FINANCING EARLY STAGE AGRICULTURE IN AFRICA

Investment of patient capital can stimulate rapid growth of agriculture in Africa, writes ***Keith Palmer***

Aerial view of intensive agriculture in Rwanda

There is enormous agricultural potential in many parts of Africa. All the necessary natural conditions – good soils and climate, plenty of land and water – are present in many countries. There is no reason why Africa cannot be a major producer of agricultural products on a scale equal to that of South America. But it will take heavy investment by the private sector to realise this potential, and the reality is that there has not been nearly enough of it. As a result the potential remains largely unrealised.

Rapid growth of agriculture is the most effective means of reducing poverty in Africa. According to the World Bank the poverty reduction impact of growth in agriculture is three times greater than comparable growth in any other sector. But since there has not been rapid growth in agriculture the opportunity to reduce poverty has not been grasped. Rural Africa remains extremely poor.

Why has there been so little private investment in agriculture? It is certainly not a lack of finance per se. There is more international interest in investing in Africa now than ever before. New private equity funds focused on agriculture in Africa are searching for viable investment opportunities. The development finance institutions have under-utilised their capital allocations for agriculture in Africa for many years.

The real problem is not lack of finance – it is lack of sufficient profitable opportunities in which to invest. The reason is straightforward: agriculture in Africa is an infant industry. It lacks the infrastructure required for commercial agriculture – such as water supply for irrigation, electricity supply to the farm gate and feeder roads to access markets. It has to incur start-up costs such as land clearing and trial planting, costs which do not have to be borne by its competitors. It lacks experienced managers and a trained workforce resulting in lower productivity and higher labour costs.

Above all infant industry by its very nature operates on a small scale and therefore does not benefit from the economies of scale available to

international competitors. As a result in many cases unit costs are high and expected returns are low. Furthermore early stage agriculture is very risky. This raises the minimum return required by private investors. With low expected returns and a high risk-adjusted cost of capital it is not surprising that many early stage opportunities are not attractive to private investors (figure 1).

But if the infant industry can 'grow up' there is no reason why it cannot be internationally competitive. As the infrastructure platform is strengthened and the benefits of scale economies and 'learning by doing' drive down costs, as the industry grows in size and matures over time, the returns on new investment will be attractive to private investors.

The challenge for the international community is how to get things started: how to deploy development assistance resources in ways that will overcome the barriers to entry, resulting in rapid growth of profitable commercial agriculture and thereby a rapid reduction in poverty.

Successful interventions should: be targeted at the market failures which create the barriers to entry; be catalytic, levering-into African agriculture new private investment in amounts many times greater than the amount of donor funding; and be time limited so that over the medium term public funds can be withdrawn, replaced with private capital and the proceeds re-invested in new early stage ventures.

The key to success is patient capital. Patient capital is long-term, low-cost, subordinated capital provided by donors and invested in the early stages of private sector agricultural ventures. It would be used to finance start-up costs, to part-fund the cost of infrastructure (such as irrigation assets) and to part-fund working capital required by small and medium-size enterprises (SMEs) and smallholder farmer organisations (SFOs), these being sponsors who would not otherwise be able to secure sufficient working capital from banks.

The long tenor and low cost of patient capital reduce unit production and delivery costs in the early years. This increases the incremental return on private investment in the venture. Subordination of patient capital reduces the risks faced by private investors. The result is to shift the opportunity 'above' the line in figure 1 making it attractive to private investors.

Patient capital should have 'upside' sharing to ensure that funders share in any unanticipated upside; and should be secured on the assets in the business to ensure that there are consequences for sponsors if they fail to comply with the conditions on which the funding was made. Conditions should always include undertakings to help integrate smallholder farmers into agricultural value chains and provide them with access to infrastructure on affordable terms.

Patient capital deployed in this way would be catalytic, levering-in large amounts of new private investment, and it would also bring transformational benefits for smallholder farmers, taking them out of poverty 'at a stroke'. Figure 2 shows an example in Zambia of how patient capital invested by InfraCo did just that.

