Private Sector & Development
A blog coordinated by Proparco

The role of private equity funding in the development of Africa’s agriculture

Jerry Parkes *Founder – INJARO*

June 4 2015

Ensuring that Africa can feed itself by 2050 and contribute to the increasing global demand for food will require well-targeted coordination and collaboration between governments, donors, entrepreneurs, the international community and investors. Private equity funds targeting specifically agricultural SMEs could provide a solution by allocating smart, patient capital to promising companies and developing them into major players in terms of food supply, job creation and poverty alleviation.

The Food and Agriculture Organization of the United Nations (FAO), rates the need for investment in sub-Saharan Africa’s agricultural sector as urgent: agriculture accounts for more than 17% of the region’s gross domestic product (GDP) and provides livelihoods for around 70% of its population. Yet if sub-Saharan Africa is to achieve food security by 2050,[1] its agricultural sector must close an annual funding gap of USD 11 billion.

The development of the agricultural sector in West Africa depends heavily on the profitable growth of thousands of small- to medium-sized agribusinesses (agricultural SMEs), which currently suffer from a lack of access to appropriately structured finance. Investment in this relatively undeveloped sector is fraught with challenges, including inadequate infrastructure, imperfect regulatory and tariff environments, uncoordinated value chains, low levels of managerial capacity and an unfamiliarity of some entrepreneurs with the private equity model.

While these challenges are being addressed by several specialized funds, ensuring that Africa can feed itself by 2050 and contribute to global food security will require well-targeted coordination and collaboration between governments, donors, entrepreneurs, the international community and investors. Private equity funds targeting agricultural SMEs could provide a solution by allocating smart, patient capital to promising companies and developing them into major players in terms of food supply, job creation and poverty alleviation.

Agricultural SMEs lack financial access

Africa’s agricultural potential is considerable but its farmers suffer from significant technology and productivity gaps, which could be closed through investment. Average farm yields for maize, for example, amount to around 17% those achieved in the developed world (1.5mT/Ha to 9mT/Ha). Increased investment in inputs and other production technologies could allow local farmers to satisfy local demand and export their surpluses to other parts of the world.

In spite of their critical role, agricultural SMEs in sub-Saharan Africa continue to encounter difficulties in accessing credit from commercial banks. This is partly because commercial banks generally lack the capacity or willingness to structure appropriate instruments for agricultural SMEs, and partly due to the SMEs lacking the managerial capacity to prepare sound business plans and articulate their financing needs effectively. A combination of this lack of communication and the desperate need for financing at any cost often results in impossible-to-meet loan repayment schedules.

This lack of access to bank credit is compounded by the very low supply of private equity capital for African businesses in general and an even lower supply for agricultural SMEs. Local institutional equity investors are required by law to invest the majority of their capital in listed equities – private equity allocations for pension funds are generally less than 5%, if even permitted – and foreign investors generally favour listed equities. The relatively higher availability of debt funding in the early stages of business ventures causes many start-ups to fund their operations with debt, resulting almost invariably in high default rates, which compound negative perceptions and fuel a vicious cycle that culminates in a reduced supply of capital, shorter loan tenors and higher interest rates for agricultural SMEs.
Private equity firms as a solution?

Private equity firms, through the funds they manage, are beginning to address these financing challenges, as their traditional model is well-equipped to invest in a typical SME and achieve targeted returns. First, they are specifically structured to provide long-term capital. Then, as sector specialists, they are better positioned to assess business opportunities and thus select those with the greatest potential. And lastly, fund managers are generally incentivized to ensure the long-term viability of a business. They therefore can invest significant effort in improving managerial capacity, providing strategic direction and improving corporate governance.

Additionally, some fund managers also seek to make social impacts through job creation, improving agricultural productivity and linking rural farmers to markets. These goals are often achieved by actively participating on the board of an investee and building capacity through the judicious use of technical assistance.

Beyond the issues of access to finance and access to talent, however, West Africa's agricultural SMEs are faced with significant challenges from a lack of infrastructure, competition from imports, unfavourable regulatory environments, dysfunctional value chains and a lack of market information. Private equity funds need to be aware of these special challenges and develop strategies for managing them – but this many depend on the extent to which they prioritize long-term agriculture sector development within their mandates.

The growing trend towards impact investment makes private equity investment managers more likely to pursue double- or triple-bottom line objectives, increasing the likelihood that they will make the extra effort to drive development in the agriculture sector. Nonetheless, the majority of private equity funds do not have the latitude to apply non-financial considerations to their investments.

Private equity firms typically address these negative externalities in three ways: focusing investment on the least problematic value chains; collaborating with other actors, such as non-governmental organizations (NGOs) or government, to leverage programmes aimed at fixing the value chain; or proactively seeking to influence the required changes, such as by lobbying governments for targeted subsidies or tax breaks to improve the viability of the sector. The choice of approaches is determined by the investor's policy and the extent to which social factors weigh in their investment strategy. Injaro Agricultural Capital Holdings, a fund managed by Injaro Investments that focuses on agricultural SMEs in West Africa, for example, targets its investments to have a positive impact on low-income people and rural smallholder farmers. This impact can be achieved by job creation in rural areas, sourcing products from rural smallholder farmers or supplying improved seeds.

