyers offer higher prices without considering the long-term benefits of reliable market access especially for products featuring fluctuating prices);
- failure to build solutions for contract default into farming contracts (e.g. including contract terms such as weather insurance or dispute resolution mechanisms that become effective in case of default of farmers or buyers or external risks such as force majeure);
- governments/ development partners/ NGOs creating disloyal competition through the creation of subsidised parastatal or NGO-type companies, allegedly to provide smallholder farmers with market access, but realistically often not as a viable and sustainable solution; and
- underrated complexity of the undertaking throughout all phases of CF development (start-up, implementation, consolidation and up-scaling) and consequently underestimated time, effort and resources required from co-contractors and 3rd party supporters.

> **Force majeur** relates to unforeseeable events after conclusion of a contract that are beyond the control of farmer and buyer. In CF, force majeure may arise, inter alia, from war, strikes, civil unrest, insect plagues/ disease epidemics or natural disasters (so-called Acts of God) such as drought, floods, hail, storms and lightning. Because of this unforeseeable and exceptional situation, both farmer and buyer shall be considered exempted from liability for non-performance of their contractual duties and shall not be held in breach of contract (partly verbatim citation Pultrone, n.d., p.2).

1.5 Crop suitability for contract farming

Contract farming is not a new approach. Nevertheless, contract farming is an innovative undertaking for most smallholders and for many buyers in developing countries. Calling for the willingness and capacities to change, contract farming is a quite demanding challenge for both business partners. Farmers have to adopt new farming technologies and farm management skills, develop new negotiation and marketing capacities, build new alliances in the form of business oriented farmer organisations and contract farming arrangements. Buyers have to develop enterprise strategies as well as management and logistics systems and structures that reach far beyond the core business. They furthermore have

to provide or leverage technical and financial assistance to promote on-farm innovations necessary to increase productivity and assure quality. Last but not least, both business partners have to change attitudes to build trustful, reliable and mutually beneficial contract relations. It is obvious that "contract farming is not for everyone. It requires willingness to honour agreements, deliver products at the right time, and resist the temptation to sell to other buyers." (Shepherd, 2012)

With this in mind, the following criteria may be more decisive for the success of contract farming schemes than the technical suitability of certain crops:

- the careful selection of both business partners;
- the identification of mutual interests and benefits;
- the awareness on their interdependency;
- the promise of balanced negotiation influence;
- the establishment of transparent two-way information flows;
- the development of necessary technical and managerial skills;
- the establishment of an efficient logistics and CF management structure; and
- the internal availability or external access to financial resources for pre-financing short-term operational costs and medium to long-term investments into qualification, technological innovations and infrastructure (e.g. irrigation, access roads, collection centres, transport and logistics).

In so far, the following typology is not a blueprint for success, since there are ample cases of failure in crops that are regarded as promising for contract farming and many (often hidden) success stories in crops that are esteemed to be too challenging for contract farming.

SNV (n.d.) recommends to selecting products that:

- farmers can grow successfully;
- have primary and secondary (for lower quality) markets;
- are not easily side-marketed; and
- can make a profit for both, company and farmers.

Looking at **technical characteristics and market access requirements**, there are situations that lend themselves more to CF than others. "When a product is of uniform quality and non-perishable, when quality can easily be observed, and when farmers are familiar with the production methods and market requirements, then transaction costs are low and spot markets would be the most efficient arrangements. These factors explain why many commodities, such as grains, root crops and pulses, are usually sold through market arrangements." (Bijman, 2008, p.11)

By contrast, in quite a number of developing countries CF is favoured by institutional arrangements that **historically evolved** from (existing or privatised) parastatals for the marketing and/or processing of commodities (e.g. cotton, coffee, sugarcane, tea, tobacco).

Goldsmith (1985; cited in Baumann, 2000, p.20) identified five technical requirements that favour the development of a contract system:

- **perishability:** crops with limited storage capacity that require fast marketing are more likely to be contracted than crops suitable for storage;
- **bulkiness:** while crops with a high value per unit of weight or volume are more viable for CF, bulkier crops with lower value per unit are less apt if long-distance transport is necessary;
- **permanence:** perennial crops (e.g. tree crops) are more suited since growers cannot easily abandon them given the up-front investments that only pay off after some years;
- **processing:** crops requiring processing lend themselves more to contract farming since buyers depend on reliable supplies to utilise installed processing capacities efficiently;
- **quality:** crops varying in quality or grown for markets requiring certain food safety, quality or sustainability standards and certification are better suited for CF than commodities of uniform quality.

The following considerations (adapted and complemented by the author from Minot, 2007; cited in Bijman, 2008, p.11) shed a more comprehensive light on some of the aforementioned criteria. Contract farming schemes are more likely to emerge and sustain if the following conditions are in place:

- when buyers (processors, retailers, exporters) expect a sufficient return on investments that allows to bear the costs of (i) paying quality premiums to farmers at least covering additional production costs (incentive); (ii) supporting farmers financially in investing into upgrading farm facilities and equipment (overcom-

ing capital constraints of small-scale famers); (iii) providing special inputs (resolving capital, knowledge and access constraints); (iv) building farmers' capacities (resolving education and skills constraints); (v) investing into CF logistics and (vi) managing a CF scheme;

- when products are perishable, (i) the need to coordinate the timing of harvest and delivery between farmers and buyers becomes crucial for reducing post-harvest losses and resulting loss of income; (ii) the bargaining power of farmers in spot markets weakens once the products are harvested thus motivating farmers to produce perishable products when there is some guarantee of market access through farming contracts;
- when technologies required for growing certain products are demanding and farmers lack the necessary technical skills, special inputs and access to finance for investments into special farm facilities and equipment, contract farming arrangements can compensate through embedded financial and non-financial services.

Rockenbauch, Will and Vielhaber (2013) use the following criteria for typifying product suitability for inclusive business models between smallholders and buyers:

- the product features, the processing stages and the required infrastructure;
- the degree of farmers' organisation and the role of lead firms;
- the structure of the value chain (formalisation and degree of cooperation/ integration); as well as
- the availability of technical and financial services and the overall framework conditions.

Against these considerations, the authors distinguish between three market segments for inclusive business models (see also the following graph):

- raw materials (e.g. sugar cane, cotton, palm oil);
- premium products (e.g. coffee, cocoa, fresh vegetables); and
- staple crops (e.g. grains, legumes, tubers).

Figure 3/ **Market segments for inclusive business models**

(Rockenbauch, Will and Vielhaber, 2013)

	Segment I	Segment II	Segment III
Product	Raw materials for industrial processing; e.g. sugarcane, cotton, palm oil	High-value/ labour intensive products, mostly for export; e.g. coffee, cocoa, fresh vegetables	Staples, mostly for local and regional markets; e.g. grains, legumes, tubers
Value Chain	Highly coordinated up to fully integrated value chains; "bottleneck" due to centralised processing	Usually high concentration at the down-stream value chain; growing coordination at the farmer level	Little integration and formalisation; highly fragmented value chains
	+	**Value Chain Coordination**	−
Opportunities	Increasing global demand and increasing prices due to growing competition for sourcing raw materials (e.g. bioeconomy)	Usually high profit margins; competitive advantage of smallholding (e.g. low family labour costs; agro-ecological conditions)	Potentially highly dynamic due to growing local and regional demand (e.g. food, feed and industrial use)
Challenges	Quality and safety requirements as well as sustainability standards; scale and continuity in supply	High food quality and safety requirements as well as sustainability standards; mainstreaming standards into local and regional markets	Enabling environment (e.g. policies, infrastructure); structuring markets (e.g. public procurement, quality assurance systems)

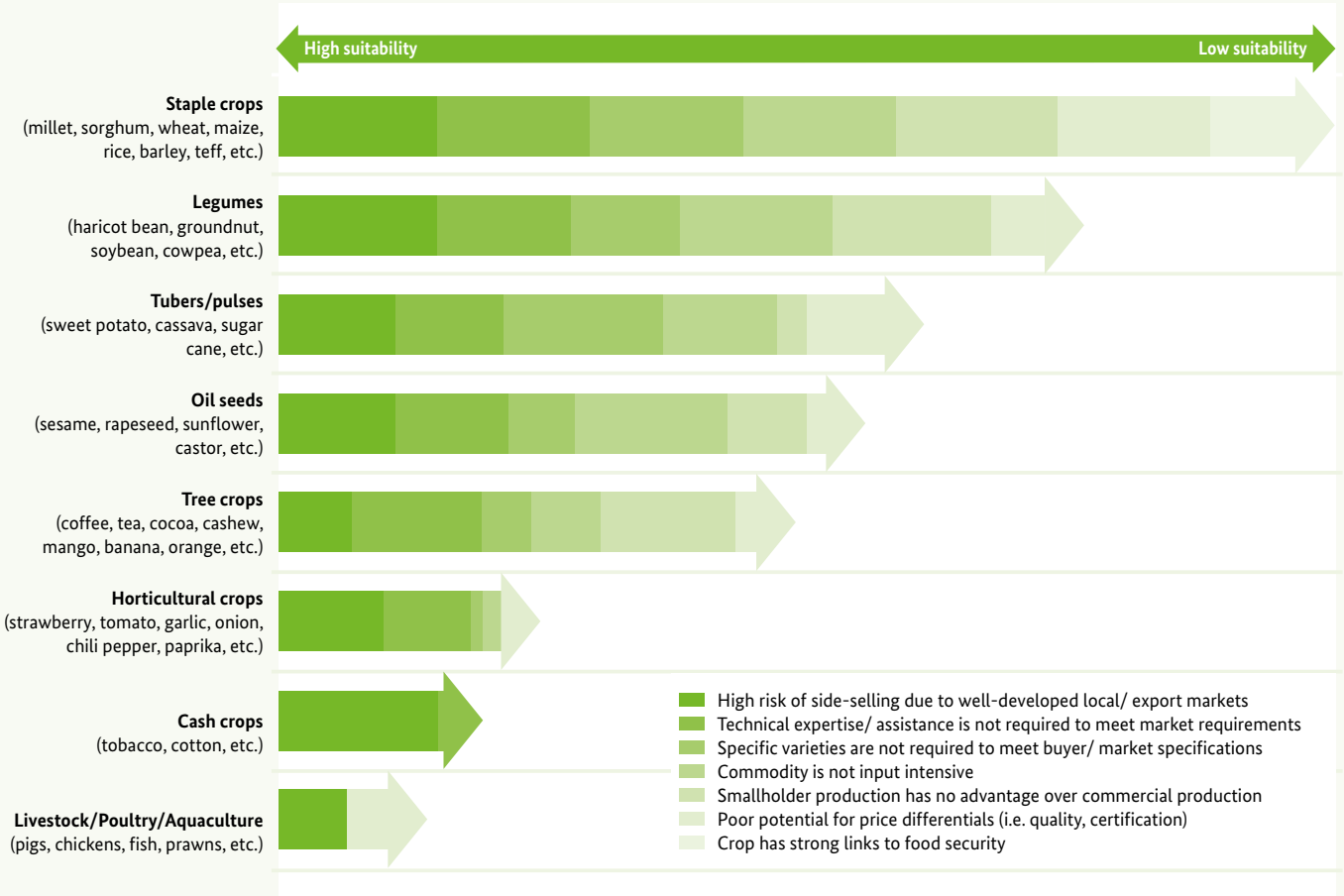
Approaching the subject from another angle, Technoserve and IFAD (2011, p.10) distinguish the suitability of crops for CF according to the following criteria (verbatim citation):

- high risk of side-selling due to well-developed local/ export markets;
- technical expertise/ assistance is not required to meet market requirements;
- specific varieties are not required to meet buyer/ market specifications;
- commodity is not input intensive;
- smallholder production has no advantage over commercial production;
- poor potential for price differentials (i.e. quality, certification); and
- crop has strong links to food security.

Each step in the decreasing colour intensity in the following illustration represents one of the aforementioned criteria. The summation of the criteria per crop range signifies the degree of suitability of that array of crops for contract farming.

Figure 4/ **Crop suitability for contract farming**

(Technoserve and IFAD, 2011, p.10)



However, as said before there is no one-size-fits-all typology of suitable crops since in some cases location-specific conditions may outweigh factors limiting the fitness of crops for CF and in other cases the situation on the ground may impede contract partners to seize opportunities of otherwise suitable commodities. Regarding the whys and wherefores that may turn less promising features into opportunities and vice versa, the following by far not exhaustive list gives some ideas:

- limited assets in small farms especially land, labour, capital (while capital constraints can be addressed through embedded or external financial services, competition of CF with food crops for land and labour quite frequently reduce the CF-potential);
- weak infrastructure and transport systems can be an advantage for establishing CF for otherwise less suitable crops since the establishment of logistic systems can open market opportunities for remote farmers, provided the logistical solutions are viable despite existing constraints;
- previous successful cooperation between farmers and buyers in other business areas can compensate crop features that may elsewhere impede CF sustainability (e.g. the recent move of cotton CFs to start up staple crop CFs for improved household food security/ additional farm income);
- well organised smallholder farmers who benefit from membership in functioning farmer organisations (groups, associations, cooperatives) and the provision of relevant services (e.g. extension, credits, collection of produce) or newly emerging well-educated young farmers;
- inter-reliant investments between the firm and the farmers that create strong interdependency can contribute to making contracts self-enforcing;
- ethical approaches of companies that are capable and willing to invest into smallholder community development projects inspired by the ideas and reputational benefits of CSR;
- business-driven approaches of companies capable and willing to invest into capacity development and market integration of smallholders through inclusive business models; and
- enabling framework conditions with regard to CF policies, legislation and enforcement and smart subsidies as well as access to financial and non-financial support services that strengthen the capabilities of contract partners and foster the commitment of complying with contract agreements.

Accordingly, it remains to be evaluated in every single case, which location-specific conditions foster and which limit the prospective and desired success of a planned contract farming scheme. The deliberations in this section give an idea of the complexity of factors that need to be considered before venturing into a CF arrangement.

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B.2/ Facilitation of contract farming: moderation of processes, technical and financial assistance

2.1 Justification and objectives

It is obvious that contract farming offers opportunities for overcoming market access barriers for farmers and procurement constraints for buyers. However, prevailing market imperfections often impede the development of trustful and long-term farmer-firm business linkages in many developing countries (see section B.1.4). The reasons are manifold and lie both in the private sector (market failure due to e.g. low productivity, lack of scale economies, asymmetric information, inequalities in ownership and voice and resulting mistrust) and the public sector (government failure due to e.g. inadequate economic and rural development policies, poor public infrastructure, inappropriate administration and resulting overall weak investment climate). As a consequence, CF business start-up costs, unit production and transaction costs as well as post-harvest losses are high and products cannot compete in regional and international markets and often even not with growing imports in local markets.

In this setting, CF development is a risky and costly venture for farmers and buyers. Considering the often significant support needs for integrating smallholders into CF schemes that bear on the company's assets and liquidity and hence on its competitiveness, public or private sector organisations, development partners or NGOs may decide to provide assistance for initiating and starting up promising CF ventures as well as consolidating and up-scaling viable CF business models. Facilitation of contract farming may include the moderation of CF development processes as well as technical and financial assistance respectively.

2.2 Facilitation principles, facilitation tasks and facilitator profiles

Given the significant role facilitators may play in CF development, certain principles have to be respected. With contract farming first and foremost being a private sector activity, facilitators have to **leave the driver's seat to farmers and their business partners** as they bear the investment risks and they have to take business decisions on their own. Since the questions how the required transformation is managed and who contributes to making necessary changes happen depend on the commitment of stakeholders in each VC and the dynamics in each local setting, a **participatory and action-oriented bottom-up approach** is the most appropriate methodology for CF facilitation. While letting the farmers and firms do their business, the public sector, development partners or NGOs interested in assisting CF development have to be prepared to provide support in areas, in which the private sector is not capable of helping itself.

With well-designed arrangements and true commitment of business partners and supporting organisations, contract farming can become a strong tool (among other measures) for changing investment challenges into business opportunities while contributing to overarching development objectives. Aspiring to support the emergence of viable and sustainable CF schemes and to achieve broad-based development impact, 3rd party facilitators have to plan for **adequate resources and a sufficient time horizon** for their assistance ('as little and short as possible as much and long as necessary'). At the same time, they have to develop and communicate a **clear exit strategy from the very beginning.**

Since the requirements for 3rd party assistance are CF-specific, decisions on support have to be based on a **capacity development and service needs assessment** of all stakeholders involved in starting up a particular CF scheme, including farmers, nucleus farmers and buyer's staff just like external stand-alone service providers if required (see section C.3, Phase 1, Step 2). Forming part of the **CF business plan** (see section C.3, Phase 1, Step 3), the results of the needs assessment have to guide the decision of 3rd party facilitators' on the type and timing of assistance to provide. By doing so, facilitators offer truly demand-oriented assistance while avoiding top-down offer-oriented approaches that neither meet actual requirements, nor find the acceptance of farmers and buyers and may even jeopardise CF development.

The following overview on types of CF-facilitation gives a rough although by far not comprehensive idea of possible support needs (for more details see section C.3, Phase 1, Step 2):

- **Moderation assistance** for CF development may include quite a variety of activities such as facilitating the identification and screening of potential CF business partners, the intermediation of contacts, the moderation of meetings and negotiations, the mediation of conflicts or the coordination of external support. Of particular importance is the ability of facilitators to act as '**honest brokers**' (sometimes also referred to as 'ethical agents') capable of facilitating trust-building between smallholders and buyers (e.g. by supporting the development of joint solutions for transparency and participation, equal voice, mutual benefits and fair risk sharing).
- **Technical assistance** may be provided in the form of support to analysing VCs, implementing CF relevant research and transferring technologies (e.g. improved varieties, integration of CF products into prevailing farming systems, innovative production, logistics and processing technologies and development of good practices), training trainers/ company or external extension staff, developing CF business plans, drafting model CF contracts, setting up quality assurance systems, supporting organisational development of farmer groups/ associations/ cooperatives, qualifying service providers, assisting policy-makers in relevant areas and the like.
- **Financial assistance** may take the form of financial services development (e.g. adequate credit, savings and insurance products), legal framework revision (e.g. leasing regulations) or public sector incentive scheme development (e.g. reduced levies and fees, provisions for tax breaks, credit guarantees or smart subsidies). Of particular importance for the success and sustainability of CF schemes is to develop solutions for **bridging the financing gap** between short-term payments to farmers necessary to support their livelihoods and initial investments into qualification and CF infrastructure on the one side and the return on investments that usually only materialises in the medium to long-term on the other side. Even if subsidies are not excluded, developing suitable financial services should be given priority over providing subsidies, which often do not trigger sustainable solutions.

It is obvious that CF development **requires strong support at the grass-roots level** (micro level) for upgrading farmers' capacities, developing farmer groups, linking farmers and firms, supporting trust-building between suppliers and buyers, setting up produce collection facilities as well as establishing embedded or stand-alone non-financial and financial services. With a view to developing sustainable structures for CF promotion, technical and financial assistance are furthermore usually necessary for developing an effective and efficient **service sector** (at the meso level) and improving the overall **business and investment climate** (at the macro level). Hence, CF development requires a systemic approach integrating measures at the micro, meso and macro levels as well as at the meta level. That is often even the most vital area for facilitation with regard to encouraging changes in business attitudes, cooperation in farmer groups and fostering **trust-building** as perhaps the most important factor for success in CF development.

In many cases, support organisations will work with teams of facilitators acting at different geographical levels (e.g. district, regional, national) and assuming different tasks. Roles and responsibilities can hence be distributed according to the skills and experiences of the team members (e.g. extension, training, service development, business planning, and policy advice). To avoid confusion and instead create confidence in the team, the roles and responsibilities of different members have to be communicated to farmers, buyers and to other support organisations.