How can patient capital best be deployed? The best approach is to create a public/private equity fund in which public sector donors (and private sector foundations and social impact investors) fund a tranche of patient capital and private investors fund a tranche of private equity expected to generate commercial returns (figure 3). The low cost of the

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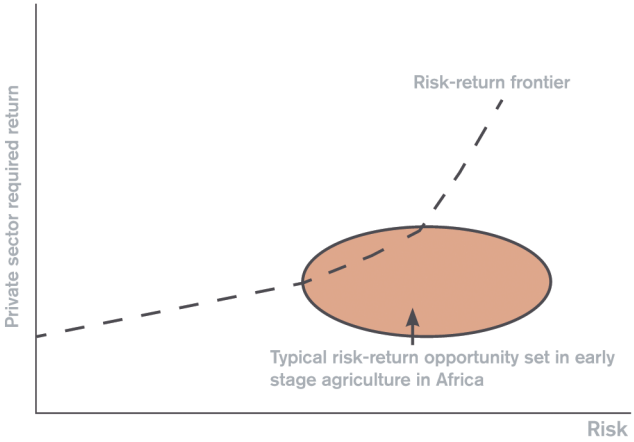

- Low expected returns and high risk in early stage agriculture leave many opportunities 'below' the risk return frontier so private investors will not invest
- Patient capital will increase expected returns and reduce risk in early years so moving opportunities 'above' the risk return frontier and making them more attractive to private investors
- Once early stage costs and risks have been reduced returns on new investment are 'above' the risk-return frontier and no further requirement for patient capital

Figure 1

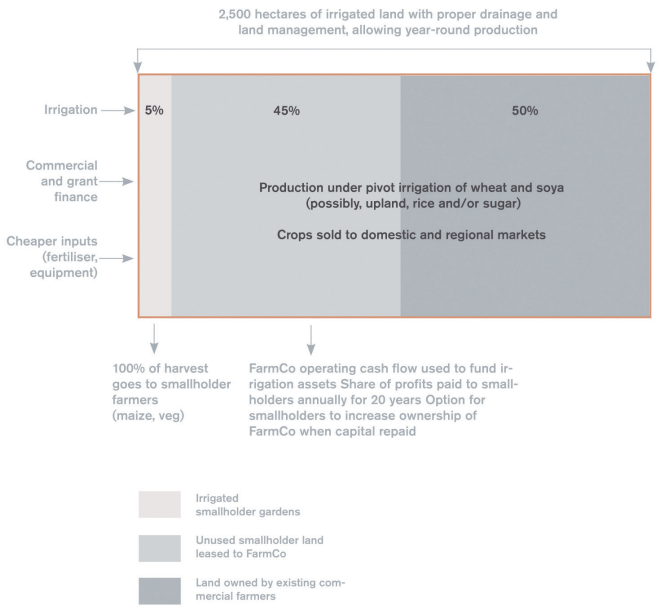

Figure 2

patient capital would lever-up private equity returns and the subordination would reduce the risks. The fund would invest both patient capital and private equity into a portfolio of early-stage agricultural ventures.

The fund would differ from a standard private equity fund in several respects. First the governance: the fund would have dual objectives. To invest in early-stage agricultural ventures that are expected to be socially and environmentally sustainable and generate commercial returns on the private equity tranche; and to deliver explicit poverty reduction objectives framed in terms that are quantifiable and can be monitored. The investment committee, made up of nominees of the funders of patient capital and private equity, would be responsible for ensuring that both of the fund's objectives were met. Second, the incentives: the fund manager would be remunerated for achieving success which in this case means delivering the outcomes sought by both the patient capital and private equity funders. Remuneration should be linked to both the financial performance of the fund and the delivery of specific targets relating to development impact and poverty reduction.

As well as patient capital there is a need for two additional development assistance instruments. The first is social venture capital (sometimes called catalytic funding). This is concessional funding from donors used to co-invest alongside SME and SFO sponsors to make a greater number of very early stage opportunities 'investment ready.' The experience of InfraCo and AgDevCo shows that small amounts of social venture capital invested pre-financial close can not only be highly effective in catalysing additional private investment but also in structuring investments so that they achieve high development impact and strongly pro-poor outcomes.