Acting in a traditional profit-maximising role

The poultry sector in West Africa is a relevant example of how a private equity fund might rank one opportunity over another. In Côte d'Ivoire, the national poultry industry association (IPRAVI) successfully lobbied the government to maintain an import tax on imported poultry products and to continue the implementation of the Poultry Strategic Recovery Plan (PSRA5) that aims to triple total local production between 2010 and 2020. Ghana's poultry sector, on the other hand, does not have such a long-term supportive development and tariff policy to protect it against foreign imports. This policy difference would oblige profit-maximising investors to avoid Ghana's poultry sector and direct its capital to Côte d'Ivoire – indeed, the International Finance Corporation and Injaro have both invested in the Ivoirian poultry sector within the last three years.

Leveraging platforms created by others

Sub-Saharan Africa's cashew processing sector is an illustration of a partnership between the private sector and NGO- and donor-funded projects that allowed private equity firms to leverage assets created by others and improve their investment performance. Donor-funded market studies, published in 2005,[2] made it possible for the private sector to assess opportunities by clearly outlining the key global players, the cost structure and the value distribution of the sector. Furthermore, the African Cashew Initiative, with its team of industry experts, provided pre- and post-investment risk-reducing support to investors – Injaro partnered with these actors in a Ghanaian cashew processing plant whose output increased almost five-fold post-investment.

Acting as a pioneering development partner

The creation of efficient local value chains is critical to increasing agricultural production, but an appropriate environment requires significant coordinated action from several parties. In 2004, according to a McKinsey Quarterly Report,[3] it was cheaper to import chicken from Brazil via the Middle East than to raise poultry locally. With US government funding, Technoserve, an international non-profit, carried out a full value chain study and an industry development plan. The McKinsey Quarterly had reported "constraints were multiple and interrelated," including "a lack of locally available feed, poor models for out-grower schemes (…) and few successful entrepreneurs operating hatcheries or abattoirs". Moreover, the report highlighted a lack of quality and sanitary standards, poor industrial organization and marketing, and weak enforcement of tariff and import regulations. Turning this around involved providing business and technical training to actors involved in grain cultivation, feed production as well as chicken rearing. The developments across the value chain were accompanied by a more than 8-fold increase in agricultural investment between 2003 and 2007 4 and resulted in the grain feed sector growing, over five years, from a USD 15 million to a 60 million industry. Involving private equity partners as capital providers at the appropriate stage in the development process could prove to be an important element in accelerating similar projects in other parts of Africa.

Another example is a partnership involving Injaro; the Alliance for a Green Revolution in Africa (AGRA), an NGO; regional governments; smallholder and commercial farmers; African and international research institutions and local entrepreneurs in working to develop local industries for the production of improved, high-yielding, resilient seeds. AGRA identifies high-potential grain producers in West Africa and provides them with the business and technical training required to operate a small-scale seed production business through a grant-funded programme. Injaro then invests in those businesses that show the greatest potential to grow into businesses capable of supplying up to 10,000 tonnes of improved seeds a year. This linking of an NGO-funded programme with the commercial sector is an approach that could be scaled up to trigger rapid sectoral growth.

New models, appropriate capital

From a private equity perspective, a two-pronged approach of focusing on agricultural SMEs and increasing strategic partnerships between players in the private, NGO, quasi-NGO and public sectors will be an important driver for development in West Africa's agricultural sector

There is a growing number of private sector players, some not pure private equity funds, acting as partners to achieve specific development objectives. AgDevCo, which is financed through a combination of grants and commercial capital, works closely with governments across Africa to develop large-scale agricultural infrastructure projects to facilitate commercial investment. Given the specific challenges faced by agricultural SMEs, private equity firms, especially those that are sector-focused, are increasingly important actors. Encouragingly, there is a small but growing number of specialist firms willing to act as pioneering development partners, striking the balance between financial returns and the long-term development of Africa's agricultural sector. It is hoped that the early achievements of these pioneers will stimulate additional development and the creation of impact-oriented fund managers. Increasing the availability of capital and technical assistance to such entities would help to accelerate the development of Africa's agricultural sector, required if Africa is to feed its growing population and contribute to meeting the increasing global demand for food.

Footnotes:

[1] Mhlanga, N. 2010. Private Sector Agribusiness Investments in Sub-Saharan Africa. Food and Agriculture Organization of the United Nations, Rome, Italy. (on p4)

[2] Williams, D. 2005. West African Cashew Sector Study: Supply-chain Analysis and Needs Assessment. West Africa Trade Hub Technical Report No. 8.

[3] McNamer, B. 2010. Helping Africans to Jump Start Their Industries. McKinsey Quarterly.

4 Mhlanga, N. 2010. Private Sector Agribusiness Investments in Sub-Saharan Africa. Food and Agriculture Organization of the United Nations, Rome, Italy.