As the previous thoughts suggest, there is a large variety of public and private, public-private, development partner and non-governmental organisations and individuals that may play a role in facilitating CF development. And some of the meso and macro level local players may require support themselves. In some countries, institutional approaches have been developed either initiated and governed by the public sector (partly regulatory and hence mandatory) or initiated and operated by the private sector (voluntary but in the sense of self-regulation) or, in some instances, jointly developed by the public and private sectors. The following very few examples illustrate the broad scope of institutional approaches to supporting or regulating contract farming respectively:

- Producer organisations may support members in understanding farming contracts, weighing risks and opportunities and negotiating with buyers (e.g. Kenya National Federation of Agricultural Producers/ KENFAP).
- Public or private organisations develop codes or practices to facilitate transparent and fair partnerships or model contracts (templates adaptable to the individual case) to facilitate CF start-ups and CF development (e.g. Horticultural Crops Development Authority/ HCDA in Kenya).
- Inter-professions in the francophone system unite representative organisations along the entire value chain and usually provide a platform for negotiations between representatives of farmer and buyer organisations (e.g. on floor/ minimum prices, seasonal planning).
- Commodity Boards (public sector entities in some countries increasingly involving private representatives) regulate sector development in general and frequently also provide regulations (mandatory) or standards/ guidelines (voluntary) for contract farming (e.g. the Cotton Board of Zambia).
- The Association of the Inter-profession for Cotton in Burkina Faso (AICB) established a 'price smoothing fund' with the objective to reduce the amplitude of yearly fluctuations in producer prices (the formerly public, recently revised, now public-private fund still has to prove its feasibility).
- The International Institute for the Unification of Private Law (UNIDROIT) in collaboration with FAO and representatives from producer and industry organisations prepares a legal guide on contract farming (see UNIDROIT, 2013a and 2013b).

Given the investment risks farmers and firms take by venturing into joint CF schemes, the responsibility of CF facilitators for providing competent support cannot be underestimated. Since the profile of honest brokers encompasses technical, business and managerial expertise as well as strong communication and networking skills, it is obvious that **facilitators have to be well qualified**. While the competence and an open-minded and performance-oriented personality are essential for farmers and buyers to develop confidence in the facilitator's intentions and support capacities, incompetent support and wrong methods, inadequate attitudes in dealing with the private sector (farmers, traders, processors, service providers, associations) and top-down approaches are all too often at the origin of CF failure.

By bringing in an outside impartial viewpoint, facilitators can play a key part in contributing sustainability considerations and solutions with regard to **achieving broader economic development impacts**, improving social equity and introducing environmentally sound production, trading and processing practices.

2.3 CF facilitation in least developed countries or fragile environments

With regard to the often-expressed perception that it is more difficult to promote CF in Least Developed Countries (LDCs) or fragile environments than in developing countries, Prowse (2012, p.6) comes to the following conclusion: "Interestingly, the comparison of 'successful' with 'failed' cases indicates that contract farming can operate successfully in a very wide range of socio-economic conditions, including conflict-affected countries, fragile states and Least Developed Countries (as contract farming is one response to overcoming the very high transaction costs in the thin and imperfect markets commonly found in such contexts)."

Since the factors hampering CF development are generally the same (ranging from risk-adversity of resource-poor smallholders, prevailing mistrust between farmers and firms, inexistent or at least inefficient services and an overall obstructing business investment climate), the possible solutions are largely compatible. However, given the specific situation in LDCs and fragile environments, CF facilitation has to apply a 'conflict-lens' and may require more resources and a longer time horizon than in other settings. Since there is no one size fits all answer to the question which type and intensity of technical and financial assistance is appropriate, all depends on the analysis of the specific capacity development and service needs of farmers and firms in their respective environments. It goes without saying that more attention has to be paid to sound analysis, especially regarding social structures and trust/ mistrust relationships as well as to identifying and integrating mutually respected opinion leaders.

Private sector development in general and value chain development (including contract farming) in particular are recognised as possible tools (among others) that can contribute to stabilising fragile environments through economic development (see Fowler and Kessler, 2013, p.12ff). Recommendations for planning and managing projects aiming at facilitating value chain development in conflict-affected environments that may also serve CF development needs can be drawn from Curtis et.al. (2010; see in particular Appendix G, p.45ff) and Grossmann et.al. (2009).

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“Undoubtedly, there are costs in creating trust or dealing only with those with whom you have long-term continuing relationships. Nonetheless, these may be necessary costs because formal impersonal contract is too weak a reed to support business transactions.”

(Macaulay, 1994, p.6)

C/ The contract farming facilitation guide

This guide offers a structured and comprehensive approach for the planning, initiation and implementation of contract farming schemes. Since feasibility is decisive for the success and sustainability of CF arrangements, the guide attaches priority to a business-oriented approach. Yet, development objectives are incorporated and in the ideal case they are anyhow congruent with the CF business objectives.

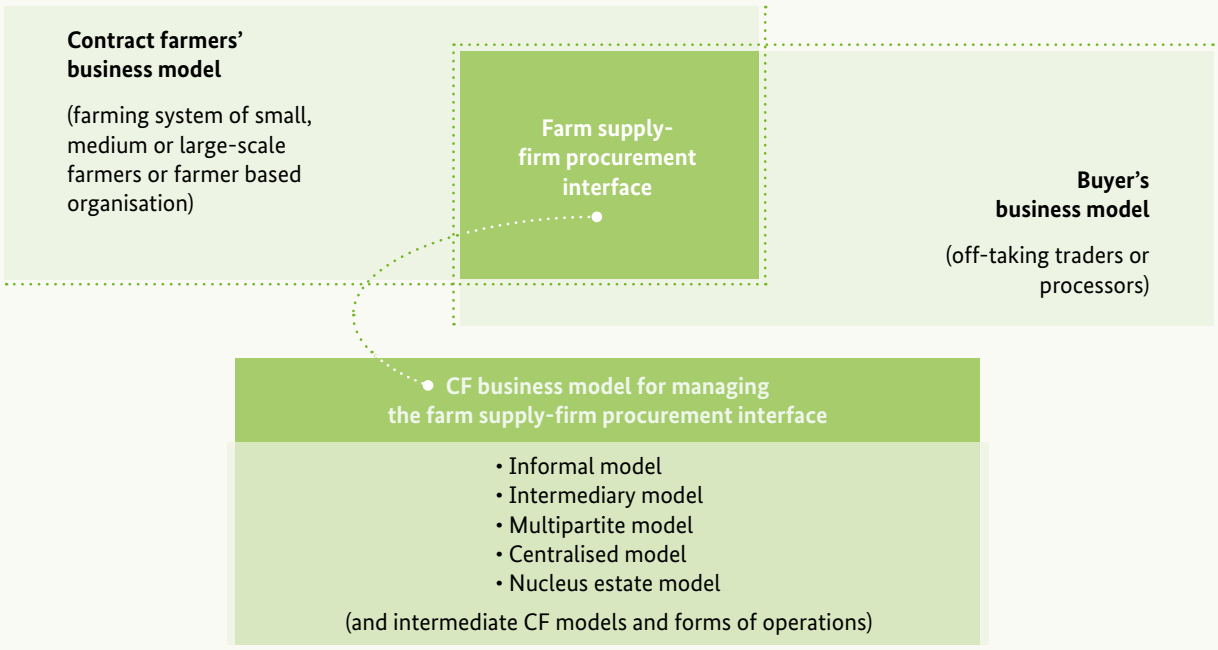
C.1/ GIZ contract farming concept: the central role of CF business model selection

Contract farming is a business model that forms integral part of the business strategies of firms and farms as co-contractors. Newly introducing contract farming implies that both, firms and farms, have to adopt innovative business models that overlap at the farm supply-firm procurement interface (see insert and following figure). The design of a business model for the management of the farm supply-firm procurement interface has to be guided by the following criteria for successful CF:

- creation of mutual benefits (incentives), e.g. through increased productivity, reduced post-harvest losses, reduced transaction costs and improved market access respectively;
- negotiation of fair and equitable contract terms relevant for successful contract fulfilment (e.g. prices, supply quotas, embedded services, rejection modalities, payment terms);
- design of an efficient CF management system enabling the buyer to establish close working relations with farmers (directly or indirectly through intermediaries);
- provision of room for 'learning by doing' to adapt the CF business model as need arises during the course of implementation.

A **business model** is characterised by the logic and the arrangements of how a company (farm or firm) creates, delivers and captures value. As the following illustration shows, the **CF business model** is challenging since it closely links the buyer's strategy with the farming systems at the farm supply-firm procurement interface. The illustration perfectly depicts the interdependency between the co-contractors and the risks involved if the design of the CF model is not appropriate for committing one or the other partner to fulfil their obligations.

Figure 5/ **CF business model for the management of the farm supply-firm procurement interface**



The conceptual foundations in the first part of this guide provide essential information for supporting the selection of appropriate CF business models:

- the description of CF business models in section B.1.1 (Box 1 and Figure 1);
- the incentives and disincentives for CF in section B.1.3 (Box 3);
- the conditions for success and failure in section B.1.4; and
- the discussion on crop suitability in section B.1.5.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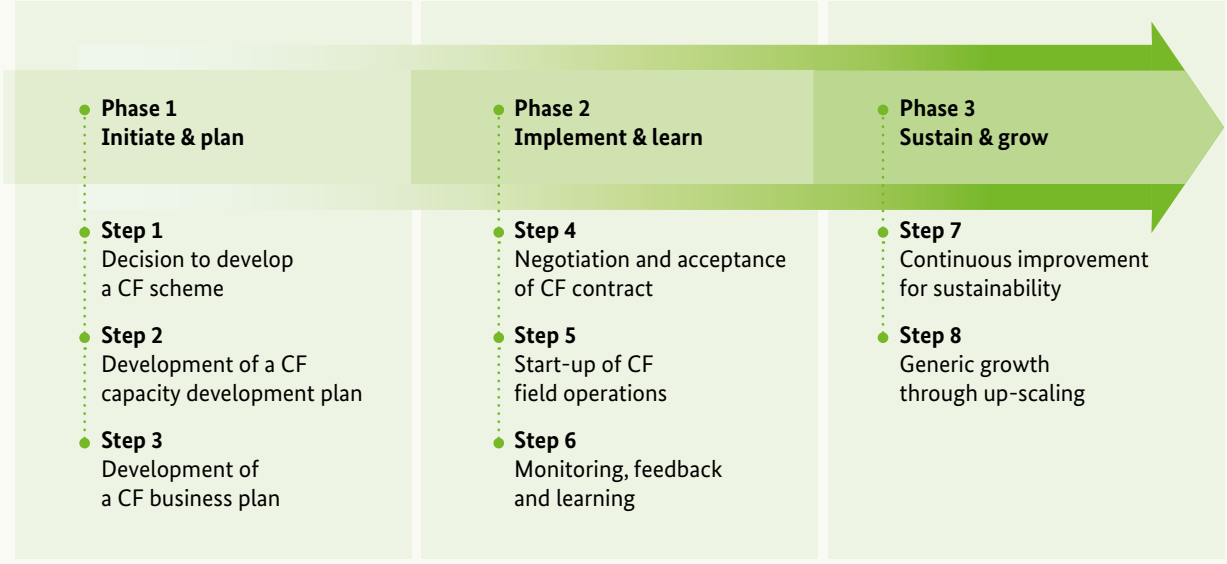
C.2/ Process-structure: three phases for developing contract farming schemes

A well-planned and practice-oriented strategy is required for translating the theory of contract farming into action. High-level management commitment of firms, serious commitment of farmers and reliable support from facilitators, an adequate time horizon and sufficient resources provided, this guide can give valuable input for building sustainable CF schemes and avoiding obstacles in the course of relationship building and CF business development. This guide proposes three phases for building sustainable contract farming structures and workable management systems for the benefit of both, farmers and buyers:

- Phase 1: Initiate & plan;
- Phase 2: Implement & learn;
- Phase 3: Sustain & grow.

The following illustration gives an overview of the phases and the related recommended steps. The rationale and proposed procedures of each phase and each step will be further explained in the succeeding sections

Figure 6/ **Process structure: phases and steps for developing CF schemes**



For a full picture of the overall process structure including phases, steps and related activities, see Figure 7 below. As a printout, the following figure may be instrumental when navigating through the phases, steps and activities in this part of the handbook.

Figure 7/ **Overall process structure: phases, steps and activities for developing CF schemes**

(as a printout, the following figure may be instrumental for navigating through the phases, steps and activities in this part of the handbook)

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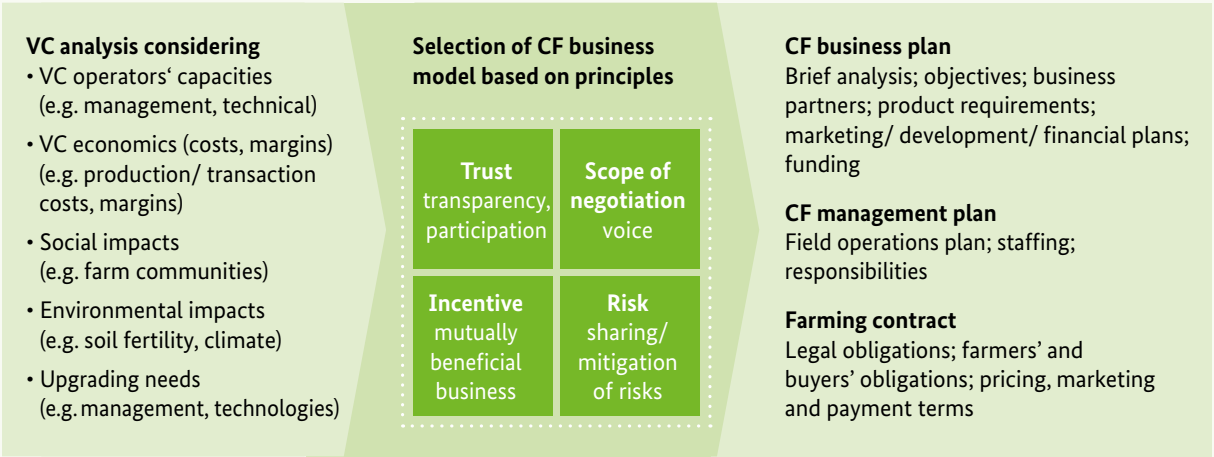
C.3/ Phase 1: Initiate & plan

It goes without saying that the necessary adoption of new managerial and technical skills as well as the necessary change in behaviour (e.g. commitment to fulfil contracts) and attitudes (especially trust, transparency and fairness) of both parties require a careful planning to translate into viable CF arrangements. Even if most smallholders so far do not realise that they run a business model and require a business strategy, they have (to be assisted) to develop a farming-system based business plan that serves as basis for informed CF negotiations as well as for well-founded business and investment decisions (e.g. annual crop planning).

Solid farm, firm and CF business planning depends on a **sufficiently profound but as simple as possible analysis** of the current supply-demand situation and prospective future market trends, the existing business and investment climate, the cost-benefit of alternative business solutions, the strengths and weaknesses of actors involved as well as the opportunities and risks connected with the adoption of CF as an innovative business model. To assess the feasibility of the business model and design realistic and realisable CF arrangements it is hence necessary to analyse the VC and to assess the investments required for the selection of co-contractors and for the establishment of appropriate CF arrangements. Furthermore, it is necessary to assess the needs and related costs for upgrading the performance of farmers and other actors involved in the CF scheme with regard to technology transfer and capacity building (individual farmers and farmer based organisations respectively) as well as the investments related to the establishment of logistic facilities and CF management structures. Finally, the terms of the CF contract are informed by the results of the VC analysis as well as the selected CF business model and the CF management plan. The following illustration captures these linkages.

Figure 8/ **Value chain analysis as basis for the selection of a CF business model, the design of CF business and management plans and the negotiation of a CF contract**



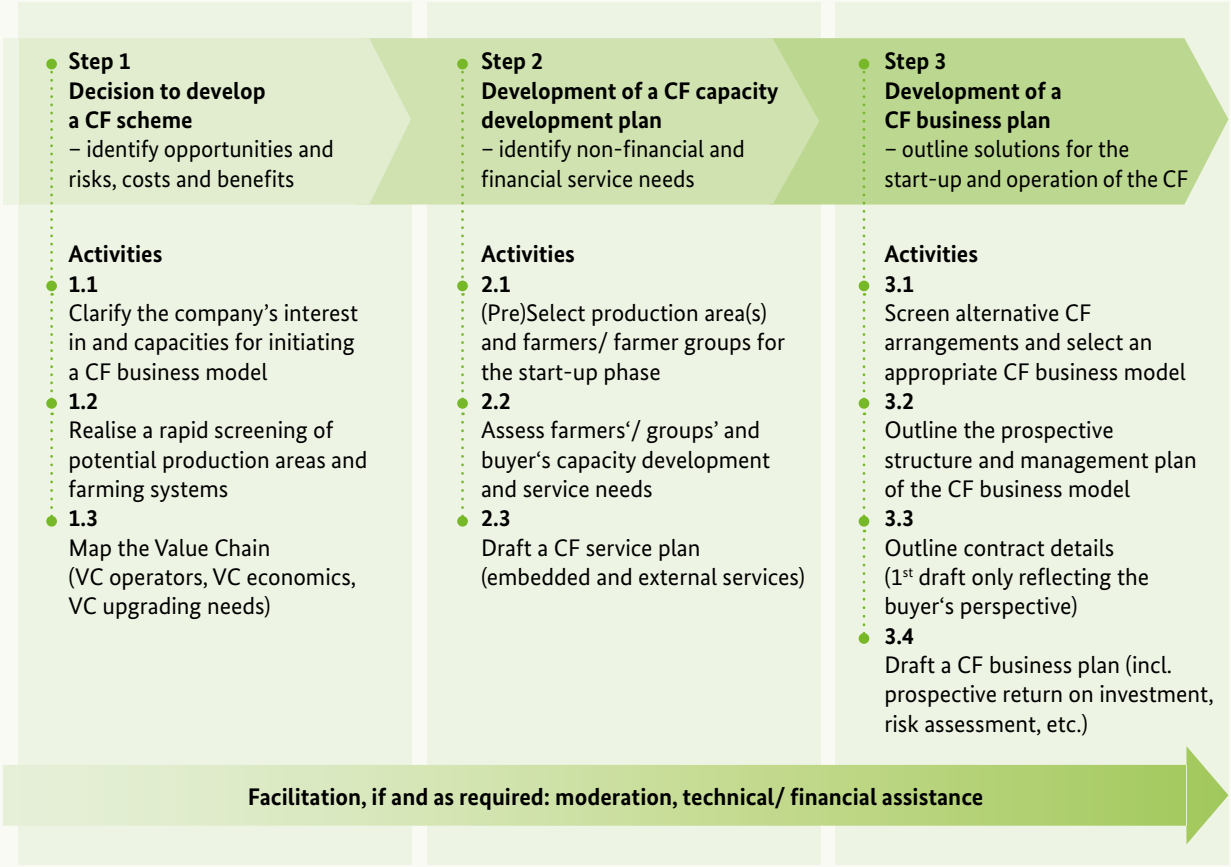
Objectives of phase 1 "initiate & plan"

The purpose of phase 1 is to assess the feasibility of the envisaged contract farming scheme. The outputs are:

- to understand the opportunities and risks:
  CF internal: buyers' and farmers' incentives, attitudes and capacities;
  CF external: markets, support services, framework conditions, motivation of facilitators;
- to develop solutions:
  CF internal: CF business model, CF business plan, CF management plan, CF contract;
  CF external: CF support/ facilitation service plan.

C.3/

Figure 9/ **Three steps and related activities for phase 1 "initiate & plan"**



Depending on the situation, neither all three steps and all activities have to be implemented, nor have the activities to be applied in the given sequence.

Key recommendation

Even if Step 1 will primarily involve the management of the off-taking company as well as internal and external key experts but not the farming community, due attention has to be paid to informing and involving potential smallholder suppliers before rumours reach farmers' communities bearing the risk of:

- **creating false hopes** about easy market access, premium prices or the like; or
- **stoking fears** about loss of autonomy or that smallholders will be driven off their lands or the like.

Further recommendations

- Reduce the complexity of analysis to 'as much as necessary, as little as possible'.
- Consider that a viable return on investment for both co-contractors is key to success.
- Consider that the adoption of innovations requires commitment, resources and time.
- Plan a gradual CF growth to reduce risks and costs of necessary learning loops.

Step 1/ **Decision to develop a contract farming scheme – identify opportunities and risks, costs and benefits**

Looking at successful and failed CF schemes shows that the point in time and the way they were planned are critical for the outcome. For the right point in time, the pressure to change for internal or external reasons (e.g. competitive pressure) is an important criteria for success. As regards planning, a structured and competent analysis is vital for success.

Whether introduced by processing or trading companies, parastatals or cooperatives, the decision whether or not to embark on CF is a strategic business decision. High-level management commitment and decision-making is required given the investments involved for setting up and operating CF schemes.

To reduce the risks and associated costs of failure, success rather has to happen by design than by default. Investing enough time and money into an assessment of the feasibility, of opportunities and risks and prospective costs and benefits will pay back through more secure and sufficient return on investments for sustaining the CF scheme.

