

# Bridging demand and supply of private investment capital

FOR SMALL AND MEDIUM AGRIBUSINESSES

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Commercial Agriculture for Smallholders and Agribusiness

The CASA programme is a flagship programme of the UK Foreign, Commonwealth & Development Office (FCDO) and is intended to increase global investment in agribusinesses which trade with smallholders in equitable commercial relationships, increasing smallholders' incomes and climate resilience.

The programme aims to help agribusinesses to scale up and trade in larger commercial markets. As part of its work CASA generates new evidence and analysis that supports a stronger, fairer and greener agribusiness sector.

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## Executive summary

### Motivation

The UK Foreign, Commonwealth and Development Office's (FCDO's) Commercial Agriculture for Smallholders and Agribusiness (CASA) programme is working to increase economic opportunities for smallholders to step up and trade in growing commercial markets. The aim is to increase investment in agribusinesses that source from smallholder farmers, and to provide evidence-based guidance for creating synergistic relationships between agribusinesses and smallholders in ways that promote smallholders' productivity and commercial potential.

This study is motivated by an apparent contradiction: suppliers of capital report a lack of investible opportunities in Africa, while demanders of capital cannot find willing partners to provide capital to them. In spite of significant amounts of private capital being available for investment worldwide (World Economic Forum, 2013; Vitón, 2018), institutional and impact investors have found it difficult to mobilize large amounts of private investment for agribusiness opportunities in Africa. This study identifies strategies for development and impact investment actors to bridge the gap between the risk–reward demands (or adjusted risk returns) of investment capital and the available supply of agribusinesses for investment. The study assesses whether what is needed is different forms of capital, or greater work to provide the pre-conditions for private investment in agri-food systems, or both of these. The resulting analysis addresses the needs and interests of both investors and investment support stakeholders.

### Objectives

The objectives of the study are the following:

1. **To analyze how investors identify investment targets**, by analyzing the key criteria, evaluation mechanisms and sources of information they use to identify and select investible small-scale and medium-scale agribusiness enterprises (agri-SMEs).
2. **To analyze current financing for agricultural small and medium-sized enterprises (SMEs)**, by identifying examples and analyzing effective models and commercial terms for providing innovative financing for agri-SMEs.
3. **To analyze and appraise effective models of technical assistance for agri-SMEs**, by identifying and analyzing approaches that have helped increase the intrinsic value and performance of agri-SMEs against key investment criteria, thus successfully improving their access to private investment capital.
4. **To draw high-level conclusions.** Is there a lack of agribusinesses available for investment that can meet investors' risk–reward requirements? Are the most common lending mechanisms inappropriate for the agribusinesses that investors are targeting? Or are investors' approaches to identifying agribusinesses for investment unfit for purpose?

5. **Develop recommendations for the impact-investment community.**<sup>1</sup> These should help to identify agribusinesses and establish the connections needed between investment-ready agribusinesses and investors, innovative financing models (including those targeting women-led SMEs) and technical assistance modalities that improve the readiness of agri-SMEs for private investment.

## Methods

The study utilized three modes of evidence creation: (i) a detailed review of published studies on the topic; (ii) existing surveys of agri-SMEs in Africa; and (iii) the primary mode – Delphi method interviews<sup>2</sup> with key stakeholders, including a range of impact investors, private equity investors and development finance institutions. The basis of the Delphi method is that deep understanding and insight can be obtained by interviewing individuals with extensive experience and successful track records in a field or profession. The Delphi technique is especially suitable where data is unavailable or where issues are too complex to use quantitative data based on pre-coded responses.

## Main findings

**Insight #1:** Investor reservations about sustained political commitment to achieving agricultural sector targets may be depressing private investment in African agriculture. Private agribusiness investment in Africa could be accelerated by a clearly articulated strategic vision at the pan-African level, backed up by credible commitment to, and effective implementation of, the plan at regional and national levels. This would include a transparent process for prioritizing and selecting a pipeline of bankable agriculture projects.

**Insight #2:** There is limited demand by agri-SMEs to take on third-party private debt or equity ownership. This can be effectively addressed over a medium- to long-term horizon. The number of agri-SMEs operating in Africa rose by 800% between 2000 and 2017, but these farms and agri-SMEs are financing their operations mainly from family equity. This suggests that **the effective demand for finance by agri-SMEs may be substantially lower than the amounts impact investors are willing to supply**. However, changes in investor and bank behaviour could increase agri-SMEs' effective demand for finance.