The second is partial risk loan guarantees. Sponsors must have access to committed credit lines to fund working capital as well as equity if they are to grow their businesses rapidly. Debt providers are extremely nervous about extending credit to early-stage agricultural ventures when the sponsor has limited track record and collateral. The solution is partial risk loan guarantees which are instruments that transfer some of the credit risks from the lender to the guarantor for a fee. There are a number of credit guarantee facilities operated by donor agencies which perform this role including the USAID DCA programme and Guarantco, a public private partnership facility funded by European governments. However, if credit to support rapid growth of early stage agriculture is to be sufficient there is a need for more loan guarantee capacity, greater willingness to take risk positions on early-stage agricultural ventures with SME/SFO sponsors and pricing that recognises the need to keep the cost of capital as low as possible in the early years.

Figure 4 shows how these three instruments would work together. Social venture capital invested in the very earliest stages creates a larger number of investment ready opportunities. It is withdrawn as soon as possible after financial close and reinvested to create more investment ready opportunities elsewhere. The patient capital fund invests a blend of patient capital and private equity at financial close. Over time the patient capital is withdrawn and replaced with private equity. Loans made at financial close benefit from partial risk loan guarantees but over time as the guarantees lapse and lenders become more comfortable with the sponsors they extend new credit lines without loan guarantees. Once the infant industry has grown into a mature, profitable industry, all the finance required to continue to grow will come from the private sector.

In conclusion, there is a real opportunity for the international community to catalyse large-scale private investment and realise the great agricultural potential of Africa. In doing so, it will meet its primary objective of reducing poverty. It will also contribute to addressing the global food security agenda and to increasing the resilience of Africa to the consequences of climate change. That really would be effective aid! ◇

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For more information www.agdevco.com

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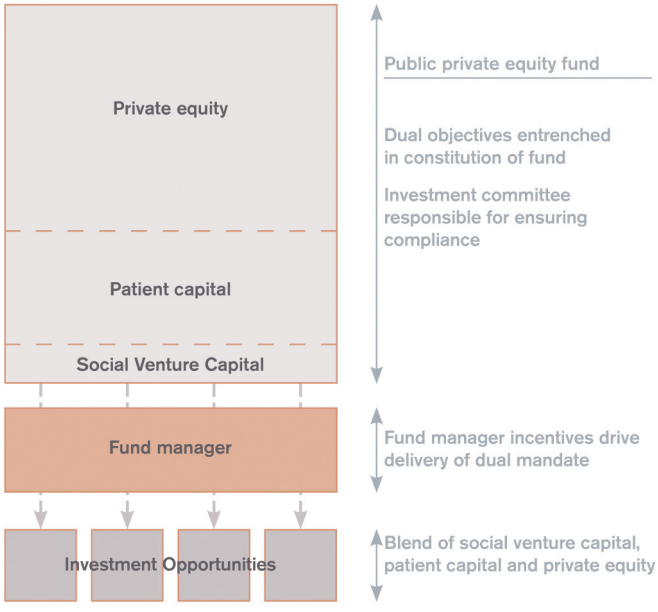

Figure 3

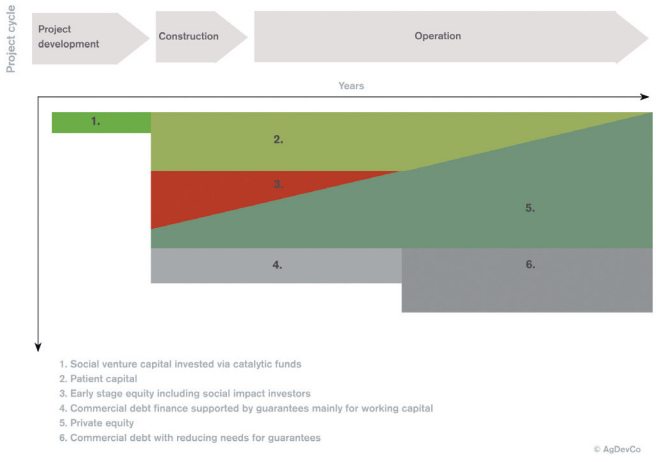

Figure 4