Box 5/ **Step 1 – Activities, issues to be considered and milestone**

Activities

1.1 Clarify the company's interest in and capacities for initiating a CF business model

1.2 Realise a rapid screening of potential production areas and farming systems

1.3 Map the value chain (VC operators, VC economics, VC upgrading needs)

Issues to be considered

In the decision on a CF scheme, the following risks have to be considered:

- Insufficient preparation due to an ill-informed interest to create quick-wins and lack of awareness on the perils entailed with a hasty startup of a CF venture without sound analysis and proper business planning;
- Giving development objectives priority over the viability of the business model thereby neglecting problems that put the success of the CF at risk (e.g. insufficient capacities of smallholders, inappropriate production areas, insufficient company resources);
- Disloyal competition through the creation of subsidised parastatal or NGO-type companies, allegedly to provide smallholders with market access, but realistically often not as a viable and sustainable business solution;
- Over or underestimating the capacities of farmers (e.g. neglecting the potential competition of food and cash crops for scarce land, labour and capital; underrating the capacities of farmers in producing traditional crops, peer learning, self-organisation, 1st stage processing e.g. grading, de-hulling, drying).

Milestone

An appropriate CF business model is selected and outlined.

C.3/

Activity 1.1/ Clarify the company's interest in and capacities for initiating a CF business model

Since the upfront investments into an innovative CF business model will only pay back if the products can be sold in the end, the company has to know its markets and the respective market access requirements. Furthermore, the product characteristics, the company's procurement requirements, the supply-side structures as well as the company's technical and managerial capacities are to be considered. Finally, a strategic decision has to be taken on the sought return on investment.

Box 6/ Activity 1.1 – Purpose, selected questions and selected tools

Purpose

The purpose of this activity is to clarify the company's interest in and capacities for initiating and developing a CF business model.

Selected questions

The following questions give ideas for clarifying the company's interest in and capacities for initiating a CF business model (the list of questions has to be completed according to the reality on the ground):

- Is there a viable long-term market opportunity? Which market and price trends/ fluctuations have an influence on CF viability (e.g. world market prices, seasonal price fluctuations)?
- Which market access requirements are to be met (e.g. food safety and quality, traceability, sustainability certification, packaging, labelling)?
- Which product features lend themselves for venturing into CF (e.g. market access requirements, specific inputs, technological complexity, outsourcing first stage processing)?
- Which alternative procurement options compete with a smallholder CF solution (e.g. spot market, CF with large-scale farms, backward/ forward integration with own estates)?
- Has the company got the necessary financial/ human resources for establishing a CF and assuring embedded services/ presence in the field for trust-building and monitoring?
- Does a CF scheme promise sufficient advantages over the current supply model to justify the required upfront investments and recurrent operational costs of a CF business model?
- In conclusion: Which interest and which capacities has the company got for initiating a CF business model? Subject to further analysis: Which advantages have smallholders over large-scale production? Which production and (e.g. 1st stage) processing stages can presumably be outsourced at a reasonable cost-benefit for both co-contractors?

Selected tools

- Internal brainstorming at management level
- Consultation with internal or external technical resource persons

Sources (see Bibliography):

- Check-list of issues to address when developing linkages; in: Shepherd, 2007, p.57
- Question Guide #1; in: Action for Enterprise and Match Makers Ltd., 2009, p.3f

Activity 1.2/ **Realise a rapid screening of potential production areas and farming systems**

The procurement needs identified in activity 1.1 guide the rapid screening of potential production areas in different locations of the country or sub-region. Usually, such a rapid assessment can be realised through desk research and by organising a round-table discussion with key experts who are knowledgeable about the farming conditions in different locations. Based on the rapid assessment, the company or the key experts develop a plan for a more in-depth VC analysis in pre-selected areas (see activity 1.3).

Box 7/ **Activity 1.2 – Purpose, selected questions and selected tools**

Purpose

The purpose is to pre-select possible production sites based on a rapid assessment of agro-ecological and socio-economic conditions (e.g. prevailing farming systems, labour availability, traditional knowledge, existing infrastructure).

Selected questions

The following questions give ideas for realising a rapid screening of potential production areas and farming systems (the list of questions has to be completed according to the specific needs of the off-taking company and the reality on the ground; some questions may not be answered in a first rapid assessment but need a more in-depth analysis and field visits):

- Which production areas are appropriate with regard to agro-ecological and climatic conditions, land tenure for farmers, cropping history, proximity to the company's collection centre(s), community framework conditions (e.g. roads, utilities, community support, levies)?
- Do the prevailing farm/ household systems favour the integration of the CF crop, or is there a risk of competition for limited land, labour, capital assets? Is it recommended to provide solutions for nutrition-balanced cash crop promotion?
- Do the socio-cultural conditions favour cooperation with the company (e.g. existing networks/ conflicts based on origin/ language; gender roles/ conflicts; traditional leadership)?
- Do farmers already have experience in cooperating within farmers' organisations (important for scale economies, peer learning, peer control e.g. for group loans/ certification)?
- Do farmers have the necessary capabilities (e.g. traditional knowledge) and commitment?
- How do farmers perform (e.g. productivity, production unit costs, quality)?
- Can productivity be increased, production unit costs reduced, quality improved?
- Do farmers already sell to the market/ supply other companies/ work in a CF scheme?
- Is there potential for clustering several farmers' organisations around collection centres?
- Are the farmers capable of doing 1st stage processing (e.g. grading, de-hulling, drying)?
- In summary: which conclusions can be drawn from the screening of potential production areas and the pre-selection of areas that are promising for starting up a CF scheme?

Selected tools

- Consultation with internal or external resource persons (key experts)
- Review of existing studies

Sources (see Bibliography):

- Check-list of issues to address when developing linkages; in: Shepherd, 2007, p.57
- LINK Methodology; in: Lundy et.al., 2012
- Question Guides #3 and #4; in: Action for Enterprise and Match Makers Ltd., 2009, p.13f

C.3/

Activity 1.3/ **Map the value chain (VC operators, VC economics, VC upgrading needs)**

As a special solution for linking farmers to markets, the contractual agreement is located at the farm supply-firm procurement node of the value chain. Obviously, the entire value chain (VC) system has an influence on the opportunities and risks for setting up a CF business model, and hence has to be considered in the decision on whether to develop a CF scheme. Therefore, a VC map has to be prepared giving a sufficiently clear picture of:

- the business actors involved from input supplies through farming up to (competing) processors, traders, parastatals and cooperatives;
- the chain functions i.e. the flow and processes of produce, information and payments;
- the production, processing and transaction costs along the VC;
- the performance of public and private non-financial and financial support services;
- the business framework conditions/ investment climate; and
- the stakeholder behaviour/ attitudes that may foster/ hinder cooperation within the CF scheme.

VC mapping is not an end in itself, but aims at understanding the business reality and external landscape as basis for viable business solutions/ CF business model design. While a solid analysis is essential, reducing the complexity of analysis to the notion of 'as much as necessary, as little as possible' has to be considered to limit the money spent on analysis to the really necessary and to avoid pointless delays in getting started.

Box 8/ **Activity 1.3 – Purpose, selected questions and selected tools**

Purpose

The purpose of the VC mapping is to provide essential information for:

- the company's final decision on whether to embark on CF or not;
- the assessment of alternative CF solutions;
- the development of the CF business plan; and
- the discussion on contract details.

Selected questions

The following questions give ideas for mapping the value chain (the list of questions has to be completed according to the reality on the ground):

- How is the VC organised? Who are the key operators, what are the key functions? Which relevant financial and non-financial services are available/ which essential services are missing? Which framework conditions (investment climate) influence VC competitiveness?
- How do different supply channels perform (VC operator capacities, VC economics)? Which 1st stage processing (e.g. grading, sorting, drying) is implemented by which VC operators? Do additional income opportunities exist for farm household members (youth, women)?
- Since transaction costs are a critical factor for deciding whether to make or buy as well as where and from whom to procure a product, the question is: which factors influence transaction costs and which transaction costs are incurred along different supply channels?
- With regard to the special interest in the supply side of the VC: which special features at the farming inputs and farming node of the VC need a more in-depth analysis to complement the questions answered under activity 1.2?
- Do farmer organisations (farmer groups, associations, cooperatives) exist? If yes, which role do they play in service provision to farmers (extension, training, collection, marketing, processing, contract management, price negotiations, lobbying)? How do they perform?
- How many companies/ traders compete in which production areas for which markets for supplies from the same smallholder farmers? How likely is the risk of farmer default due to poaching by competitors/ side-selling by farmers?
- Does a sector organisation (association, federation, inter-profession, board) exist? Which role does it play (e.g. market information services, platform for seasonal/ annual price negotiations between farmer and buyer organisations, CF code of practice, policy dialogue)?

- How favourable/ unfavourable are the national/ local framework conditions (e.g. company law and specific CF legislation, company registration and bribery, economic and social infrastructure)? How likely are government interferences (e.g. in strategic food crops)?
- Which 3rd party support organisations (government, development partners, NGOs) are already working with farmers or are prepared to support CF development?
- In summary: What can be concluded from the VC mapping? Is the VC competitive? Which strengths, weaknesses, opportunities and threats (SWOT) are relevant for the CF model design and CF business plan? Which innovation and upgrading needs are crucial for CF success? Which political, production, marketing, credit etc. risks need to be considered?

Selected tools

- Consultation with internal or external resource persons (key experts)
- Review of existing studies

Sources (see Bibliography):

- Check-list of issues to address when developing linkages; in: Shepherd, 2007, p.57
- FATE methodology; in: Match Makers Ltd., 2008
- LINK Methodology; in: Lundy et.al., 2012
- M4P Toolbook for VC Analysis; in: M4P, 2008
- Question Guide #1; in: Action for Enterprise and Match Makers Ltd., 2009, p. 3f
- ValueLinks methodology; at: IVLA website

C.3/

Step 2/ **Development of a CF capacity development plan – identify non-financial and financial service needs**

The success and sustainability of CF schemes largely depends on the willingness and capacities of small-scale farmers and their organisations, buyers and their staff and probably intermediaries (e.g. nucleus farmers or hired collection centre or external extension staff, sometimes NGOs) to adopt new skills and innovative technologies; in particular:

- technical (e.g. Good Agricultural Practices/ GAP for known or new crops, good post-harvest handling practices and perhaps value addition/ 1st stage processing technologies);
- managerial (e.g. farming as a business, record-keeping, contract negotiation, input logistics and collection centre/ area management, CF operations management); and
- organisational (e.g. development of strong famer groups/ associations/ cooperatives, efficient communication and coordination between farmers and buyers).

Equally important are the availability of and access to financial services for farmers and buyers, both for medium to long-term investments and short-term operational costs. Considering the literally inexistent (even if slowly emerging) rural finance sector in many developing countries, embedded credits provided by buyers (or input suppliers) are often the only source of financing for small-scale farmers. Embedded financing is primarily made available in-kind by facilitating access to appropriate inputs (e.g. seeds of improved varieties, fertilizers, plant protection products) and sometimes also for CF crop-specific farm/ farmer group equipment (e.g. harrows, oxen-ploughs, possibly tractors) and facilities (e.g. storage, grading shed, 1st stage processing). As trust-building measure, pre-financing may also be provided for school fees, farmers' livelihood needs or social obligations.

The buyer in turn requires access to banks or other financial services to re-finance the credits provided to farmers alongside own investments into CF operations and logistics as well as trading or processing facilities. Availability of and access to further financial services will support CF development: e.g. money transfer (important to reduce risks of handling large cash amounts for payments to farmers at collection centres), savings (e.g. individual accounts for re-investments into farming; or group savings), leasing (e.g. for farm machinery and equipment) and insurance (e.g. weather-indexed crop insurance). Furthermore, governments or development partners may provide financial assistance with a view to promoting agricultural or VC development in general and CF development in particular (e.g. co-financing of initial investments, credit guarantees, first loss default guarantees, input or other subsidies).

Finally, capacity development in general and the offer of embedded services in particular contribute to changing attitudes necessary for building long-term and reliable CF relations and thus reducing default risks on both sides. Change of attitudes refers to building mutual trust, respecting own contract obligations and the co-contractor's contract rights, sharing information in a transparent way, agreeing on fair contract relations and granting equitable scope of negotiation and the like for the mutual benefit of both CF partners.

Box 9/ **Step 2 – Activities, issues to be considered and milestone**

Activities

2.1 (Pre)Select production area(s) and farmers/ farmer groups for the start-up phase

2.2 Assess farmers'/ groups' and buyer's capacity development and service needs

2.3 Draft a contract farming service plan (embedded and external services)

Issues to be considered

The following issues have to be considered in the (pre) selection of production areas and suppliers, the assessment CF capacity development and service needs and the drafting of a CF service plan:

- If Step 1 does not provide sufficient information for a final selection of locations for the start-up (pilot) phase, the buyer has to pre-select production areas and farmers/ farmer groups to generate more evidence (e.g. service needs) to back the final selection process.
- Following the (pre)selection of locations, the buyer initiates contacts with potential suppliers (possibly via 3rd party facilitators already working in the area) to create awareness on the company's interest and introduce the CF concept in general.
- The first contacts between farmers and buyers are critical for initiating trust-building and due attention has to be paid not to create false hopes among farmers (e.g. easy market access, premium prices) or to stoke fears (e.g. loss of autonomy or land use rights).
- For the start-up (pilot) phase, it is recommended to select smallholders already coming with basic farming/ business skills, showing some risk readiness and innovation capacities (early adopters). This allows rapid success to motivate contract compliance on one side and fast learning for quick up-scaling on the other side. The bias against assistance to more advanced smallholders should lose ground against the opportunity to advance the up-scaling of CF projects and hence the achievement of broader development impacts.
- Both, technical assistance and credit services are usually required to introduce innovations in farms. Smallholders appreciate embedded services provided by buyers. This can contribute to strengthening CF linkages but may also trigger default risks (see Step 3).
- To become strong CF business partners, it is necessary that smallholders realise scale economies by joining farmer groups/ associations/ cooperatives (to reduce transaction costs and improve performance e.g. through peer learning, joint negotiations/ collection).
- In the past, many farmer organisations have been formed to serve social/ community interests and many cooperatives have been formed top-down by governments to channel e.g. input subsidies. Consequently, member commitment, structures, leadership and member services are usually not appropriate for CF needs and have to be upgraded.
- Given the weak contract enforcement systems in many developing countries, neutral arbitration services (e.g. traditional court, opinion leaders) are vital for mediation in case of default of either contract side; provided arbitration is accessible for small-scale farmers.
- Financing CF usually implies high risks for both co-contractors: farmers risk over-indebtedness and buyers risk default in supplies (volumes, quality, timeliness) and/ or recovery rates; next to failure of appropriate legislation and enforcement, the risks are linked to weak scope of negotiation on the farmers' side, to inappropriate CF arrangements and/ or weak CF business management and especially to mistrust between the business partners. It is therefore recommended, not to provide more embedded financing than really necessary, at least in the beginning and as long as the farmer-buyer linkages remain fragile; furthermore, there are different possibilities for buyers to reward repayment and to mitigate default risks (see Step 3).
- The perhaps most challenging task is to assure proximity of CF management and service delivery to farmers. Depending on the CF business model and the capacities of potential service providers, non-financial services can be provided as embedded service through company staff, nucleus farmers or other intermediaries or by farmer organisations or external service providers such as sector associations, government extension or NGOs.
- Given the buyer's specific interest and product requirements, for which farmers have to acquire distinct skills and capacities, it is usually the company's responsibility to organise and finance necessary training and mentoring systems.

C.3/

- The relation between the buyer's embedded service offer and the government extension service has to be clarified and approaches aligned. While public extension usually focusses on basic messages, specific CF technologies are better extended through CF structures given the economic interest of the buyer in improved farm and CF performance.
- However, considering the often considerable non-financial and financial service needs for integrating smallholders into CF that may bear on the company's assets/ liquidity and on its competitiveness, governments or development partners may decide to support CF development through technical or financial assistance (see section B.2). While sufficient time and resources have to be provided to support the emergence of sustainable schemes, external partners have to plan for a clear exit strategy from the very beginning.
- Since the objective of governments and donor organisations is usually to assist resource-poor and marginalised farmers with a view of fostering rural economic growth and reducing food insecurity, due attention has to be paid not to let development objectives override business reasoning (e.g. in the selection of production areas and farmers). This is a crucial success factor since farmers and buyers take the business and investment risks and have to sustain the CF scheme in the long run without external assistance.

Milestone
A contract farming capacity development and service plan is drafted.

Activity 2.1/ **(Pre)Select production area(s) and farmers/ farmer groups for the start-up phase**

The (pre)selection of locations and farmers/ farmer groups for the start-up phase (usually used for piloting the CF model) draws upon the results of Step 1. If the rapid screening of potential production areas and farming systems (see Activity 1.2) and the VC mapping (see Activity 1.3) do not provide sufficient information for a final selection of locations and suppliers, the capacity needs assessment has to be realised in pre-selected production areas and among pre-selected farmers/ farmer groups. The information generated in Step 2 will then serve the final decision on locations and suppliers for the start-up phase.

Note
Since considerable costs and time are involved in searching, screening and qualifying suppliers, it is reasonable for buyers to invest sufficient time and money into the initial selection of locations and farmers. The higher the probability to retain trained and experienced producers in the system, the less the search/ training costs and time in the long run and the easier the up-scaling of the CF scheme (e.g. through farmer-to-farmer enrolment).

Box 10/ **Activity 2.1 – Purpose, selected questions and selected tools**

Purpose
Given the fundamental importance of the selection of appropriate locations and committed farmers/ farmer groups willing and capable to contribute to the success and sustainability of a joint CF business, the purpose is to support informed decision making of buyers.

Selected questions
The following questions provide ideas for the (pre) selection of locations and suppliers:

- Which locations are suitable with regard to agro-ecological and climatic conditions, land tenure, farm sizes and yield potential, sufficient numbers of potential CF farmers in spatially limited areas (to reduce transaction costs), availability of workers, supportive local government and traditional leadership, infrastructure (roads, communication, water, power, etc.) and prevalence of insecurity (risk of loss of produce or cash through theft or bribery)?
- Which of these locations are close to the company's location or possible sites for collection and/ or service centres (important regarding transport/ transaction costs, visibility in the field/ proximity of services and speedy handling of inputs and perishable products)?
- If required agro-ecological conditions are far-off, more appropriate farm systems are secluded in less densely populated areas or the risk of side-marketing/ poaching is high in easily accessible areas: Does the cost-benefit ratio speak in favour of selecting more remote areas?
- If the company intends to spread procurement according to harvest seasons in different agro-ecological zones or to spread the potential risk of weather-induced crop failure: which locations complement each other within a country or sub-region?
- Are there extension services, donor programmes or NGOs who know potential suppliers and can broker linkages?
  Due attention has to be paid to apply clear criteria for supplier selection guided by business and not by development reasoning, clan relations or the like.
- Are there farmer groups/ associations/ cooperatives with committed membership and leadership, experiences in joint economic activities and/ or peer-learning? Does the socio-cultural context foster or impede horizontal cooperation in farmer organisations?
- Do the farmers have secure usufructuary or proprietary rights over the farm land? Do they have access to draught animals or machines and equipment (own or hired)? If need arises, do farmers have access to external labour at reasonable costs?
- Which activities are currently implemented by women or young people and which influence will the CF scheme have on their roles, work load and inclusion? Which barriers have to be overcome and measures taken to assure their inclusion at equal terms?