**Insight #3:** There is great potential for improved policies to mobilize equity capital from SME agribusiness firms themselves. Trader surveys in Sub-Saharan Africa (SSA) reveal that many SME agri-entrepreneurs start as farmers. They tend to have superior knowledge of

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<sup>1</sup> The term 'impact investors' encompasses a broad set of organizational types, including multilateral and bilateral agencies, development finance institutions (DFIs), foundations, NGOs, social investors, and others. While all of these have in common that they seek both social and financial returns, some are much more risk adverse than others while some may focus on a different set of financial instruments ranging from purely subsidized to more concessional and blended finance arrangements. Social investors (also referred to as impact investors) are mostly private entities and are closer in terms of risk appetite and financial instruments to commercial banks than they are to grant-oriented foundations. The roles that each of these entities can play in promoting an efficient agri-SME financing landscape can vary widely.

<sup>2</sup> See Delphi interview details and process background document - <https://www.casaprogramme.com/wp-content/uploads/Delphi-Interview-questionnaire-and-process.pdf>

clients in their local area and social connections with them, facilitating the development of a client base. Most smallholders do not have enough capital to become viable SMEs, but about 10% do. Since there are roughly 125 million farm households in SSA, 12 million farm households have the potential to develop into SME agribusinesses in Africa. But only a small percentage of these actually become SME agribusinesses. Why not more? And how can conditions be modified to incentivise more of them? The fundamental constraints are a lack of incentives and the behaviours of other actors, including governments and impact investors, that indirectly depress resources from reaching the majority of SME agribusinesses that operate outside their programmes.

**Insight #4:** For institutional investors to provide more capital to impact investors working with African agri-SMEs, the systemic sources of risk and transaction costs in African agricultural markets need to be addressed, as do smallholder farms' high costs of production. Suppliers of private debt and equity face high risks and variable returns. Impact investing intentionally seeks to create both financial and societal returns. Pension funds and insurance companies represent 48% and 39% of global assets, respectively. These asset owners are rarely able to manage and pay their future financial liabilities (long-term payments) or to accept the unpredictable cashflow generation typically associated with agriculture. In other words, the world's biggest capital providers, representing 87% of global assets, face a huge constraint on working with impact investors in African agriculture.

Few impact investors are producing both market rates of return *and* sustainable social impact (the definition of impact investing). Supporting agri-SMEs to achieve even one of these outcomes usually requires a long term, patient capital approach, which tends to be unattractive to investors who insist on a five- to seven-year exit strategy. To increase the supply of capital available to impact investors – and to increase agri-SMEs' demand for debt and equity – the following systemic areas need to be addressed: (i) ensuring a sufficiently stable macroeconomic environment; (ii) establishing a sectoral policy-enabling environment that is predictable and transparent; (iii) encouraging surplus-producing zones and ensuring low production costs; and (iv) implementing blended finance and de-risking mechanisms.

**Insight #5:** There tends to be a discrepancy between impact investment funds' target rates of return and those expected by investors. This expectations gap and the inability to generate required returns might explain the difficulty in expanding funding from impact investors. Some 83% of US-based pension funds surveyed believe that impact investment funds have unestablished track records. Until fund managers develop track records and deep experience of working with impact enterprises, institutional investors will remain apprehensive. The shortage of funds for impact investors in African agriculture reflects the current high risks in African agriculture. Government commitment to strengthening African government institutions (rule of law, anti-corruption, free flow of foreign currency, property rights), will lead to a greater supply of funds becoming available.

**Insight #6:** The sector's fragmented nature means that deal sizes remain small. This constrains the number of mainstream intermediaries in the impact investment sector. The Delphi interviewees indicated that in any given African country, there are typically fewer than 10 viable agribusiness firms that could have a minimum deal size that would be suitable for most impact investors. Most institutional investors want an exit timeline, but investors need to work closely with firms over time till they reach a size at which they can absorb larger amounts of debt or equity capital. Some interviewees stressed the need to be on the ground, so as to understand agri-SME clients and innovate products to match their needs.

**Insight #7:** More rigorous methods of measuring social impact may increase the supply of funding from institutional investors to impact investors. Institutional investors need to trust

what is being reported to them. Some may be discouraged by perceptions of unrealistic assessments of social impact. Many investments produce externalities, i.e. impacts on other parts of a system that are not necessarily taken into consideration by the investor. For example, some recipients of impact investment provide subsidized services and inputs to promote project objectives, which could unintentionally erode the market for commercial operators. Greater rigour in measuring social impact may lead to more confidence in social impact claims.

**Insight #8:** Human capacity development will be required to generate more profitable agri-SMEs and expand financing for agri-SMEs. Limited human capital is a major impediment to private investment in SME agribusiness. A systemic approach is needed. African universities contribute by far the greatest numbers of undergraduate and masters-level workers in African countries' labour forces. The workers graduating from African universities then influence the quality of the rest of their countries' workforce, through the training that they provide to others – in primary and secondary schools, in agricultural training colleges, in technical and vocational education and training schools, in public sector jobs, in civil society and in the private sector. A one-year increase in average tertiary education levels is estimated to raise annual GDP growth in Africa by 0.39 percentage points, and eventually to yield up to a 12% increase in GDP (Darvas et al., 2017). Agri-food systems development in Africa, including private investment in agri-SMEs, is likely to co-evolve together with the upgrading of African countries' workforces. Fortunately, the pace of educational improvement in Africa is faster than in any other region of the world.