C.3/

- Does the CF crop fit into the farming/ household system without compromising subsistence needs? Or is there a risk of trade-offs between household food security and the CF crop regarding scarce smallholder assets (land, labour, capital)?
- Labour is often scarcer than assumed: what are the opportunity costs for the use of family labour for the CF crop? Does the farm have sufficient family labour in case the CF crop requires care at the same time as the food crops? Can workers be hired at reasonable cost?
- Have the farmers got sufficient basic farming skills or even specific knowledge on the CF crop? Can they relatively fast and with reasonable input in training/ extension meet the buyer's quality requirements?
- Are there 'recommended' smallholders having a track record in CF or as reliable suppliers to traders/ processors or having met their loan repayment obligations in input programmes? Are more innovative farmers pro-actively approaching the buyer? Are there 'new generation' farmers who are better qualified and better informed?
- In many developing countries, the farm population is ageing due to rural-urban migration. In case of longer-term investments (e.g. irrigation, perennials/ permanent crops), do the farmers have a succession plan or can the farmers sell/ let the land for rent?
- Are there intermediaries already known by farmers or members of farmer groups who are respected opinion leaders capable to become nucleus farmers? Are there committed traders capable to manage collection centres either independently or as company staff?
- Are there service providers for capacity building (e.g. training, extension, research, demonstration plots), for operational services (e.g. input supplies, transport, storage) and for financing needs (e.g. credits and savings, money transfer, insurance) within reach?
- Is there a nearby market or processing opportunity for the second/ lower grade to provide an additional income for farmers/ perhaps providing income for women selling in the market or processing?
  This may also contribute to reducing the risk of side-marketing.
- If the CF-product lends itself for establishing value-addition/ 1st stage processing close to farmers' fields (e.g. to improve shelf-life or reduce transport volumes): are farmer groups/ village-level people, especially women interested to venture into these activities?
  While such activities offer additional income opportunities, due consideration has to be paid to the opportunity costs for farmers/ women given the commitment of assets (space, labour, capital) that will not be available for other activities (e.g. core activities and competencies such as the production of food crops).
- In order to avoid resentments against the buyer, tensions/ conflict in the farmer community and farmer default (e.g. extra-contractual selling): Which farmers, aggregators, traders are presently involved in the VC and risk to be crowded out by the CF scheme?

Selected tools

- Rapid assessment tools

Sources (see Bibliography):

- Contract farming checklist; in: Wageningen et.al. (n.d.)
- Firm choice of a procurement location; in: Barrett et.al. (2011), p.8
- Identifying production areas/ selecting farmers; in: Eaton and Shepherd/ FAO (2001), p.86f

Activity 2.2/ **Assess farmers'/ groups' and buyer's capacity development and service needs**

To improve productivity and reduce unit farm production and unit CF transaction costs and hence improve CF profitability, farmers and buyer's staff have to develop new technical, managerial and organisational skills. Since inputs, machine services, harvesting, transport and storage, grading and packaging (operational services) are frequently provided by private traders, partly by farmer organisations or by the off-taking company, they also have to be considered in the CF service plan. Furthermore, financing requirements for initial investments (facilities, setup of management structures, training and advice, etc.) and recurrent operational costs and re-investment needs have to be met.

Both, non-financial and financial services can be offered by private service providers (e.g. companies, associations), governmental or non-governmental organisations or by the buyer in the form of embedded services. Availability, access and service costs as well as the own capacity development needs of private and public service providers have to be assessed. This will facilitate a decision on whether these services can be met by external partners or have to be provided as embedded services.

Overall, non-financial and financial services may be required by nearly every actor within and outside (external service providers) the CF scheme: farmers and their organisations; intermediaries such as nucleus (lead) farmers or company field staff or externally hired extension agents or aggregators; CF management staff such as farmer group representatives, company or externally hired collection centre/ area managers; the company staff; and often also external service providers (government extension, NGO staff, private service providers).

Box 11/ **Activity 2.2 – Purpose, selected questions and selected tools**

Purpose

To better understand the non-financial and financial service needs of all actors involved in the CF scheme, a rapid assessment of capacity development and service needs is evident for finalising the CF business model and developing a viable CF business plan.

Selected questions

The following questions give ideas for the assessment of the capacity development and service needs of farmers and the company:

- Which conclusions can already be derived from the results of Step 1 and Activity 2.1 with regard to capacity development and service needs of all internal and potentially also external actors involved? Which questions remain to be answered?
- Whose and which specific skills and other relevant capacities require upgrading at farm level when looking at the prevailing farming systems and the distribution of work between men, women, youth on the one side and family or hired labour on the other side?
- Which entrepreneurial skills do farmers need to become competent partners in the CF scheme (keywords: farming as a business, farmer business schools, production planning and cost management, grasp of contract contents and negotiation skills)?
- Which technical guidance do farmers/ workers need for producing traditional or new crops according to buyer's specifications (e.g. integration of the CF crop into the prevailing farming systems, GAP, possibly international quality or sustainability standards/ certification)?
- How, by whom, where and at which costs can the respective extension/ training best be organised, specific materials be developed (external training institutions, farmers' unions, government extension services, consultancy companies, buyer's staff)?
- How, by whom, where and at which costs can the close-by mentoring/ monitoring best be realised (farmer groups, near-to-site nucleus farmers, company staff, hired field advisers, public extension, NGO advisers)?
- Are close-to-farmers sites for demonstration plots available (e.g. nucleus farmer fields, public extension/ training or company's collection centre sites) that can be used to demonstrate farming practices following the seasonal work schedule? Where and at which costs?

C.3/

- Are farmers already organised in groups, associations or cooperatives? Are these organisations strong enough for common activities within the CF scheme? Which kind of organisational development is necessary to strengthen them? Who can do it at which costs?
- Which other capacity development needs have farmers, female family members or enterprising young village people got in related areas such as provision of operational services such as seed multiplication, plant protection, aggregation or 1st stage processing, etc.?
- Which other ways of conveying technical skills, transferring new technologies, imparting experiences on good organisational practices in farmer organisations, motivating farmers can be used (e.g. exchange visits with other groups, company/ processing plant visits)?
- Which technical and managerial skills and capacities do other CF actors such as nucleus farmers, collection centre managers, transporters have to develop (e.g. quality assurance from farm to firm, farm auditing, management of input distribution and produce collection)?
- Which capacity development needs do the internal/ external service providers have to serve the CF scheme in a competent and business-oriented way (nucleus farmers, farmer organisations, CF managers, training institutions, extension agents, etc.)?
- Capacity development is not a one-off event; rather, to enable farmers and other CF actors to translate theory into daily work routines it is indispensable to assure post-training mentoring and regular refresher/ upgrading trainings. How can this be organised?
- Which input support do farmers need for realising expected yield increases/ meeting quality requirements? Who has got a sufficiently developed distribution system for delivering inputs in-time (embedded/ external)? Which costs are implied?
- Which further operational services are required (machine services for land preparation, plant protection, harvesting, collection, storage, transport)? Are external private service providers available/ accessible or is it more desirable to use embedded services for better visibility of the buyer in the field? How do costs and benefits compare?
- Which financing needs have farmers got? Are financial service providers within reach of farmers (banks, mobile banking, micro-finance institutions, insurance)? If yes, are the credit/ insurance conditions affordable for farmers in relation to prospective sales returns?
- Which alternative options exist for short, medium and long-term financing? At which conditions can buyers re-finance if they have to provide embedded loans? Can farmers or buyers access financial assistance offered by governments, donor organisations or NGOs?
- Overall, which innovative service solutions can be used for reaching out to large numbers of farmers and reducing service transaction costs (e.g. information and communication technologies/ ICT for a broad range of information/ extension messages/ mobile banking)?

Selected tools

- Capacity development needs assessment tools

Sources (see Bibliography):

- Business development services/ financial services; in: Will, 2008, p. 55ff/ 64ff
- Check-list of issues to address when developing linkages; in: Shepherd, 2007, p.57
- Developing the capacities of target groups; in: Will et.al., 2008
- Question Guides #6, #7, #8; in: Action for Enterprise and Match Makers Ltd., 2009, p.21ff
- Rural Extension/ Vol. 1: Basic Issues & Concepts; in: Hoffmann et.al., 2009
- Rural Extension/ Vol. 2: Examples & Background Material; in Hoffmann et.al., 2009
- Rural Extension/ Vol. 3: Training Concepts & Tools; in: Gerster-Bentaya, Hoffmann, 2009
- Rural Finance decision tools; in IFAD, 2010
- Rural Finance Learning Centre (RFLC); RFLC website
- Supporting institutions; in: Dawes et.al. (2007), p.18ff

Activity 2.3/ **Draft a contract farming service plan (embedded and external services)**

Summarising the results of Activity 2.2, the buyer can draw conclusions on the efforts and resources involved in providing necessary non-financial and financial services to start up and run the CF scheme. Furthermore, decisions can be taken which of the required services can better be provided through embedded systems or external service providers.

Box 12/ **Activity 2.3 – Purpose, selected questions and selected tools**

Purpose

The resulting CF service plan gives an overview on vital services in the short, medium and long run, potential private or public implementing partners, resources involved and potential financing contributions from 3rd parties (e.g. government, donor projects, NGOs). The CF service plan forms part of the CF business plan (see Activity 3.4).

Selected questions

The CF service plan summarises the results of **Activity 2.2** and delivers important information for developing the CF business plan (see Activity 3.4) by answering the following questions:

- Which non-financial and financial capacity development and service needs have CF operators and service providers got in the short, medium and long run at all relevant nodes of the VC?
- Which non-financial and financial services shall be provided through embedded systems and which through external service providers (in the latter case: consider the possible negative implications on trust-building of reduced visibility of the company at farm level)?
- Which actors will be involved for embedded services (e.g. own company staff, farmer organisations, nucleus farmers) and for external services (private, public, projects, NGOs)?
- Which investments are required into service facilities (e.g. input storage and distribution, collection centres, training places, on-farm/ near to collection centre demonstration sites)?
- Is the government/ are donor organisations interested to implement public-private partnership (PPP) projects with the buyer? If yes, for what kind of investments/ activities (infrastructure investments/ capacity development)?
- Are there institutional approaches supporting capacity development that can be involved?
  To mention just a few: initiatives at national level uniting actors along the VC (e.g. the Cotton Board of Zambia/ CBZ or the Ghana Grains Council/ GGC); federations or round tables at regional or international levels (e.g. the East African Grain Council/ EAGC, the East African Business Council/ EABC or the African Cashew Alliance/ ACA) or regional donor supported projects (e.g. the Competitive African Cotton Initiative/ COMPACI, the African Cashew initiative/ ACi or the Trade and Global Value Chains/ TGVC initiative).
- Are there institutional initiatives supporting financing of CF?
  To mention just a few: Burkina Faso set up a Cotton Fund (fonds de lissage) mainly meant to smoothening world market price volatility and safeguarding revenues for producers; Zimbabwe launched a US $ 12 million Agriculture Fund in 2012 among others meant to stimulate CF development; and the Round Table on Sustainable Palm Oil (RSPO) recently announced the introduction of a smallholder support fund to assist small-scale farmers achieve certification and reduce the risk of exclusion from standards-ruled markets.

Selected tools

- See activities 2.1 and 2.2

C.3/

Step 3/ **Development of a CF business plan – outline solutions for the start-up and operation of the CF scheme**

As shown in Figure 8, the development of the CF business plan is based on the VC mapping (see Activity 1.3), the assessment of capacity development and service needs (see Step 2) and the decision on the CF business model (see Activity 3.1) while it informs both the CF management plan and the design of the farming contract. It is obvious that CF requires thorough planning since it is about the management of the usually quite fragile farm supply-firm procurement interface (see C.1, Figure 5). Tying large numbers of smallholders (even if organised in farmer organisations) with one buyer, the management of such a conjoint business is a real challenge. The main reason is that largely different capacities and at least partly divergent interests have to be aligned to a degree that allows to creating and sustaining a mutually beneficial venture.

In this setting, farming contracts are intended to provide the necessary sound footing for the fair and equitable sharing of risks and benefits between farmers and buyers. But experience shows that a farming contract is not worth the paper it has been written on if there is no trust between farmers and buyers. TRUST is decisive for the willingness to honour agreements and for reducing moral hazard problems such as diversion of inputs or side-selling (the latter often in response to poaching by competing buyers), unduly imbalanced negotiation power, biased rejection practices, late or non-payment. Recognising the impact of these realities on the success of the CF venture (and hence on the return on investments of the CF for farmers and buyer), due care has to be exercised on screening alternative CF arrangements, selecting an appropriate CF business model, outlining pertinent contract details and drafting a realistic and realisable CF business plan.

Note

- When drafting the CF business plan, due attention has to be paid to considering a realistic growth path for the CF scheme and guesstimate the maximum size, at which the scheme is still manageable and cost-benefit-wise competitive with other business models (see Phase 3, introduction).
- The CF business plan and the CF management plan remain drafts as long as no agreement has been concluded with the farmers since the final CF business/management plans have to reflect the farmers' ideas and concerns (see Phase 2, Step 4).

Box 13/ **Step 3 – Activities, issues to be considered and milestone**

Activities

3.1 Screen alternative CF arrangements and select an appropriate CF business model

3.2 Outline the prospective structure and management plan of the CF business model

3.3 Outline contract details (1st draft only reflecting the buyer's perspective)

3.4 Draft a CF business plan (incl. prospective return on investment, risk assessment, etc.)

Issues to be considered

- Alongside the results of Step 1 and Step 2, the description of CF business models and contract types (see section B.1.1) as well as the deliberations on incentives and disincentives (see section B.1.3), conditions for success and failure (see section B.1.4) and crop suitability (see section B.1.5) provide fundamental information for the final screening of alternative CF arrangements.
- Considering that trust is key for the sustainability of business relationships, the CF design has to factor in relevant concepts. Trust accrues from ownership, voice, risk and reward (Vermeulen and Cotula, 2010, p.5), involving quite ambitious but necessary success factors such as (see section B.1.4): (i) economic viability and incentives with an equitable cost-benefit-'plus' for both, suppliers and buyers; (ii) fair give-and-take relations (scope of negotiation); (iii) sharing of ownership and risks according to the quite divergent capabilities of both sides; (iv) opportunities for technology transfer and innovation to stimulate increased farm productivity and chain efficiency; (v) an enabling investment climate and 3rd party support that promote the competitiveness of the CF scheme; as well as (vi) sound analysis and planning as precondition for the design of viable CF schemes.
- Further key principles: (i) ownership is with the farmers and the buyer as co-contractors, not with the facilitators (government, donor programmes, NGOs); (ii) farmers have to remain independent and have to be qualified to take their own business decisions since they bear the investment/ production risks; (iii) farmgate prices and payment conditions have to consider the needs of farmers (for the price: recovery of production costs plus fair margin; for the payment: consideration of seasonal cash-flow/ livelihood requirements).
- The decision on the CF business model as well as the outline of the management plan, the CF contract and the CF business plan are also influenced by regulations or voluntary standards. To give just a few examples: regulatory code of conduct (CoC) for contract farming (e.g. Horticultural Crops Development Authority/ HCDA in Kenya), national sector-wide code of practices (CoP; e.g. Cotton Board of Zambia), international sustainability standards (e.g. Cotton made in Africa/ CmiA, FairTrade) or corporate standards (e.g. Nestlé's Creating Shared Value). Another interesting move is the 'Green Paper on unfair trading practices (UTP) in the business-to-business food and non-food supply chains' recently adopted by the European Commission, which aims at promoting fairer and more sustainable trade relationships (including overseas supplies).
- Additionally, regulators (e.g. Conseil Café Cacao/ Cote d'Ivoire) or chain-wide organisations (e.g. Cotton Board of Zambia) or inter-professions may set/ recommend seasonal minimum prices. However, if the prices are not based on business reality or if the set price is not flexible enough to adapt to seasonal/ inter-annual price fluctuations in main markets (e.g. world market), CF schemes may break down (the case of cotton in Zambia some years back or of soya in Ghana in 2012). Hence, sophisticated price finding mechanisms have to be developed if the regulated/ recommended price is to promote and not to risk smallholder inclusion through contract farming.
- When drafting the business plan, buyers have to consider that CF schemes hardly can achieve break-even in the first year (experience shows that break-even will only be realised after three to five or even more years).
- The CF business plan and the CF management plan remain drafts, as long as no agreement has been concluded with the farmers since the final CF business/ management plans have to reflect the farmers' ideas and concerns (see Phase 2, Step 4).

Milestone

The business plan explains the CF structure and gives a realistic assessment of its viability.

C.3/

Activity 3.1/ Screen alternative CF arrangements and select an appropriate CF business model

Since the CF arrangements (especially the visibility and accessibility of the buyer/ buyer's staff or representatives in the field and the quality of embedded/ external services) have an important influence on relationship continuity, CF business model options have to be weighed up carefully. The better the CF model is planned at the onset, the less costly and time-consuming adaptation will be necessary at a later stage. With respect to the different CF business models (see section B.1.1, Box 1 and Figure 1), it should be noted that:

- the boundaries between one model and the other are fluid with regard to organisational structures and operational arrangements;
- the models chosen for starting up a scheme may (usually do) change over time through the integration of lessons learnt and changing attitudes or due to the emergence of new technologies or changing external conditions (markets, regulations, policies); and
- a model that proves to be appropriate for the start-up phase may need to be adapted and perhaps changed for the consolidation and scaling up phase respectively.

Box 14/ Activity 3.1 – Purpose, selected questions and selected tools

Purpose

The purpose of this activity is to screen alternative CF arrangements, to identify the most appropriate CF business model for the given internal situation (buyers' and farmers' incentives, attitudes and capacities) and the external setting (markets, support services, framework conditions, facilitators) and to outline the business model in detail.

Selected questions

The following questions give ideas for screening alternative CF arrangements and selecting an appropriate CF business model (based on the results of Step 1 and Step 2 as well as the description of the CF business models in section B.1.1, incentives and disincentives in section B.1.3, the conditions for success and failure in section B.1.4 and crop suitability in section B.1.5; possibly also some questions under Activity 3.2):

- How shall the functions/ work routines be distributed between farmers and the buyer's staff in the first instance and possible intermediaries in the second instance (nucleus farmers, farmer organisations, aggregators or committed traders)?
- How shall the CF operators relate to each other regarding communication and coordination (e.g. from seasonal crop planning and contract/ price negotiations through exchange on crop development/ harvest forecasts during the season up to end of season wrap-up)?
- How shall the product flow be organised (from on-time input distribution/ probably mechanisation and advisory services up to timely harvest and collection of produce and appropriate post-harvest handling)? This decision is largely influenced by the product features (e.g. perishability) and the requirements regarding quality assurance/ food safety standards.
- Which explicit initial investments and recurrent costs are involved in meeting specific quality or sustainability standards?
- If 1st stage processing/ value addition at farm, farmer group or village level is an opportunity (depending on produce characteristics and presumably only in the medium term): Who will invest into this venture and how can this activity best be integrated into the communication, product and payment flows?
- Which services should and can the buyer provide as embedded services (depending on e.g. the specific skills and knowledge required and buyer's staff capacities, the existence, performance and costs of external service providers, the financing needs and sources)?
- Which CF arrangements are furthermore appropriate for: access to improved seeds (e.g. farmer field multiplication); training and extension (including demonstration fields); input loans and input distribution systems; collection/procurement logistics; record-keeping, quality assurance and traceability from farm to firm; reducing the risk of extra-contractual marketing (side-selling poaching)?

As regards the last point, it is recommended to organise weighing, grading and the decision on rejections close to farmers. Ideally, grading is done by farmers themselves or at least in their (or a neutral person's) presence to avoid that farmers feel cheated. This will also enable farmers to sell low-grade (yet safe) produce to local markets. Instead of wasting rejects, farmers can thus realise revenues, improve the gross margin and reduce the production unit costs.

- Which CF business model (see section B.1.1, Box 1 and Figure 1) fits the specific situation best?
  Further important decision criteria are: the buyer's company management and financial capacities; the spatial dispersion of producer locations; the minimum requirements for farmer grouping to achieve necessary scale economies and chain efficiency; the availability/ non-availability and capacities/ qualification needs of external intermediaries such as nucleus farmers/ farmer organisations/ contracted service providers. If required, a tri-partite CF business model may be considered involving a bank accepting the contract or supplied produce as collateral for pre-financing farm/ livelihood needs.
- How does the prospective feasibility (rough estimate of the cost-benefit) of different CF business models compare with regard to: required investments and expected return on investments; operational complexity and operational costs; expected productivity (increased yields, reduced unit production costs) and efficiency gains along the supply chain (reduced transaction costs and post-harvest losses); and overall regarding expected cost-benefits for the buyer and farmers?
  In order not to raise over-ambitious expectations, prudent assumptions should be made on yields/ productivity increases, chain efficiency and also default rates during the start-up phase.
- How do the different CF business models compare with regard to specific advantages or risks such as: ease of transfer of innovative technologies to improve farming practices of traditional crops or to introduce new crops/ varieties, raise productivity and improve quality; supervision of production and harvest practices; control of volumes, qualities and timeliness of supplies; organisation of post-harvest handling; tracking of contract fulfilment; and prevention against default either on the farmers' or the buyer's side?
- In conclusion: Which CF business model is the most appropriate according to the screening of alternative CF arrangements? How does the CF business model have to be designed to fit to: (i) the buyer's medium to long-term business strategy; (ii) the suppliers' farm/ household systems and their livelihood needs; (iii) the existing capacities (land, labour, capital) and the short, medium and long-term capacity development needs of both co-contractors; (iv) the local, national and international framework conditions (including prospective future market trends/ price fluctuations); as well as (v) the need to reduce/ mitigate risks (production, marketing, political, credit risk, etc.) for both business partners and the way to share risks according to the divergent capacities of both business partners?

Selected tools

- Management team of the buyer's company, at least partly involving farmer/ farmer organisation representatives as well as perhaps intermediaries, external experts and facilitators
- Description and pros & cons of CF business models in section B.1.1 (Box 1 and Figure 1)
- Incentives and disincentives for CF in section B.1.3 (Box 3)
- Conditions for success and failure in section B.1.4
- Discussion on crop suitability in section B.1.5

Sources (see Bibliography):

- CF arrangements and challenges for buyers and farmers; in: Holmes, 2012, p.3
- CF arrangements for reducing the risk of side-selling; in: Holmes, 2012, p.3
- FATE methodology; in: Match Makers Ltd., 2008
- Institutional arrangements in the Zambian cotton sector; in: Tschirley & Kabwe, 2009, p.18
- Organisation of production; in: Lundy et.al., 2012, p.160ff
- Question Guide #1; in: Action for Enterprise and Match Makers Ltd., 2009, p.3f
- Types of contract farming; in: Eaton and Shepherd/ FAO, 2001, p.43ff

C.3/

Activity 3.2/ Outline the prospective structure and management plan of the CF business model

The firm's visibility in the field, the suppliers' confidence in the CF management and the control of potential risks (cost drivers, food safety and quality, default) by both partners are vital for the sustainability of the CF scheme. This requires a situation-specific physical setup and a suitable mentoring/ monitoring system. Accordingly, the CF organisational structure and CF management system have to provide efficient solutions for timely, transparent and trustful coordination and communication between farmers and buyer.

This activity is about the structures and procedures for CF coordination and internal communication necessary to reduce supply/ procurement uncertainties and risks, increase supply chain efficiencies (and hence reduce transaction costs) and increase value-added for farmers and buyers (through technology transfer and change of business attitudes and relationships). The structures and procedures depend on the product features, the farmers' capacities and farming systems, the existing infrastructure, the staff's competencies and the availability of competent intermediaries and the company's management and financial resources. Step 2 and Activity 3.1 already provide essential information for drafting solutions for the organisational structure and management system.

Box 15/ Activity 3.2 – Purpose, selected questions and selected tools

Purpose

The purpose of this activity is to outline solutions for a smooth, effective and efficient management of the farm supply-firm procurement interface according to the selected CF business model. The final layout of the organisational structure and setup of the management system depend on the results of the negotiations with suppliers (see Step 4).

Selected questions

- Which organisational structures and management system are appropriate to assure the timely distribution of inputs, the transfer of appropriate technologies, the scheduling of harvest and collection of produce, the organisation of post-harvest logistics and finally the on-time and transparent settlement of payments and deduction of pre-financed loans?
- Which CF setup and procedures are presumably required in the medium to long run? To reduce initial investments to the necessary and risks of losses in case of failure to the minimum: Is it possible to take a gradual approach to developing the organisational structure and management system?
- Which elements are indispensable for the start-up phase?
  Consider: the better the scheme is managed right from the beginning, the closer the relations between farmers and buyer and the lower the default rate as well as the risk of failure and loss of initial investments.
- Since the systems depend on the type, qualification, spatial dispersion and number of farmers/ farmer groups and intermediaries involved: How many suppliers have to be integrated to satisfy the buyer's requirements regarding installed processing capacities/ sales opportunities?
  Consider: the better the suppliers are already known (to the buyer, intermediaries, 3rd party supporters), the less dispersed their locations and the closer the ties between farmers and buyer's staff/ intermediaries through mentoring/ monitoring, the lower the number of suppliers to be contracted. In reverse, it is necessary to contract larger numbers to secure at least the minimum supplies required to satisfy the buyer's needs.
- Which CF arrangements are required for encouraging productivity gains and quality assurance, transaction cost-efficiency and reduction of default risks as well as probably 1st stage processing at farmer or village-level and/ or sales of rejected lower grades to rural markets/ processors?

Possible solutions: (i) build on existing relations and references for supplier selection; (ii) set up a multi-levelled structure that allows guidance of farmers throughout the production cycle/ visibility of the company in the field (e.g. setup of a cascade learning/ mentoring/ control system involving individual farmers/ 10-15 farmers organised in farmer groups/ nucleus farmer/ field adviser/ collection centre/ area manager); (iii) know the farms and farming systems and develop a quota system that considers the supply capacity of individual farmers; (iv) develop application and control structures and procedures (embedded or external services) if plant protection is a sensitive issue due to standard compliance/ certification needs; (v) introduce harvest forecast systems allowing to monitor individual farmers' prospective harvest volumes and times; (vi) create an incentive system to improve commitment for mentoring and monitoring at the different cascade levels (e.g. premiums for volumes and share of first quality supplied; reward for high repayment rates); or (vii) allow farmers to sell a certain share of the produce to other buyers or to use it for household subsistence; (viii) involve traditional leaders and consider visibility in/ contributions to community development; etc. Note that the higher the pre-financing volume by the firm (mainly inputs on loan), the better structures and procedures have to be established involving sometimes considerable transaction costs.

- Since the competence and commitment of all staff involved in the CF management are vital for success or failure: Which CF-coordination/ management capacities have to be built and incentive systems established at the different nodes of the multi-levelled management system?
- Which farmer groups/ associations/ cooperatives exist already? How strong are they? Which organisational support do they need to become member/ service/ business oriented and able to take on CF-tasks (e.g. concerted crop planning, input distribution, application/ control of the use of plant protection according to standards, internal auditing for group certification, group lending, peer learning, contract negotiation)?

  Note that quite many cooperatives have produced mixed results in numerous developing countries especially when government/ NGO driven and influenced.
- Concluding, which initial investments and short/ medium/ long-term re-investment and operational costs are involved for setting up/ maintaining the structures and managing the CF scheme (consider also possible additional externally caused costs such as for security measures due to prevalence of theft and bribery)?

Selected tools

- Management team of the buyer's company, at least partly involving farmer/ farmer organisation representatives as well as perhaps intermediaries, external experts and facilitators
- Conditions for success and failure in section B.1.4
- Discussion on crop suitability in section B.1.5

Sources (see Bibliography):

- CF arrangements and challenges for buyers and farmers; in: Holmes, 2012, p.3
- CF arrangements for reducing the risk of side-selling; in: Holmes, 2012, p.3
- Basic models and key characteristics; in: Technoserve and IFAD (2011), p.2ff
- Institutional arrangements in the Zambian cotton sector; in: Tschirley & Kabwe, 2009, p.18
- Question Guides #5-8; in: Action for Enterprise and Match Makers Ltd., 2009, p.19ff
- Managing the project; in: Eaton and Shepherd/ FAO, 2001, p.83ff

C.3/

Activity 3.3/ **Outline contract details (1st draft only reflecting the buyer's perspective)**

The farming contract specifies the sellers' (farmers') obligation to supply the volumes and qualities as specified and the buyer's (processor's/ trader's) obligation to provide embedded services, to off-take the goods as specified and to realise the payments as agreed.

Clarity on contract obligations and rights as well as fair and equitable contract terms based on transparent criteria (e.g. price formula and input and credit cost calculation) are fundamental for trustful business relations, contract fulfilment and reduced moral hazard on both sides. This is especially true in settings, in which contracts are hardly enforceable due to failure of the judiciary system; but even if the legal system works it is close to impossible for smallholders due to the costs involved.

Note
Farming contracts have to be simple enough to be understood by largely illiterate farmers and comprehensive enough to assign clear obligations and rights to farmers and buyers.

Box 16/ **Activity 3.3 – Purpose, selected questions and selected tools**

Purpose

The main purpose of this activity is to flesh out a draft contract that will serve as basis for discussions/ negotiations with farmers (see Phase 2, Step 4).

Selected questions

- Which contract type fits best for the CF arrangement (see contract types in section B.1.1, Box 2): market specification contract, production management contract or resource providing contract?
- Which contract form and substance fits best for the CF arrangement (see section B.1.1): (i) informal or formal, verbal or written form; (ii) concluded with individual farmers or farmer groups; (iii) obligations described quite vague or reasonably specific; (iv) renewable each season or long-term agreements; (v) specifications based on case by case negotiations or on a sub-sector code of practice?
  For typical contract specifications see Box 17 below.
- Are there already contracts that can serve as a basis for the planned CF since they have proven to satisfy the requirements of farmers and buyers?
  Be aware that there is no contract blueprint but models can be used provided they are adapted to the specific case.
- Which regulatory (government) or self-regulatory (industry/ sector code of conduct) provisions can guide contract development or are mandatory (e.g. regarding contract rights, price-setting, dispute settlement)?
- Which legal contract elements have to be observed?
  The following legal elements are to be observed: (i) Freedom to contract (free decision of farmers/ buyers to negotiate and conclude a contract); (ii) Good faith (trust in the honest intention of both parties not to cause damage to each other); (iii) Termination (specification of the conditions of contract expiry); (iv) Force majeure (possible exemption from liability in case of unforeseeable/ exceptional situations); (v) Performance (both contract parties are bound to realise their obligations as specified); (vi) Non-performance/ compensation (consequences for any party's failure to meet obligations); (vii) Dispute settlement (agreement on ways to settle contractual disputes through mediation, arbitration, prosecution).
- In case external intermediaries are contracted in a multi-levelled CF arrangement (see Activity 3.1): Which business partners conclude contracts with whom? How can the buyer in this case assure contract transparency/ consistency and visibility in the field?
- In case women do the (main part of) farm work but have neither the land rights nor the voice nor the authority to sign a CF contract: How can the contract be specified to reflect the rights and requirements of women?
- How to reduce moral hazard/ default risks?
  Since side-selling by farmers/ poaching by competing buyers are a real threat to CF success, co-contractors should try to obviate risks by adopting appropriate contract specifications (see Box 18 below).

Selected tools

- Buyer's CF contract task group involving, if possible, farmer representatives and, if necessary, 3rd party facilitators/ experts

Sources (see Bibliography):

- Question Guide #9; in: Action for Enterprise and Match Makers Ltd., 2009, p.32ff
- Contracts and their specifications; in: Eaton and Shepherd/ FAO, 2001, p.58ff
- European Commission Green Paper on unfair trading practices; see CTA, 2013

C.3/

Box 17/ **Typical contract specifications**

Contract parties

- On the side of the suppliers, the contract can be signed by individual farmers or farmer group representatives.
- Special attention has to be paid to assure female farmers' rights if conventions or the absence of a land title preclude women from signing farming contracts.
- In case of multi-levelled CF arrangements, contracts are signed between different partners at different nodes of the chain (it is important to assure consistency along the cascade).

Contract duration

Depending on crop characteristics:

- seasonal contracts for annual crops (possibility of renewal/ re-negotiation)
- longer-term contracts with provisions for periodical re-negotiation/ amendments for perennial crops.

Quality specifications

Clear definition of:

- the required varieties/ seed and the quality standards/ grades;
- the quality assessment criteria and method (including tolerances);
- the quality control procedures (when, where, by whom, in the presence of farmers?);
- the payment for possible external costs such as laboratory analysis (by whom?); and
- the consequences of non-conformity (rejection, price reduction).

Quantity specifications and procurement schedule

- Allocation of a supply quota by supplier or farmer group (volume or area-based, entire crop or fixed quantity). To avoid default, the quota should be based on the farm size, farming system and livelihood needs of the farm household.
- Agreement on the minimum share of the 100% produced from seeds provided by the buyer (as a trust-building/ default risk mitigation measure, buyers may only procure e.g. 70% while allowing farmers to use the other part for subsistence or sales in the free market).
- The timing of delivery is important for the efficient utilisation of the buyer's capacities and meeting his customers' procurement requirements (in some crops, the harvesting time can be influenced through crop husbandry practices e.g. planting time, irrigation, etc.).

Production specifications

- Explanation of the cultivation practices to be applied such as integrated crop management, good agricultural practices/ GAP (detailed crop-specific guidelines may be annexed to the contract).
- Usually, the buyer claims the right to frequently inspect farmers' field operations to assure compliance with required standards (especially if the buyer provides inputs such as seeds, fertilizers, agrochemicals and wants to control correct application or probable diversion).

Harvesting and crop delivery specifications

- Decision on crop delivery and transport arrangements (at farm gate, at collection centre, at processing unit).
- Distribution of farmers' and buyer's tasks and required handling practices in harvesting, collecting, grading, packaging, transporting and/ or (intermediate) storage of the produce.
- If these operational services are provided by the buyer or external intermediaries/ service providers, the costs may be fully or partly charged to the farmers (to be negotiated).
- Provisions for the usage of rejected produce (see also Box 18 below).

Pricing specifications

- To assure transparency, the pricing formula (calculation basis) has to be explained to farmers and specified in the contract; furthermore, market and price information have to be made available to farmers and effects of market dynamics on contract prices explained.
- Floor prices (also referred to as minimum or base prices) are sometimes fixed by governments, public-private platforms or inter-professions (especially in commodities) using usually quite complex pricing mechanisms.
- The pricing formula 'fixed pricing' is agreed at the beginning of the season or at contract conclusion respectively. The price is usually based on prevailing market prices and trends (the reference market has to be stipulated) and is typically aligned with quality criteria/ grades ('indexed'), since rewarding quality generally pays back. For excess of quota fulfilment, the buyer may pay a bonus (see payment specifications below).
- The pricing formula 'flexible or dynamic pricing' reflects the market situation. The price calculation may be based on (i) real-time local or regional prices (spot-market price, but usually slightly higher), (ii) international commodity or import/ export parity prices, (iii) varying seasonal prices (seasonal price-scale), (iv) auction quotations or (v) consignment prices. Under the flexible formula, prices may also be freely negotiated thus reflecting the bargaining power of the contract parties.
- The pricing formula 'split pricing' involves a floor price paid on delivery or at the end of the season and a final instalment factoring in the price realised by the buyer when selling on. Typically, farmers and buyers agree on sharing resulting costs and revenues.
- The pricing formula also has to make transparent the costs involved for embedded services that are usually deducted from farmers' sales revenue at the end of the season (inputs supplied, technical assistance/ operational services provided, loans extended).
- To extenuate the shortcomings all three aforementioned pricing mechanisms entail, farming contracts usually combine elements of all three pricing formulas depending on criteria such as production costs and profit margins for producers, transaction costs and a sufficient return on investment for buyers, competition in the production area (considering the risk of poaching in open markets), prevailing market prices or if applicable, international commodity prices or import/ export parity prices, seasonal price fluctuations and prospective long-term price trends.

Payment specifications

- Common payment terms: if possible, the agreement should provide for scaled instalments according to the liquidity requirements of farmers during the season, especially at harvest time; the final payment is usually due at the end of the season or after the buyer knows the on-selling price; the contract has to clarify the provisions for award for 1st grade or deduction for lower grades respectively; the costs for pre-financing embedded services by buyers (e.g. input supplies, other loans, advisory services, operational services) are deducted from the farmers' sales revenues, usually from the last instalment. Some buyers do not charge extension services or interest rates; some hide these costs in other items, which is not recommended since such behaviour jeopardises transparency and trust.
- Typical payment modes: farmers usually prefer cash-in-hand (possibly involving security problems at the place of payment); with the emergence of mobile banking, more farmers have opened bank accounts through which payments can be realised; bank transfers are also necessary in case of tri-partite agreements involving banks for pre-financing or inventory credits (e.g. warehouse receipt system); for reasons of transparency and trust-building, payments should in general be made to individual farmers, not via nucleus farmers or farmer groups; payment modes also have to cater for appropriate arrangements for assuring payment to women involved in contract farming activities.
- In contracts with intermediaries, performance based payments are quite frequent. In case of multi-levelled CF arrangements, the buyer may reward nucleus farmers, own staff or contracted intermediaries managing a collection centre or a CF area e.g. for the fulfilment (or the excess of fulfilment) of agreed quotas, achievement of high shares of first grade or high repayment rates. Note: whether the premiums cascade down to also motivate farmers is difficult to control for buyers in a multi-levelled system.

C.3/

Embedded service specifications

- Specification of the provision (and timing) of non-financial and operational embedded services (e.g. input delivery, advisory services, training, land preparation, plant protection, harvesting, transport and logistics) and related costs.
- Specification of financial embedded services (seed, fertilizers and/ or plant protection products on credit, possibly cash credits or insurances) including credit modalities (especially interest rates) and measures to mitigate credit risks.
- Cost recovery (see payment terms above).

Dispute settlement specifications

- The contract should prescribe ways of settling contract disputes that are typically judicial proceedings, arbitration or mediation. Generally, amicable dispute resolution is preferable over legal proceedings, especially for smallholders who have not got the means to go to court and in countries with weak judicial systems.
- The agreed dispute settlement mechanism should be near to farmers and involve a mutually respected person (e.g. traditional leaders, representatives from the municipality) and a representative of the farmers and of the buyer.

Registration

- In some countries, farming contracts have to be registered with statutory bodies to verify for example whether the buyer is licensed or has a track record as CF contractor (the purpose is to avoid that farmers are subject to unfair contract practices).

Box 18/ **Possibilities to reduce moral hazard/ default risks**

Contract negotiations

- Assure fair and transparent price negotiations including joint development (at least farmers' understanding) of price formula and joint calculation of prices.
- Make sure that farmers realise a cost-benefit-'plus' (incentive) and explain that better profits may only be realised in the medium to long run.
- Explain the benefits of contract compliance while clarifying the sanctions for non-compliance (e.g. denial of contract renewal and hence exclusion from input supplies).
- Do not make promises that the buyer cannot keep, do not expect more from farmers than they can realistically fulfil.

Contract specifications

- Clearly specify the buyer's obligations (e.g. provision of embedded services, payment delays) and rights (e.g. to control quality) and possible sanctions in case of default.
- Clearly specify the farmers' obligations (e.g. quality, volumes, delivery times) and rights (e.g. presence during quality control) and possible sanctions in case of default.
- Develop a price formula based on a reasonable minimum price and a flexible top-up to reflect market price fluctuations (however, in highly volatile markets, this system is only feasible for buyers if a realistic minimum price is calculated and accepted by farmers).
- Offer price premiums for contract fulfilment regarding agreed qualities, volumes (quota) and repayment schedules.
- Agree on scaled payment instalments according to the liquidity requirements of farmers (due attention has to be paid to the cash-flow capacity and pre-financing possibilities of buyers).
- Consider price formulas for lower (rejected second) grade produce if off-taken by the buyer and sold to other outlets.
- Offer farmers the opportunity to grade the produce themselves and the right to sell rejected produce to rural markets.
- Specify a share of contracted produce that has to be sold to the buyer (e.g. 70%), leaving a share to farmers they can use for subsistence needs or sales in the free market.
- Offer a convincing package of embedded services at reasonable conditions compared to external services.
- Agree on a mutually respected 3rd party for dispute settlement based on amicable conflict resolution through mediation/ arbitration (see above).

Other measures linked to farmers

- Identify farmers that are willing/ capable to comply with contracts (e.g. farmers with a track-record of repayment in CF or input programmes, 3rd party references).
- Establish a good data-base on CF farmers/ farmer groups (either as individual firm or as pre-competitive measure among several firms or at association/ inter-profession level).
- Employ motivated staff (collection centre/ area managers)/ contract committed nucleus farmers and give incentives (e.g. bonus payments) to foster accountability.
- Assure field presence, good communication and trustful cooperation between farmer representatives, nucleus farmers and collection centre/ CF area managers.
- Assure intensive monitoring while providing clear provisions for sanctions in case of default (e.g. 'punishment' through exclusion from the CF scheme).
- Support access to relevant services that are not embedded in the CF arrangement (e.g. access to improved seeds, extension services for other crops, credits or insurance).
- Facilitate technology transfer both for the CF crop and other crops produced for subsistence or surplus marketing.
- Foster group lending as a way to assure contract compliance through peer pressure. However, group lending needs strong leadership, functioning democratic structures and trustful relations within the group; preconditions that are rarely met.