## Recommendations

Section 4 consists of proposals for consideration by African governments, impact investors and development partners and donor organizations. The proposals for African governments and pan-African organizations are oriented to (i) produce national/continental agricultural investment plans and initiatives that move from aspirational documents to concrete implementation plans with budgets and task calendars specifying the activities and time frames for implementation, in order to raise investor confidence about African government commitment to agricultural transformation plans; and (ii) improve the “enabling environment” to raise the expected returns to private investment in African small and medium-scale agricultural firms. Proposals for impact investors are drawn from Delphi experts' views of approaches that have been effective in the past or gaps that must be addressed. Proposals for development partners are also drawn from Delphi experts perceptions of effective and ineffective past donor-funded activities.

## Conclusions

In response to the main questions motivating this study, i.e., *“is there is a shortage of agri-businesses available for investment that can meet investors' risk-reward requirements, or are the most common lending mechanisms inappropriate for the agri-businesses that investors are targeting?”*, this study concludes that both are true, with most Delphi experts emphasizing the first point. The final section of the report presents six main conclusions, all emanating from the Delphi expert process and additional sources as cited.

**First, there is no evidence of a shortage of investible funds for African agribusiness.** In fact, over \$12 trillion was invested in alternative real assets<sup>3</sup> globally in 2017. Only 2.3% (\$267 million) of this was in food and agriculture and forestry, and only 4% of that was invested in Africa (0.35% of global alternative real asset investments). Even if only 1% of total alternative assets were to be reallocated to African agribusiness, the result would be a 12-fold increase in private investment food and agriculture assets under management. **The current slow – or lack of – reallocation reflects an inability to find bankable investments** (Vitón, 2018).

**Second, the policy and enabling environment remains highly risky.** Sustained government commitment will be needed to attract substantially more private investment in the foreseeable future. The flow of private investment to SSA agriculture may rise dramatically in countries where the state has a clearly articulated vision and implementation plan for agri-food systems development. The restructuring and rehabilitation of distressed state-owned assets into new enterprises has been common in relatively developed countries for many years but has yet to become a major feature of SSA agriculture.

**Third, many investors' most common products may be inappropriate or insufficient for the agribusinesses that investors are seeking to target.** Roughly half of the Delphi respondents emphasized the need for investors to adopt different approaches, such as working with smaller firms, with deal sizes in the \$100,000 to \$1 million range, and taking a long-term perspective. According to the respondents, investors should learn about the widely different circumstances of African agri-SMEs and develop more innovative products. Delphi experts often identified the following options for consideration: relatively simple digital platforms for lending to smallholders, project preparation facilities, addressing property rights and titles to land, cooperative models for achieving scale economies in engaging with smallholder farmers, partnerships with sub-national banks that are closer to the end clients, and in some cases, approaches relying on blended finance and de-risking mechanisms.

**Fourth, scale is important.** While the geo-strategic need to feed a planet of 10 billion people is an investment proposition, the re-organization of smallholders into alternative commercial and economic structures will likely be required as a catalyst for investment flows. Holding company models, in which smallholders have a financial interest through equity, can harness and aggregate investment capital, which then flows down to smallholders.

**Fifth, diversified enterprises can reduce risk.** Agricultural commodity prices tend to be relatively unpredictable, especially in landlocked African markets. Outside a few countries, including Russia, Ukraine, Brazil, Malaysia and Indonesia – price risk and unpredictability prevented the development of a deep pool of sophisticated capital prepared to invest in primary producers. Capital-intensive primary agriculture has remained fragmented, and the investment opportunities have taken place further along the value chain. Integration strategies have to be considered in order to establish a pool of equity capital for smallholders.

**Sixth, parallel strategies are not mutually exclusive.** The success of Brazil's agribusiness sector over the past 20 years is often seen as a template for other developing countries. Brazil runs what can almost be considered as parallel strategies. One is a large-scale, efficient international corporate agriculture sector with operations that span a variety of value

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<sup>3</sup> Alternative assets are those which cannot be categorized as stocks, bonds, or certificates. Some examples of alternative assets include certain real estate, commodities, farmland, agribusinesses, foreign currency, insurance products, derivatives, venture capital, private equity, hedge funds, and distressed securities.

chains. This sector represents 1% of the country's farms but uses 44% of its farmed area. Simultaneously, a Brazilian government strategy focuses on hunger, nutrition and the resettlement of small-scale farm families, as well as other rural development and social programmes targeted at the poor. Brazil highlights conclusively that a model which supports both has certain advantages.





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