C.3/

- Develop opportunities for additional farmer/ household income (e.g. opening markets for other crops that fit into the CF system e.g. for intercropping; 1st stage processing).
- Offer shares in the company (primarily practised in cooperative-owned or social enterprises) or shares in 1st stage processing if initially set up by the buyer.
- Make contributions to farmers' welfare/ community development (e.g. health and funeral funds, school fees, school building and equipment).

Other measures linked to 3rd parties

- Link up with government bodies involved in agricultural/ rural development (ministry, municipal entities, public extension), explain the benefits of CF and the threats through extra-contractual selling and motivate them to support contract compliance by farmers.
- Establish relations with national producer associations/ farmer unions, chambers of agriculture, emerging VC boards or inter-professions to create a platform for CF promotion and self-regulation (see next bullet point).
- If there is no industry or public-private dialogue platform: agree with other buyers on a pre-competitive basis not to buy from farmers contracted by competitors; as a further step, a joint data-base may be set up providing information on all CF farmers including information on default; finally, a code of conduct/ code of fair competition may be developed.

Activity 3.4/ **Draft a CF business plan (incl. prospective return on investment, risk assessment, technical and financing requirements, etc.)**

The CF business plan describes the strategic objectives as well as the operational and financial means necessary for a successful development of a CF venture. Guidance by a well thought-out business plan is especially important for an undertaking, in which the complex management of the farm supply-firm procurement interface presents a real challenge. In this setting, a CF business plan can serve several internal and external objectives, namely:

- As a design instrument, the plan provides vital information for financial and managerial decision-making for the CF start-up, consolidation and (if up-dated) the up-scaling phase.
- As a management instrument, the CF business plan provides strategic and operational orientation for running the CF scheme.
- As a monitoring instrument, the plan provides facts and figures for CF decision-making (e.g. contract specifications, investments) and for the assessment of business results.
- As a financial management tool, the CF business plan provides detailed information that can be used for credit applications or 3rd party technical or financial support.

Note

The business plan may be used for credit applications. However, it is usually not advisable to run into heavy debts with a start-up CF scheme given the quite frequent default risks. On the contrary, to increase the probability of success and reduce the risk of failure, it is recommended to start small and adopt a stepwise approach to consolidating and up-scaling the scheme. Once a critical consolidation achieved, the (up-dated) business plan may also serve credit application needs.

Even if it is recommended to start up a CF scheme as far as possible with own resources (farmers and buyer), the business plan may be submitted to 3rd party facilitators for technical or financial support. Presenting an elaborate concept will contribute to gear 3rd party assistance to real CF business needs (instead of overriding development objectives). If well prepared, the business plan also provides a baseline for the monitoring of impacts required by 3rd party facilitators (government or donor organisations) for documenting impacts.

C.3/

Box 19/ **Activity 3.4 – Purpose, selected questions and selected tools**

Purpose

The purpose of this activity is to draft a CF business plan providing practicable solutions for CF management and CF financing (both key for CF success or failure). The draft CF business plan will be finalised following discussions and negotiations with farmers in Step 4 (the results of which will be integrated into the final business plan).

Selected questions

Drawing on the information generated in Steps 1 and 2 and Activities 3.1 to 3.3, this activity is meant to answer the following questions:

- Which elements have to be covered in the CF business plan?
  Apart from the outline of the vision, mission and objectives, the description of the ownership, the business (location, human, financial and natural resources, organisational structures and management, infrastructure and processes, procurement and marketing, etc.), the financial part is of major importance (break-even, liquidity and profitability analysis, cash-flow analysis and return on investments as well as risk assumptions, financial needs and funding sources).
- Which period should be covered by the business plan?
  It is recommended to follow a strategy of healthy generic growth for the CF scheme (slowly enough to be financially affordable and to allow the development of sustainable structures, fast enough to achieve a viable scale). Experience shows that it takes 3 to 5 years (sometimes longer) for CF schemes to reach break-even.
- On which assumptions should the business plan be based?
  Given the challenging setting in most developing countries, it is recommended to use conservative estimates (e.g. adoption of new technologies and resulting yield increases, contract compliance regarding quota fulfilment and quality compliance, etc.) and to consider relatively high management efforts and costs for the start-up and consolidation phase.
- Which minimum investments into production and logistics facilities and equipment and which operational systems and costs are involved for an efficient management of embedded services and sufficient visibility in the field necessary for trust-building with and mentoring and monitoring of farmers?
  With regard to operational costs, due attention has to be paid to CF-specific transaction costs since they are usually neglected or underestimated (e.g. costs of drafting, negotiating and enforcing contracts (through internal or external means); maladaptation costs in case of farmers' or buyer's default; CF-specific set-up and operational costs related to CF governance; trust-building/ bonding costs for securing commitments).
- At which point in time should banks be approached?
  Even if it is not suggested to apply for bank credit and risk a high debt burden for starting up a (still fragile) CF scheme, financing institutions should be involved at an early stage to build reliable working relations and, if necessary, jointly develop CF-specific products.
- Which measures should be considered in the business plan to reduce investment risks, which are especially high in the early years of CF development before trustful relationships are built (non-supply/ procurement risk, low recovery rate/ credit risk)?
- Expecting that break-even will realistically only be achieved after 3 to 5 years: Which solutions can be developed for bridging the financing gap between immediate investment and operational as well as farmers income requirements and expected return on investment?

Selected tools

- Buyer's CF contract task group involving, if possible, farmer representatives and, if necessary, 3rd party facilitators/ experts

Sources (see Bibliography):

- Agricultural business plan guidelines; in: Republic of South Africa, 2011

C/C4/

C.4/ Phase 2: Implement & learn

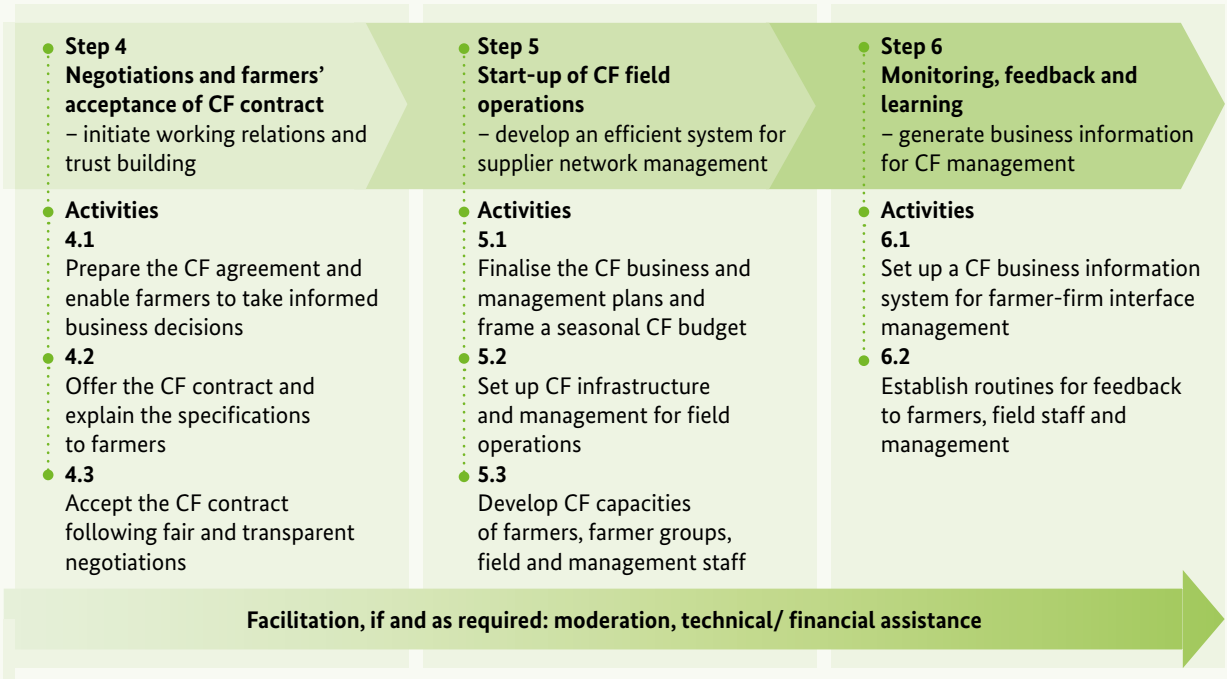
Just like sound planning is imperative for adopting a realistic CF strategy and for developing a realisable CF business plan (Phase 1), implementing a trial period and learning from contract partners' initial experiences, success cases and challenges (Phase 2) is vital for developing viable CF ventures and up-scaling CF schemes (Phase 3).

Since a CF scheme will only be as successful as both business partners are committed, reasonable care has to be paid to building mutual trust and loyalty. Equally important for motivating farmers and the buyer to honour their contracts are adequate capacities enabling both to take informed business decisions and to perform in their respective functions. Consequently, trust, loyalty and performance are indispensable for making the joint CF venture profitable for both. Having this in mind, it becomes obvious that CF contracts have to be negotiated and CF schemes managed in a transparent and participatory manner. Involving farmers from the onset and respecting their business interest is essential for creating ownership for the CF development process.

Objectives of phase 2 "implement & learn"

- to facilitate responsible participation of both parties in CF negotiations and implementation;
- to develop necessary basic skills of farmers to be able to assess the firm's contract offer and take an informed decision on contract acceptance;
- to clarify roles and responsibilities and to set up the organisational structures and a CF management system for the start-up of field operations;
- to generate business information for strategic decisions and daily operations as well as continuous improvement of the CF scheme (monitoring, feedback and learning loops).

Figure 10/ **Three steps and related activities for phase 2 "implement & learn"**



Depending on the situation, neither all three steps and all activities have to be implemented, nor have the activities to be applied in the given sequence.

Recommendations

- Respect farmers as serious business partners.
- Enable farmers/buyers to take informed decisions.
- Recognise that trust, loyalty and reward create ownership that is at the origin of success.
- Use the trial phase for identifying viable strategies for consolidation and up-scaling.

C.4/

Step 4/ **Negotiations and farmers' acceptance of CF contract – initiate working relations and trust building**

Responsibility for the performance and sustainability of the CF scheme rests with the buyer and the farmers. Both have to bear the business risks for their parts in the investments of land, labour and capital. At the same time, they have to reap the fruit in an equitable, fair and transparent way. Sharing risks and rewards in this sense requires trust and ownership meant as willingness and capacity to take responsibility for own business and joint CF decisions and for the reliable and accountable fulfilment of all obligations arising from the farming contract. In such a joint venture, trust and ownership are key to success. However, the reality often looks differently resulting in uninformed business behaviour, in mistrust and contract default. This may be due to insufficient information on the reality on the ground (thus the prominence of Phase 1) and it is often due to insufficient knowledge and skills for informed business decision-making on the side of smallholders. Even though not sufficiently recognised, it is in the obvious interest of the buyer that farmers develop proper entrepreneurial skills to become serious business partners able to conduct negotiations and contribute to CF development in a competent way.

Note
Against this background, it is recommended to involve farmers at an early stage into the assessment of the CF potential, the development of CF arrangements, the CF contract and the CF business plan (see Phase 1). In so far, Phase 1 and 2 partly run in parallel.

It is furthermore obvious that farmers have to be supported to develop basic skills for understanding and managing their part in the CF scheme as a business. Farmers have to be able to assess the implications of the CF contract on their farming system, to decide on the required investments of usually scarce farm assets and to calculate the prospective return on these investments. Basic skills of this kind have to be built before the buyer offers the contract and the farmers negotiate and accept or refuse the agreement.

Box 20/ **Step 4 – Activities, issues to be considered and milestone**

Activities

4.1 Prepare the CF agreement and enable farmers to take informed business decisions

4.2 Offer the CF contract and explain the specifications to farmers

4.3 Accept the CF contract following fair and transparent negotiations

Issues to be considered

- The final selection of locations and farmers (based on Activity 2.1) has to be guided by strategic CF considerations and strict criteria; the selection should never be done arbitrarily or imposed by external stakeholders.
- Fair and transparent conditions for farmers' participation in the negotiation process and sufficient time and explanations enabling farmers to really grasp the CF arrangements and both parties' obligations and rights, are important for achieving farmers' commitment.
- Respecting the capacities and concerns of farmers and trying to find joint answers to their questions (about risks and rewards, technical implications and knowledge gaps, etc.), are the first and vital steps for building the trust that is necessary for success.
- Only if farmers get a voice in this sense and are capable of taking an informed decision whether to accept the CF contract or not, they will be willing to commit necessary resources and to honour the contract.
- For a better understanding of the buyer's investment risks, it is necessary to explain farmers that it usually takes 3 to 5 years before a CF scheme pays off for the buyer. While the company has to bridge the financing gap between short-term obligations (pre-financing of inputs and services and payment of farmers in time) and the medium to long-term return on investments, the farmers have to appreciate that honouring their part of the contract is just as decisive for success or failure of the CF scheme as the buyer's commitment.
- To facilitate farmers' understanding of quite complex legal contract issues, it may be considered to invite a legal adviser as a neutral person to explain contract details to farmers. This will also contribute to creating trust into a fair negotiation process.
- Consider male-female relationships and customary rules for authority for contract negotiation and signature; if women do the farm work, their workload has to be observed in the design of CF arrangements and a fair income share assured in the CF contract.
- Consider the effects the CF will have on the farming systems and livelihoods of farmers and their families; to avoid adverse impacts of potential additional/seasonally conflicting work load on the livelihood/food security situation, appropriate solutions have to be found.

Milestone

A critical number of farmers required for satisfying the procurement needs of the buyer have accepted the mutually negotiated and agreed CF contract.

C.4/

Activity 4.1/ **Prepare the CF agreement and enable farmers to take informed business decisions**

As already discussed, informed business decisions are important for success. Since farm and firm investment decisions are largely based on the expected return on investments (reward), cost-benefit and risk assessments have to be realised to allow informed decision-making. However, most smallholders lack the necessary entrepreneurial skills and usually do not keep farm records providing information on production costs and sales returns. Furthermore, resource-poor farmers are usually risk-averse owing to inadequate understanding of and capacities to calculate business risks and identify risk mitigation possibilities.

Box 21/ **Activity 4.1 – Purpose, selected questions and selected tools**

Purpose

In a bid to enabling farmers to take an informed decision on whether to join the planned CF scheme or not, the purpose is to build basic skills to understand the CF arrangements and the prospective costs, risks and benefits involved.

Selected questions

Building on the results of Activity 2.1 ((pre)selection of production areas and farmers/ farmer groups for the start-up phase) and Activity 2.2. (assessment of farmers'/ farmer group's and buyer's capacity development and service needs), the following questions provide further information for planning appropriate measures in preparation of CF negotiations:

- Which elementary skills do farmers require to weigh their decisions with regard to joining the CF scheme or not? Which skills do nucleus farmers require?
  An introductory course such as the Farmer Business School or the Farming as a Business approach would serve the needs of farmers and nucleus farmers if adapted to the requirements for CF negotiations. This should also involve a basic understanding of the costs and margins incurred at the up- (input dealers) and downstream (buyer) ends of the VC as well as the transaction costs involved between farms and firm. This will enable farmers to negotiate as a competent business partner able to assess farm economics, weigh investment opportunities and risks and to understand his own position within the CF scheme.
- Which role can existing farmer groups/ associations/ cooperatives play at this stage?
  Farmer organisations can play a key role in CF development if they are strong enough e.g. regarding ownership by members, democratic structures, committed leadership, competent management and clear benefits for members. If these conditions are not in place, the buyer may support organisational development to make farmer organisations part of the CF arrangement. The main interest is to achieve scale economies by bundling input distribution and members' supplies, facilitating peer learning, collective bargaining and joint access to external services (e.g. group lending, transport) and, if possible, reducing the risk for individual farmers. If well managed, the scale economies arising from collective action will contribute to reducing transaction costs, both for farmers and buyers.
- In case of absence of strong farmer groups: Does it make sense to transform existing more socially-oriented or to create new farmer groups to serve as contract partners or intermediaries between farmers and the buyer?
  As a matter of principle, farmer organisations should never be created top-down or forced by outsiders to change since the probability of failure is high. If there is no farmer group that exhibits basic strengths, organisational development efforts will not bear fruit within short and hence not within the start-up phase of the CF scheme. Sufficient resources and time will have to be made available to build farmer organisations bottom-up, which is the only way to assure commitment, leadership and necessary accountability for joint economic activities.

- How can farmers/ nucleus farmers/ farmer organisation representatives get a better picture of the buyer's procurement requirements and hence better judge the challenge of meeting his specifications?
  To facilitate a better understanding of usually quite strict compliance criteria, farmer representatives may be invited to visit the buyer's facilities where the requirements for processing, logistics and market access can be explained while visiting the facilities and observing the work processes.
- Who will implement the farmers' training in basic entrepreneurial skills?
  This question is left to the buyer's decision. However, in many cases 3rd party facilitators are willing to support with technical assistance given their interest in promoting the inclusion of smallholders into VCs/ CFs, their experience and competence in farmer trainings and organisational development (however, training quality should not be taken for granted but checked case by case).

Selected tools

- Farmer Business Schools, Farming as a Business or other approaches
- Development of posters explaining the basics and principles of CF

Sources (see Bibliography):

- Capacity development concept; in: Will et.al., 2008
- Farmer Business Schools; in: Matthess, 2012
- Organisational development; in: Winkler et.al., 2006

C.4/

Activity 4.2/ **Offer the CF contract and explain the specifications to farmers**

One of the foundations of contract legislation is the freedom to contract. For CF, this implies the free decision of farmers and buyers to negotiate and conclude a contract. Furthermore, a contract has to be offered by one side and accepted by the other side before it becomes binding. In the majority of cases, a buyer offers a contract to farmers; in exceptional cases, (strong) farmer organisations may offer a contract to buyers.

Box 22/ **Activity 4.2 – Purpose, selected questions and selected tools**

Purpose

To provide a sound basis for decision-making, the buyer has to explain the contract details, leave room for discussing concerns and give farmers sufficient time for assessing the contract offer by talking it over with other farmers, trusted 3rd party facilitators or others.

Selected questions

The following questions may guide the process of offering the CF contract to candidate farmers:

- Before submitting the offer: Have the contract terms be checked for comprehensibility also for a largely illiterate farming community and, if necessary, translated into vernacular (usually recommended to avoid misunderstandings and the fear of farmers to be cheated)?
- Have any farmers, nucleus farmers or farmer group representatives participated in the drafting of the CF contract (see Activity 3.3)?
  If yes, these representatives may be best placed to explain the draft contract to fellow farmers.
- Which approach should be taken to assure that farmers feel well informed and treated as serious business partners?
  It is recommended to take enough time and organise several meetings to allow farmers to ask questions and raise concerns during the meetings and reflect and re-consider opportunities and risks between meetings. Possible topics: in the 1st meeting discussion of the CF arrangements, possible benefits and risks and risk mitigation possibilities; in the 2nd meeting assessment of embedded/ external services, pricing formula (including possible bonus payments or deductions according to grades) and payment terms, risk sharing and prospective cost-benefits (according to varying performance); and in the 3rd meeting discussion of roles and responsibilities of both contract partners as well as arbitration and conflict resolution possibilities. Further subjects are: the possible role of commodity organisations/ boards in floor price setting or other pricing formulas (mostly for commodities such as cocoa, cotton, sometimes cashews or for strategic staple crops). It may be thought of inviting a representative to one of the meetings.
- What is the benefit for the buyer to use such a lengthy process?
  First and foremost, the discussions provide a platform for knowing each other and starting to building trust. In the second place, the additional information generated (e.g. on specific pros and cons of the location, on traditional knowledge of farmers, on activities of other buyers or potential service providers nearby the location) as well as the concerns raised and proposals made by farmers will provide sound material, facts and figures for finalisation of the CF contract as well as the CF business and management plans.

Selected tools

- Buyer's CF contract task group involving farmer representatives and, if necessary, 3rd party facilitators
- Development of posters explaining the basics and principles of CF

Sources (see Bibliography):

- Contracts and their specifications; in: Eaton and Shepherd/ FAO, 2001, p.58ff
- European Commission Green Paper on unfair trading practices; see CTA, 2013
- Guiding principles for responsible contract farming operations; in: FAO, 2012
- Question Guide #9; in: Action for Enterprise and Match Makers Ltd., 2009, p.32ff
- Stage 2: firm contract offer; in: Barrett et.al., 2011, p.4

Activity 4.3/ **Accept the CF contract following fair and transparent negotiations**

As a logical consequence to the buyer's contract offer (see Activity 4.2), the farmers may or may not (freedom to contract) accept the contract following negotiations of conditions offered. To achieve commitment it is indispensable that each individual farmer decides on his or her own, whether to join the CF or not. If the decision is based on ill-informed considerations or false hopes or if it is directed by unequal power relations, social pressure or external advisors (well-meaning but not necessarily in the interest and according to the risk-preparedness or priorities of farmers), failure or at least low performance is usually inevitable.

As stated earlier (farmer selection; see Activity 2.1), more pro-active and innovative farmers (early adopters) are more likely to join the CF scheme at an early stage, while others will only commit themselves once the advantages (cost-benefit-'plus') are proven, the structures are settled and the management is known. The decision of farmers should be accepted, even if this may result in low participation at the beginning. It will be easier to create a quick success story with early adopters. The laggards will join in once they witness the improved technologies, easier access to inputs and operational services, increased yields and incomes or an improved reputation of their neighbours.

C.4/

Box 23/ **Activity 4.3 – Purpose, selected questions and selected tools**

Purpose

The purpose is to develop a joint buyer-farmer approach to transparent and fair negotiations as a further step towards developing efficient communication and trustful cooperation. The negotiation results and additional information gathered along the way form the basis for the finalisation of the CF contact, the CF business and management plans.

Selected questions

- How can buyers create a platform, in which farmers feel respected as serious business partners and do not suspect the buyer to assert his greater negotiation power?
  Aspiring to develop a network of reliable suppliers, the buyer (his representatives) should have a lively interest in creating a favourable climate for negotiations based on equal footing. Buyers may invite an honest broker to facilitate negotiations. However, due attention has to be paid that facilitators do never speak on behalf of farmers but moderate the discussions between farmers and buyers who both have to speak for themselves. To facilitate farmers' understanding of the quite complex legal contract issues, buyers may also consider to inviting a legal adviser as a neutral person to explain contract details to farmers.
- Which contract specifications have to be agreed upon before the contract can be signed/ farmers registered?
  Apart from the pricing formula and payment terms, the allocation of a supply quota is among the most important specifications to be agreed upon. Quotas may be volume-based but are usually area-based with the supply quantity calculated on the basis of expected yields; the criteria for the quota allocation commonly comprise suitability of land, farm size, farmer's cultivation skills, land preparation and cultivation methods, historical yield data if available, availability of family or hired labour and subsistence requirements. Furthermore, the contract parties have to agree on the timing of supplies, services to be provided and the dispute settlement/ arbitration system.
- Which further issues have to be considered that may not be specified in the CF contract but concern the management of the CF scheme?
  Buyers and farmers have to reach a consensus on their respective roles and responsibilities in maintaining an efficient and trustful relationship, on structures and areas for shared decision-making, on regular exchange of information, on problem-solving mechanisms before dispute settlement becomes a need, etc.
- What particularities have to be considered if intermediaries are involved in the CF scheme and the contract relations are not directly negotiated and signed between farmers and the buyer?
  In this case, the buyer should try to negotiate contract terms with the intermediary, that oblige him to conclude appropriate agreements with farmers that are likely to motivate them to comply with their supply obligations. To achieve the intermediary's commitment, the buyer may agree on bonus payments (e.g. for quota fulfilment, high shares of first quality or reward for high recovery rates).
- Have registration rules and regulations to be considered?
  In some countries and usually for commodities, contract farmers have to register with authoritative bodies and pay a registration fee (sometimes paid by the buyer on behalf of the farmers). Occasionally, the buyer obliges the farmers to pay a registration fee to assure their commitment, to increase the probability of recovery of input loans and to reduce the (liquidity straining) pre-financing burden on the buyer's side for inputs, operational services and CF management.

Selected tools

- Buyer's CF contract task group involving, if possible, farmer representatives and, if necessary, 3rd party facilitators/ experts

Sources (see Bibliography):

- Question Guide #9; in: Action for Enterprise and Match Makers Ltd., 2009, p.32ff
- Contracts and their specifications; in: Eaton and Shepherd/ FAO, 2001, p.58ff
- European Commission Green Paper on unfair trading practices; see CTA, 2013
- Stage 3: smallholder contract acceptance; in: Barrett et.al., 2011, p.5

Step 5/ **Start up CF field operations – develop an efficient system for supplier network management**

Step 5 is about implementing what has been planned in the first phase and agreed upon in the CF contract (see Step 4). While the CF capacity development and service plan (see Activity 2.3), the CF management plan (see Activity 3.2) and the CF business plan (see Activity 3.4) are to be kept as simple and concise as possible, they have to provide an easy to apply and operational foundation for getting the CF started.

The more mature the CF planning, the better the operational structures and the management system are adapted to the reality the faster the field operations can be put in place. Yet, the supplier network management has to be very flexible to remain alert and smart in answering to the multitude of challenges that will certainly emerge during the course of implementation.

Note
Since a successful start-up phase will convince suppliers to stay with the buyer and laggards to join in, sufficient time and resources have to be made available for strategic and efficient management of the CF scheme right from the very beginning. Furthermore, great importance has to be attached to employing committed and able professionals for CF management as well as selecting skillful and adept nucleus farmers or other intermediaries working directly with the farmers. A successful start-up phase is especially important since the experiences gained and good practices developed will be used for consolidating the CF scheme and for developing a concept for up-scaling.

C.4/

Box 24/ **Step 5 – Activities, issues to be considered and milestone**

Activities

5.1 Finalise the CF business and management plans and frame a seasonal CF budget

5.2 Set up CF infrastructure and management for field operations

5.3 Develop CF capacities of farmers, farmer groups, field and management staff

Issues to be considered

- By finalising the CF capacity development, management and business plans drafted in Phase 1, further information gathered during initial farmer trainings (see Activity 4.1) and contract negotiations (see Activities 4.2 and 4.3) should be integrated to come up with realistic and realisable plans.
- During the start-up phase, realistic procurement planning for assuring the utilisation of installed processing capacities and the fulfilment of customer requirements will be a real challenge for the buyer given uncertainties about capacities and reliability of suppliers. Trying to avoid undersupply, the buyer may contract more farmers than necessary if only calculating expected area-based supply volumes. But in this case, the buyer has to have a solution at hand for alternative marketing of potential surplus in order not to be obliged to reject oversupplies since the resulting frustration of farmers would create a serious risk for CF sustainability.
- To avoid tensions, it should again be checked whether farmers' contract obligations are appropriate for the prevailing farming systems/ farm assets. Due attention has to be paid, not to trap farmers in debt overload, not to prompt rededication of land or labour to the CF crop to the detriment of staple crop (subsistence) production and not to create gender inequalities when farmers try to honour contracts.
- Against this background, jointly developing a seasonal CF work plan including benchmark data and framing a seasonal CF budget based on the business plan will provide the buyer and farmers with a clear mandate and a management tool facilitating farm-level and CF-level planning, operations and monitoring.
- Since visibility in the field will be decisive for establishing trustful farmer-buyer relations and two-way information flows are necessary for detecting possible problems at an early stage, due care has to be attached to set up operational structures that are close to farmers (via company staff and nucleus farmers/ farmer organisations or other intermediaries).
- For the same reasons, buyers should be careful in selecting and preparing own field staff, nucleus farmers and intermediaries since their attitudes towards farmers and their technical and managerial qualifications will be critical for farmers' acceptance and hence in the end for farmers' compliance with CF agreements.
- Given uncertain credit repayment as long as buyer-farmer relations are in their infancy, it is recommended to limit the credit risk by reducing input pre-financing to the really necessary. With maturing CF relations and satisfying recovery rates, credits may gradually be increased (for inputs up to the level needed for reaching profitable yields).
- In the same line of thinking, it is not advisable to extend credits to farmers or other village-based investors for establishing 1st stage processing at the very beginning and as long as there is no track record of credit repayment.
- Given the challenging technical and financial requirements for jump-starting a CF scheme with smallholders, the buyer may consider to apply for assistance by the government or development partners. The CF business plan provides an excellent basis for doing so.

Milestone

The CF operational structure and management system provide an efficient and effective setup for the practical organisation of CF scheme.

Activity 5.1/ **Finalise the CF business and management plans and frame a seasonal CF budget**

As pointed out above, the CF business plan describes the strategic objectives as well as the operational and financial means necessary to develop the CF scheme. The business plan serves financial and managerial decision-making, provides strategic and operational orientation for CF management and facts and figures for the assessment of business results. The business plan may also be used for applying for credits or 3rd party technical or financial support. The CF management plan outlines solutions for a smooth, effective and efficient management of the farm supply-firm procurement interface according to the selected CF business model.

Once the business plan is finalised, a CF task group (including the buyer, the company's management/ field staff together with farmer representatives/ intermediaries) develops an annual/ seasonal work plan and a CF budget. The CF work plan and CF budget will serve as management tool at all levels from farm to firm.

Box 25/ **Activity 5.1 – Purpose, selected questions and selected tools**

Purpose

The purpose of this activity is to lay the foundations for efficient CF management by completing the CF business and management plans and developing a joint buyer-farmers work plan and CF budget.

Selected questions

- Which considerations guide the finalisation of the CF business and management plans?
  If well developed, the draft plans already give a clear picture about the prospective development of the CF scheme over the next 3 to 5 years as well as about the operational structures and the management system. However, the intensive dialogue between the CF partners during Step 4 provides additional insights that will contribute to making the plans more realistic and realisable. For further directions on the development of the business and management plans see Activities 3.2 and 3.4.
- Which critical success and risk factors have to be re-assessed before finalising the plans?
  First and foremost, the buyer has to re-calculate whether the expected margins will be sufficient to justify and support significant up-front investments (e.g. collection and service centres, mobility solutions for nucleus farmers, field staff or other intermediaries) and recurrent operational costs (staff, logistics, embedded services). An often underestimated cost factor are the time and resources necessary for creating good working relations (coordination, information exchange) and visibility of the buyer's representatives in the field (including advice and control/ monitoring of crop husbandry, harvesting, collection and procurement). Furthermore, bonus systems for farmers, nucleus farmers, intermediaries and own staff should be considered to foster performance (based on quota fulfilment, share of first grade, loan recovery rates, etc.). The buyer should also carefully re-think the level of pre-financing farmers, since credit risks are high for both partners (recovery risk for buyers and over-indebtedness for farmers), especially during the start-up phase.
- Which elements are to be considered in the seasonal CF work plan?
  The work plan is about joint crop planning including timelines and responsibilities for distribution of seeds and other inputs, for crop husbandry (following GAP principles or explicit standards required by the buyer), quality assurance, harvesting, collection, grading, logistics, transport and record-keeping, etc. The work plan also includes all other services provided within the CF arrangement either through embedded services or by external providers (e.g. operational services, extension and training, credits).

C.4/

- What is the CF budget about?
  The CF budget states the related expected costs and returns and sources of financing (buyer, farmers or external through bank credits, technical or financial assistance). The CF budget should also present the timelines for expenses and revenues (cash flow) as a basis for farm and firm business planning and for smallholders' livelihood/ liquidity requirements (the importance of the latter for reducing moral hazard has been explained in Box 18).
- Given that the start-up phase involves considerable financial engagement (even if calculations are on the conservative side): Which optional solutions exist for realising necessary CF start-up investments?
  The main question is, how the financing gap can be bridged between short-term payments for supplies and the upfront investments into qualification and infrastructure on the one hand and the return on investments on the other hand, which only materialises in the medium to long run. Basically, the start-up financing is shared by farmers (investing into land, labour and sometimes small amounts e.g. for registration) and buyers; with a high burden and risk on the latter given the usually substantial CF scheme establishment costs. In many countries, bank lending is not (yet) a solution since financial institutions still perceive agriculture in general and smallholder agriculture in particular as a high risk venture. While some adequate financial products exist (e.g. inventory credits, insurance), barriers for longer-term start-up infrastructure investments are still quite high. In this setting, governments and development partners are increasingly prepared to provide financial assistance to CF scheme development. Yet, due care has to be taken that general development objectives do not override the CF business strategy thus probably reducing the prospects for success. In this context, the CF business plan makes relevant information available for government's/ development partners' decision-making on support.

Selected tools

- CF task group (buyer's management and field management staff, selected nucleus farmers, other farmer representatives and, if involved, intermediaries)

Sources (see Bibliography):

- Agricultural business plan guidelines; in: Republic of South Africa, 2011
- Managing the project; in: Eaton and Shepherd/ FAO, 2001, p.83ff
- Question Guides #5-8; in: Action for Enterprise and Match Makers Ltd., 2009, p.19ff
- See also Activities 3.2 and 3.4

Activity 5.2/ **Set up CF infrastructure and management for field operations**

The CF management plan, CF work plan and the CF budget provide the framework for the establishment of field operations. The main CF management functions are:

- to assure sufficient presence of the firm in the field (especially at farm/ nucleus farm level) to build the suppliers' confidence in the buyer's commitment and management capacities;
- to select farmers and nucleus farmers, to assure their timely registration, to train and advise farmers, to monitor and control the application of agreed agricultural practices;
- to assure well-timed ordering and distribution of sufficient inputs as well as the coordination of harvesting and collection, quality control, transport and logistics;
- to identify, communicate and manage possibly emerging risks (cost drivers, food safety/ quality, default, etc.).

The effective management of field operations requires appropriate human and financial resources, hands-on and efficient (regarding transaction costs) approaches, a situation-specific physical setup and a suitable mentoring/ monitoring system for engaging large numbers of farmers via nucleus farmers, intermediaries and/ or own staff.

C.4/

Box 26/ **Activity 5.2 – Purpose, selected questions and selected tools**

Purpose

Managing CF schemes necessitates clearly defined priorities, roles and responsibilities, strategic location of collection/ service centres as well as timely, transparent and trustful coordination and communication between farmers and the buyer.

Selected questions

- Which physical structures and logistics provisions respond to the requirements for the start-up phase?
  On the one hand, the operational and physical structures have to be up to the requirements for managing usually dispersed smallholders in the selected locations. On the other hand, operational and infrastructure costs have to be limited to the absolutely necessary. Weighing up the options is especially difficult for the start-up phase given the interest to create a success story as basis for up-scaling while trying to reduce the investment risks as long as the outcome is uncertain regarding procurement security and loan recovery. The location and layout of the CF infrastructure depends on the product features, the farmers' locations and capacities, the existing infrastructure (e.g. access roads, warehouses), the requirements for input distribution, produce collection, grading, transport (often very important for timely conveyance of produce from the farm to the collection point) as well as potentially for mechanisation services (e.g. for land preparation).
- Which operational structures and management arrangements are appropriate for an efficient coordination of field activities, transfer of improved farming practices and information exchange as basis for the development of reliable, trustful and long-term farmer-firm relationships?
  While the operational layout largely depends on the specific situation, it is obvious that a CF scheme generally builds on a multi-level operational system involving: the firm's management (high-level commitment is key to success); a CF department at the company's principal office (overall planning and coordination); CF collection/ service centre managers (own staff or intermediaries; responsible for similar tasks but at the de-central level); if the area is quite extended or farms are very dispersed, (own or hired) CF zonal managers may be required; contracted nucleus farmers or farmer organisations (responsible for coordinating, mentoring and monitoring farmer groups of 10-15 individuals); and contract farmers. At all management levels, clear roles, responsibilities and work routines have to be defined and capacities built for CF management as a new job profile.
- Which are the main tasks of the CF management?
  The performance of the CF management is decisive for success or failure of a CF scheme. At each CF management level, the staff or externally contracted intermediary is responsible for the smooth functioning of: knowledge transfer (e.g. GAP, quality assurance, traceability, record-keeping), bulk input procurement and distribution, pre-financing and loan recovery, coordination of operational services as well as organisation of training and extension, mentoring and monitoring services, record-keeping and accounting, etc. The management duties are explained in detail by Eaton and Shepherd (2001) as well as Action for Enterprise and Match Makers Ltd. (2009; see Bibliography below). Last but not least, staff and intermediaries at all levels are held to be alert to spot possible conflicts before they become a serious problem to be able to take early remedial action.

Selected tools

Sources (see Bibliography):

- Institutional arrangements in the Zambian cotton sector; in: Tschirley & Kabwe, 2009, p.18
- Intervention Brief #2; in: Action for Enterprise and Match Makers Ltd., 2009, p.70
- Job description for field extension officers; in: Eaton and Shepherd/ FAO, 2001, p.138
- Managing the project; in: Eaton and Shepherd/ FAO, 2001, p.83ff
- Question Guides #3-13; in: Action for Enterprise and Match Makers Ltd., 2009, p.19ff

Activity 5.3/ **Develop CF capacities of farmers, farmer groups, field and management staff**

Alongside access to inputs, markets and credits, farmers explicitly appreciate technical assistance by buyers in the form of training, extension and mentoring and farmer group development. All these services constitute non-monetary incentives for CF farmers (in contrast to monetary benefits as explained in Box 3). The buyer's primary objective in building farmers' (and other VC operators') capacities is to reduce production unit costs by increasing yields and the share of first grade output and reduce transaction unit costs by increasing supply chain efficiency and reducing post-harvest losses. In a fair and equitable partnership, both, the buyer and the farmers will increase their profits through these efficiency gains. At the same time, technical assistance provided by buyers contributes to trust-building and to motivating farmers to honour their contracts (reduced default risk).

C.4/

Box 27/ **Activity 5.3 – Purpose, selected questions and selected tools**

Purpose

While capacity development and service needs of farmers, farmer organisations, nucleus farmers, buyer's field or office staff or external intermediaries have been assessed in Step 2, the purpose of Activity 5.3 is to plan and implement capacity and organisational development activities either through embedded services or externally contracted service providers.

Selected questions

- Which tasks are involved in implementing capacity development activities?
  In a first step, service needs are identified (**see Step 2**). The preparation, implementation and follow-up of trainings are described in Will et.al. (2008, p.17ff). An important decision for buyers is whether to develop in house staff capacities for embedded services or to outsource to external service providers This is not only informed by a simple cost-benefit assessment but should also consider possible unintended side effects, namely visibility in the field and trust-building with own staff versus the risk of cutting off farmer-buyer relations when contracting external services. If government or development partners offer technical assistance, it has to be assured that the trainings or extension services or other services are truly needs-oriented (not offer-oriented) and meet the quality requirements of the CF scheme. In the past, the risk of disconnection between the buyer and suppliers was distinctively higher when government or development partners came in as facilitators since they tend to directly train farmers instead of doing so through the CF scheme.
- Which topics are of special importance?
  In general farmers' capacity development needs cut across various areas including crop-specific technologies (to enhance productivity, assure quality, take up new crops, produce according to buyer's requirements), entrepreneurial and CF business management skills (among others gross margin and cash flow analysis, financial management regarding required re-investments into farms) and farmer group development and the like. Furthermore, new skills may be required to mitigate climate change effects, to fight new pests and diseases (e.g. fruit fly has become a serious threat to African tree fruit producers in recent years) or to adopt more sustainable agricultural practices (e.g. conservation farming/ minimum tillage).
- Which approaches prove to be especially effective?
  Exposure to good agricultural practices (field days, demonstration fields, exchange visits between farmer groups) or to quality assurance requirements (visits of the buyer's packaging station or processing plant) proves to be very important since the farmers can themselves discover the differences between prevailing and required practices. Such approaches are especially effective when staged according to key crop husbandry activities starting from land preparation through disease control and crop protection up to harvesting and post-harvest handling at the buyer's place. Furthermore, entrepreneurial/ farm management skills and joint activities in farmer groups play a decisive role for upgrading smallholder farming systems. Trainings in Farming as a Business or Farmer Business Schools and organisational development have opened eyes for better crop planning, joint action in farmer groups and more reliable linkages with off-takers.
- What else has to be considered?
  The specific roles and needs of male and female farmers and farm workers have to be considered when planning and implementing trainings, extension programmes, field days and the like (e.g. trainings for women should be organised near to the farm locations since they usually cannot afford to be absent from the household for longer than a few hours).

Selected tools

- Organisation of trainings/training of trainers, extension, field days, organisational development, etc.

Sources (see Bibliography):

- CF capacity development plan; see section C.3, Step 2
- Capacity development concept; in: Will et.al., 2008
- Farmer Business Schools; in: Matthess, 2012
- Intervention Brief #6; in: Action for Enterprise and Match Makers Ltd., 2009, p.74f
- Question Guides #6-8; in: Action for Enterprise and Match Makers Ltd., 2009, p.21ff
- Rural Extension/ Vol. 3: Training Concepts & Tools; in: Gerster-Bentaya, Hoffmann, 2009

Step 6/ **Monitoring, feedback and learning – generate business information for CF management**

Monitoring is a management tool for strategic decision-making and daily operations. CF monitoring is about the planning, operationalisation and control of activities in line with the objectives and approaches outlined in the CF business plan. It is hence about the sequencing and timing of input-to-farm-to-firm operations, the control of contract fulfilment, of costs and revenues and, as a result, of individual CF operators' and overall scheme performance. If appropriately designed, monitoring of CF activities can provide data for various uses:

- timing of daily management of CF operations (e.g. input distribution, organisation of extension/ field days according to cropping calendar);
- progress in business operations (e.g. input procurement/ distribution according to seasonal needs, individual farmers'/ overall harvest forecasts);
- performance of CF operators (e.g. productivity, quota fulfilment, share of first grade supplies, recovery rate, outstanding repayments);
- control of operational efficiency and risks (e.g. control of production and transaction unit costs, control of production/ handling/ credit/ marketing/ external risks);
- adoption of innovations (e.g. introduction of improved varieties/ uptake of new farming practices with results expressed in yield increases or quality improvements);
- identification of good practices for up-scaling and areas for improvement (e.g. identification of over- or under-performing locations, cost-efficient performers or cost drivers, contract default);
- etc.

Without creating additional costs, the reporting system should also provide data for assessing broader impacts such as farmer incomes, employment creation, gender participation or community welfare development. These data are required by government or development partners providing technical or financial assistance but may also serve the company's reputation.

Box 28/ **Step 6 – Activities, issues to be considered and milestone**

Activities

6.1 Set up a CF business information system for farmer-firm interface management

6.2 Establish routines for feedback to farmers, field staff and management

Issues to be considered

- Traditional monitoring known from technical or financial assistance projects is not well suited to CF business needs.
- While the monitoring system should be designed as simple and user-friendly as possible to assure continuous maintenance and use, it should be as comprehensive as necessary to provide relevant information for strategic business decision-making and operations.
- Clear objectives and monitoring requirements have to be defined to guide the development of the system (reporting, data collection and processing as well as feedback and knowledge management routines).
- The objectives of monitoring have to be made transparent and the relevance and usefulness explained to all CF operators to create acceptance, facilitate data collection and create willingness to learn from the feedback.
- With a view to facilitating early adjustments to changing framework conditions, community and market as well as social and environmental developments should be monitored as well (even if less frequently). This will help identify new opportunities (e.g. famers interested to join, small-scale service firms) and possible risks (e.g. trade-offs between subsistence and CF crops, tensions within the community due to included winners and excluded losers or new buyers starting to poach CF farmers).

Milestone

A manageable monitoring, feedback and learning system is in place and is integrated into daily work routines.

C.4/

Activity 6.1/ **Set up a CF business information system for farmer-firm interface management**

Just like in any business, the CF management and operators have to generate necessary data for steering the quite complex and challenging farm supply-firm procurement interface, which is the CF business. As a consequence, monitoring is not only about credible record-keeping at every operational level (input supplies, production, harvesting, collection, transport and logistics and so forth up to the point when the off-taker sells to his customers) but also about the efficient and effective interconnection and interpretation of these records and correspondent business decision-making and management of daily operations.

Box 29/ **Activity 6.1 – Purpose, selected questions and selected tools**

Purpose

The challenge is to develop a simple and user-friendly CF business information system that provides required facts and figures for strategic CF business decision-making and daily CF operations.

Selected questions

- What can and should be measured?
  Since monitoring will only serve as a management tool, if it is integrated into daily work routines of CF operators from farm to firm, expectations on measurable data have to be realistic and monitoring systems kept simple.
- How can smallholders comply with record-keeping obligations?
  Illiterates can usually handle simple data collection sheets or (up-coming) text-message based data collection. If this is not possible (or not trusted), nucleus farmers, farmer organisations, external extension workers or others can be involved into farm-level record-keeping.
- Which additional or complementing information systems may facilitate transparency and CF business decision-making?
  In Zambia, the Cotton Ginners Association, the Cotton Board of Zambia, the Food Security Research Project and the Competitive African Cotton Initiative (COMPACI) jointly developed the Cotton Producers' Database, which monitors sector productivity and income performance at household and national levels as well as information on side selling and pirate buying based on individual farm data.
- For further information see sources below.

Selected tools

Sources (see Bibliography):

- Cotton Producers' Database Zambia; in: Zambia Cotton Ginners Association et.al., n.d.
- Intervention Brief #14; in: Action for Enterprise and Match Makers Ltd., 2009, p.87f
- Monitoring performance; in: Eaton and Shepherd/ FAO, 2001, p.105ff
- New Business Model Principles Scorecard; in: Lundy et.al., 2012, p. 97ff
- Question Guide #14; in: Action for Enterprise and Match Makers Ltd., 2009, p.46ff

Activity 6.2/ **Establish routines for feedback to farmers, field staff and management**

The CF business management system has to provide two-way information flows. While recorded data are fed from the field to the office, information generated by processing these data has to be fed back to the field. If, for example, the buyer's management concludes that the contract terms or work plans have to be attuned due to market or price developments, quota adjustments due to changing supply capacities (e.g. introduction of new technologies or weather-induced crop failure), farmers' and buyer's representatives have to meet to re-negotiate the CF contract or re-adjust the work plans.

Box 30/ **Activity 6.2 – Purpose, selected questions and selected tools**

Purpose

The purpose of this activity is to develop transparent and efficient communication systems for timely feedback of information generated by the CF business information system and related buyer's proposals or decisions to the field.

Selected questions

- How can the feedback systems be organised?
  Information can be channelled during regular meetings, which are anyhow organised between farmers and buyer's representatives in the field (at the occasion of input distribution, trainings, mentoring and monitoring, etc.). To assure timely communication of urgent issues at all CF levels, a cascade system for information distribution has to be established (e.g. via mobiles, which are also increasingly used for providing extension messages, for record-keeping and traceability needs).
- Which CF levels have to be involved in case the CF contract has to be re-negotiated?
  If contract relevant issues are up for discussions, out-of-band farmer-management meetings have to be organised (similar to Activities 4.2 and 4.3). It is recommended that such sensitive topics are raised before they become a problem and are dealt with in a transparent and fair manner to avoid conflicts.

Selected tools

- Intervention Brief #14; in: Action for Enterprise and Match Makers Ltd., 2009, p.87f
- Monitoring performance; in: Eaton and Shepherd/ FAO, 2001, p.105ff
- New Business Model Principles Scorecard; in: Lundy et.al., 2012, p. 97ff
- Question Guide #14; in: Action for Enterprise and Match Makers Ltd., 2009, p.46ff

C.4/

C/C.5/

C.5/ Phase 3: Sustain & grow

Developing and sustaining a CF scheme is a challenging and risky venture; and that during business start-up, consolidation and growth. The main reasons are the investments involved, namely those of small-scale farmers who are resource-poor and risk-adverse and those of buyers who are challenged with bridging the financing gap between short-term pre-financing and medium to long-term return on investments and resulting frequent liquidity problems. Just like for any other business, persevering the first seasons (often years) is decisive for reaching break-even and permitting healthy generic growth is decisive for achieving sustainability.

With experience showing that it takes at least three to five years to reach break-even, the start-up phase has to be followed by a consolidation period, which already has to be scheduled and budgeted in the original CF business plan (see Step 3). Consolidation is of particular importance since CF growth will only succeed if anchored in stable foundations, which are characterised by trustful and loyal farmer-buyer linkages, workable CF structures and accountable and efficient CF management. During consolidation, the CF business model, business plan, operational structures and management system are reviewed for their practicability, cost effectiveness and scalability and are, if necessary, revised. By doing so, special attention has to be paid to envisage a realistic and realisable growth path and to appraise the approximate maximum size, at which the CF scheme is still manageable and cost-benefit-wise competitive with other business models. It may for example be that larger farms and more efficient and profitable plantations crowd out smallholder solutions when reaching a certain size. But every case is different since even then the market may prefer and appreciate smallholder solutions if certifiable according to international (or increasingly regional or national) sustainability standards.

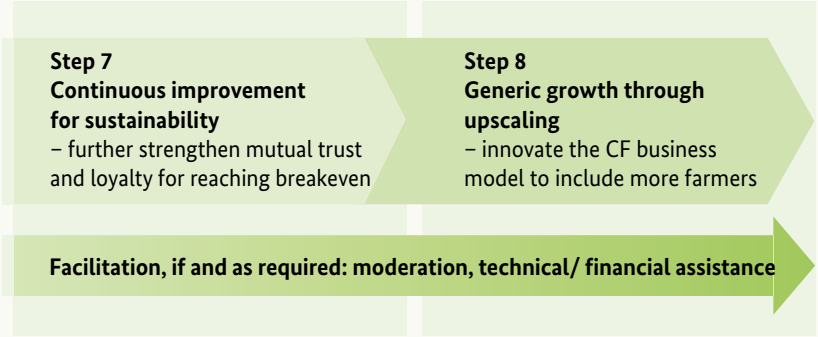
It is obvious that sufficient time and resources are necessary for consolidating and growing CF schemes up to a point where they are really sustainable. Since experience shows that quite a number of schemes break down once direct governmental or development partners' assistance ceases, business planning and arrangements for CF growth have to be viable, primarily based on own resources of the business partners and guided by business reasoning and not by development objectives.

Objectives of phase 3 "sustain & grow"

- to reach break-even and sustainability without over-indebting farmers and over-stretching buyer's financing capacities and liquidity;
- to integrate lessons learnt and good practices developed during the start-up phase into the strategy for the consolidation and up-scaling of the CF scheme;
- to adapt the initially developed CF business model and arrangements with a view to making the scheme resilient against ever changing internal and external challenges.

C.5/

Figure 11/ **Two steps for phase 3 "sustain & grow"**
(for activities refer back to Steps 1 to 6)



Recommendations

- Pay enough attention to further strengthening trust and loyalty based on mutually beneficial supply-uptake relations ('win-win') to avoid low quota fulfilment and high credit losses.
- Adapt contractual arrangements if necessary and invest into continued capacity development to facilitate repeated contracting since starting over and over again with new farmers is too costly.
- Assure transparency/ avoid mistrust by involving farmers into decision-making on possibly necessary adjustments of the CF business model and plan (farm supply-firm procurement interface).
- If governments or development partners decide to support CF up-scaling: provide a clear exit strategy from the very beginning while committing sufficient time and resources.
- But: avoid over-reliance of the CF scheme on 3rd party facilitators for reaching break-even and growing since this may compromise CF farmers' and the buyer's commitment.

Step 7/ **Continuous improvement for sustainability – further strengthen the CF for reaching break-even**

As said before, the better the CF business model and arrangements are planned at the onset, the less costly and time-consuming adaptation will be necessary at a later stage. Accordingly, the original CF business plan (see Step 3) already has to consider activities, time and resources required for the continuous improvement of the scheme during the consolidation period. But experience shows that CF business models often have to be revised during or after the start-up phase and even later due to insufficient understanding of the starting position and resulting ill-informed planning, the uncertainty of farmers' response as well as changing market, political and other framework conditions.

Consequently, both farmers and the buyer and the CF management have to be prepared to learn from feedback and own observations and be capable of adjusting the CF business plan, operational structures and management system or even of completely re-inventing the CF business model and turning the CF arrangements all over. Continuous improvement is essential for gaining and maintaining the commitment of farmers (e.g. to avoid that CF farmers become manipulable by poaching) and is hence important for the sustainability of the CF scheme and forms integral part of the CF management's tasks.

Box 31/ **Step 7 – Activities, issues to be considered and milestone**

Activities

Refer back to: Steps 1 to 6 and related Activities

Issues to be considered

- Assess the track record of farmers, nucleus farmers, collection centre managers at the end of every season (screening for e.g. quota fulfilment, share of first grade, recovery rate) and decide on whether to continue the CF or employment contract or not.
- Integrate new farmers/ nucleus farmers to replace those who have been screened out and to reach the number of participating farmers necessary to reach break-even (motivate laggards to join, use nucleus farmers and others to recommend new entrants).
- Derive lessons learnt (see Step 6) for upgrading CF business model and CF performance (see also Activity 1.4/ success and failure and Box 18/ moral hazard, default risks). Document scalable good practices in the form of e.g. CF standards and/ or operational guidelines.
- Further qualify CF staff and/ or intermediaries to efficiently manage the scheme (e.g. mentoring and monitoring farmers; identification of problems whether due to pests, diseases, weather or farmer-firm relationships; development of problem-solving measures).
- Improve the CF business information system (if necessary) to better integrate it into daily work routines and better serve CF management needs (e.g. upgrading from basic hand-written forms to a mobile or computer-based 'paperless' system).
- Support farmers (training, extension) to carefully plan and realise re-investments of (reasonable parts of) the CF revenues into farming to reduce production unit costs and increase yields and quality while not compromising subsistence needs.
- Develop systems for supporting farmers to gradually increase input use while avoiding high risks of diversion or non-repayment (e.g. progressive pre-financing of inputs from season to season as embedded service or through a tri-partite agreement with a bank).
- Work with farmers and, if relevant, with extension and research to improve the farming systems (e.g. intercropping, crop rotation, conservation farming) for the benefit of farmers (e.g. balance subsistence-cash crops) while better meeting the buyer's requirements.
- Support farmer organisations to take up a role in CF management in proximity to farmers (e.g. joint learning, input distribution, produce collection, mentoring and monitoring, internal audits in case of group certification, group lending, risk sharing, dispute resolution).
- Improve the post-harvest handling of produce (e.g. transport, grading, packaging, storage, 1st stage processing) to reduce post-harvest losses and unit transaction costs to improve the profitability of the CF scheme and increase the income of all contract parties.

C.5/

- Establish routine analyses of farm and post-harvest economics since production and transaction unit cost and cash-flow assessments provide valuable management information for continuous improvement, preventive and corrective action.
- Improve the CF's internal capacities for reducing default risks (e.g. transparent and clear criteria and rules for rejection, for sanctions in case of default, for the accountability of own staff or intermediaries, for late payment).
- Identify opportunities/ support additional income generation and off-farm labour opportunities for CF farmers and their families as well as other community members (e.g. identification of markets for rejected produce, 1st stage processing, if reasonable a 2nd CF crop).
- Organise regular exchange visits at all horizontal levels of the CF scheme i.e. between farmers, between farmer group representatives, between nucleus farmers, between collection/ service centre managers to discuss CF upgrading opportunities and learn jointly.
- Organise regular meetings involving different vertical levels of the CF scheme i.e. farmers, nucleus farmers and collection centre managers and buyer's representatives from the principal office to assure transparency and discuss issues of CF interface management.
- Take stock of relevant service providers, assess their capacities and promote their settling near CF locations to create agribusiness clusters (clusters are groups of farms and allied enterprises/ organisations that cooperate to achieve shared goals).
- Promote spill-over effects of the CF scheme and leverage emerging interest of communities or other entities to start local economic development activities (e.g. construction/ rehabilitation of access roads/ market places; promotion of CF/ service business start-ups).
- Develop an 'early warning system' for the observation of relevant external changes (e.g. market trends, political or regulatory changes) to facilitate early decision-making on necessary adjustments.

Milestone
The start-up CF scheme is financially viable and sufficiently sustainable to withstand possible future setbacks.

Step 8/ **Generic growth through up-scaling – innovate the CF business model to include more farmers**

Even if up-scaling is commonly necessary to achieve critical profitability and hence sustainability, due attention has to be paid not to expand faster than the buyer's company can manage and sustain financially. Thinking of the outreach objectives, they have to be guided by an appraisal of the approximate 'optimum' size, at which the scheme is still manageable and cost-benefit-wise competitive with other procurement solutions. When screening alternative CF arrangements (see Activity 3.1) and developing the CF business plan (see Activity 3.4), the question of size already has to be preconceived. But it is a difficult issue and there is so far no documented experience available that could guide decision-making on the 'optimum' size of CF schemes.

When reaching out to new locations, it has to be considered that CF arrangements, operational structures and management systems can usually not be perpetuated without adaptation. Since up-scaling requires substantial investments (facilities, equipment, staffing, training and other services, input pre-financing), the buyer has to think through the financing needs and the company's own resources followed by an assessment of the possibilities of external financing through the bank sector or through technical or financial assistance offered by 3rd party facilitators. In the ideal case, the original CF business plan (see Activity 3.4) already considers the activities, time and resources required for the generic growth of the scheme.

Up-scaling is about reaching out to integrate more farmers into the CF scheme by using scalable approaches and tested instruments. While outreach costs may be reduced by using scalable good practices, it cannot be taken for granted that the approaches and instruments developed and adjusted at an earlier stage can directly be applied in other regions and settings. In order to reduce the (quite frequent) risk of failure, the original CF business model and CF arrangements may have to be adapted to the specific agro-ecological, socio-economic, market competition, infrastructure and political conditions, etc. in other locations.

Further to site-specific disparities influencing up-scaling, changes in framework conditions (e.g. policies, regulations, prices, consumer preferences) require to be monitored and considered in CF business model innovation.

It is obvious that up-scaling requires sound planning, a strategic approach and sufficient time and resources (human, financial) for the establishment of the necessary CF infrastructure, the presence of the company in the field and broad-based capacity building of suppliers, staff and intermediaries.

C.5/

Box 32/ **Step 8 – Activities, issues to be considered and milestone**

Activities

Refer back to: Steps 1 to 6 and related Activities

Issues to be considered

- Assess the 'optimum' CF size, which the buyer can still manage and sustain financially and which is cost-benefit-wise still competitive with other solutions comparing smallholder with probably more efficient larger farm arrangements (see Activities 3.1 and 3.4).
- Attach due attention to the selection of appropriate locations and nucleus farmers/ farmers/ farmer groups given the importance of this step for the success and sustainability of CF up-scaling (the selection process can draw on the results of Activities 1.2 and 2.1).
- Build on existing relations with nucleus farmers/ farmer groups/ intermediaries/ service providers to identify and select truly interested new entrants; use likely spill-over effects such as awareness on the CF scheme in neighbouring communities.
- Develop an up-scaling strategy adapted to location-specific conditions, based on a realistic assessment of required time and resources for initiating contacts, building trust, developing capacities, establishing the CF infrastructure/ field operations (see Steps 1 and 2).
- Select and contract qualified staff and/ or intermediaries responsible for CF field operations and CF management at different levels between the principal office and the field and develop the management and technical skills of new staff/ intermediaries.
- Check the scalability of the good practices developed during the start-up and consolidation phase and documented in the form of CF standards or operational guidelines and adjust them to the specific circumstances in the selected new locations (if necessary).
- Identify possible private and public service providers in the new locations and conclude cooperation agreements/ contracts if advisable (see also section B.2):
  (i) associations, unions, inter-professions or a board providing services such as market information, a CF farmers' database, a platform for price negotiations between farmer and buyer organisations, a CF code of practice or policy dialogue (see Activity 6.1);
  (ii) providers of operational services (e.g. external input dealers, agricultural machinery services, transport & logistics services, plant protection services);
  (iii) providers of other non-financial services (e.g. research, extension, training, organisational development);
  (iv) providers of financial services (e.g. short-term loans, medium to long-term investment credits, insurance, leasing, bank accounts and savings).
- Identify possible governmental, development partner or NGO supporters and, if advisable and possible, conclude cooperation agreements for CF up-scaling (see also section B.2):
  (i) regional or local authorities interested in supporting CF up-scaling (local or regional economic development) or agricultural/ rural development entities (e.g. extension services for basic agricultural skills) but consider whether they are sufficiently equipped;
  (ii) governmental organisations at the national level or development partners offering support to value chain and/ or CF development.

Milestone

The CF scheme follows a sustainable growth path (slowly enough to be financially affordable and to allow the development of sustainable structures, fast enough to become/ stay competitive in main target markets).

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Published by
Deutsche Gesellschaft für
Internationale Zusammenarbeit (GIZ) GmbH

Registered offices
Bonn and Eschborn
Germany

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Design and layout
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Printed by
Metzgerdruck, Obrigheim
Printed on FSC-certified paper

Photo credits
Cover: ©GIZ/ Dragan Vildović
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As at
June 2013

GIZ is responsible for the content of this publication.

On behalf of
Federal Ministry for Economic Cooperation and Development (BMZ)
Division for rural development and global food security

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