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SPOTLIGHT ON AFRICAN AGRICULTURE

Agriculture remains fundamental to the development of Africa. It is the dominant employer and a key factor in GDP growth. This sector remains central to food security, poverty reduction, growth and stability on the continent.

THE CASE FOR AFRICAN AGRICULTURE

African agriculture is among the most pressing development challenges of today. It has international repercussions since success (or failure) in African (primary) agriculture will have an enormous impact on the international community in its search for greater food production and security. As the emerging world becomes more prosperous, the demand for food increases and changing diets will create demand issues around protein and higher quality foodstuffs. The international Development Community can play a major role, but only if it is willing to modify its current approach by putting more emphasis on the Private Sector.

Individual success stories are heartening and commendable, but until progress is made on a broad basis, they will remain mere historical footnotes. Sectors thrive when a threshold of critical mass has been crossed. Smallholder farmers in Africa play a vital role, but to place the burden of food production solely on them is one dimensional and often an excuse for not tackling the real difficulties head on. Instead, small and medium sized enterprises (SMEs) – operating commercially, using technology where it delivers productivity, embracing change and willing to take risks – must be part of the solution. Africa needs thousands of successful commercially run SMEs; they cannot be centrally planned, but the conditions to make them successful can be put in place. First and foremost, this means risk capital and a willingness to embrace commercial success and to withstand failures. This is not an advocacy for 'anything goes'; vulnerable constituencies (smallholders, the environment) need to be considered; however, protecting them does not mean standing still.

SEEKING COHERENT FINANCIAL POLICIES

A great deal of material is presented by the academic community, by major development agencies, foundations and NGOs on the most appropriate policies for the agriculture sector. The aid allocated by the international Development Community that targets African agriculture is increasing. Yet the fact remains that African agriculture is at best 'a work in progress'. Its potential continues to be unfulfilled and if analyzed over any length of time, the performance has been weak.

The topic of food security has reached an international dimension in recent years. This is largely the result of increased volatility in food prices, which has led to substantial political and social unrest in parts of the developing world (e.g. Mozambique in 2010). In 2009 at the G8 meetings in L'Aquila, the world's leaders made a multibillion dollar pledge to tackle food security. Similar pledges were made at other global summits in Rio and Mexico. Yet progress seems haphazard and too few new bold ideas are being pursued.

Current opinion on the most suitable policies is polarized between those that focus their interventions around strengthening the smallholder model, thus preserving the status quo, and the more recent private equity style intervention where money has been channelled into funds that are mandated to make commercial investments. While this latter approach has worked in some parts of the world, most notably Latin America, in Africa the jury is still out.

THE ROLE OF GOVERNMENT

All over the world, governments are intimately involved in the agriculture sector. In most developed countries the sector is heavily supported by government subsidies and often by favourable trade policies.

In countries such as Brazil (deemed to have benefitted from an agricultural revolution), the government was critical in the early phases. In other BRICs there is evidence that governments help through state owned development banks such as the Russian Agricultural Bank or through fuel and fertilizer subsidies as happens in India.

In Africa, governments have far less financial flexibility. Where the government finances can bear the burden, some governments are playing a substantive role (notably in South Africa or most recently in Nigeria). However, in most African countries government finances are simply not available to provide the necessary resources.

This creates the very opportunity where the international Development Community can have an impact. For this to be done successfully there needs to be a change in the current approach to financing the sector. Most importantly the Development Community needs to support the concept that in Africa, their funds should be used to build sustainable businesses and not just to fund studies or to support only the smallholder sector. While supporting smallholders can have a beneficial short term impact, in the long run Donors need to focus on what is likely to provide the most sustainable model. Countries such as Brazil have faced this challenge and allowed the market to dictate the necessary changes.

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The Need to Avoid Shadow Governments

We believe that the Development Community has a role to play in building African agriculture and that this should be done through providing capital and technical assistance. The underlying aim should be to help create businesses that over time have the potential to be financially sustainable. All too often the DFIs end up creating initiatives that have no prospect of becoming self sustainable. To support and monitor these efforts, unwieldy and bureaucratic structures are being put in place. These operate like 'shadow governments' with many of the bureaucratic disadvantages, but without providing any funding. All too often more time is spent on analyzing the problem than actually building businesses.

The Importance of Finance

It is surprising how many reports are being written about building a sustainable African agriculture platform without any focus on issues relating to finance. Most of the currently available literature is written primarily from the vantage point of theoretical development economics. This manifests itself in a number of ways:

Firstly, there is not enough analysis of the extent to which sustainability has to embrace the need for profitability and hence 'financial sustainability'. In our experience most companies fail because their business model is flawed or insufficiently capitalized, rather than because they are not 'green enough' or 'inclusive enough'. It is commendable that new businesses should be pushed to embrace a number of development metrics such that African agriculture is nudged to develop along responsible lines. However (and this is certainly not mutually exclusive), it should be remembered that the absolute key to sustainability is financial viability.

Only if this sector is profitable can it be relied upon to increase rural wages and offer secure employment to the rural poor. Only financially robust businesses will have resilience to withstand the inevitable volatility of agricultural markets in the absence of government support. A model which relies on constant and increasing donor support is unsustainable.

The second aspect of finance that is important to consider is the process by which international funds are allocated to African agriculture. This is particularly important since a significant part of the funding is aid.

It is perfectly understandable that government aid should be used to eradicate hunger and to help humanitarian emergencies. However, to the extent that Donors wish to use their funds to build sustainable businesses, this must be done within commercial parameters. Donor funds can play an invaluable role in risk mitigation, providing low cost debt and equity and in strengthening financial balance sheets. But the process must exist for the DFIs to be able to do this. Currently the Development Community seems to be in a quandary. They articulate many of these objectives but clearly lack the know-how or resources in order to implement their strategic goals. Almost always they fail because they try to avoid the discipline of financial goals and argue they are better replaced with development or social goals.

Thirdly, one needs to look at the nature of markets – how they are best developed or even started. The most robust markets exist where there are many financially healthy players, where the cost of entry is low and where information is easily available to all interested parties. In the context of African agriculture the best way that the Development Community can help is to encourage new firms to start, to help them grow by providing capital and to undertake policy or technical assistance to enable better information flows. They should resist the urge to think that markets benefit from propping up the weakest participants; support needs to go to businesses that have the potential to become leading market players.

Africa is not Different

Too often we hear that because of the prevailing market structure in Africa, commercial solutions need to be compromised in favour of purely developmental ones. We think this profoundly patronizing and unlikely to build the sustainable models that Africans so desperately need. As advisers to, and investors in African agriculture we see no evidence that Africans want to be treated differently. Like everywhere else, economic development, prosperity and personal fulfilment are aspirations that motivate Africans. Africa may need tailored approaches to economic growth, but like anywhere else, economic growth requires commercial sustainability.

An SME (African or otherwise) is an ongoing commercial concern, professionally run, capable of innovation and seeking to generate a return on invested capital. We should not redefine what constitutes commercial and sustainable to suit ideology or a specific geographically focused development mission.

SMEs, the Importance of Primary Production

Many of the DFIs would argue that they are already making a large commitment to supporting the development of African agriculture and that they have done so for decades. Maybe so, but the results have not been compelling.

Their current policies are either polarized around propping up the smallholder farmer (which is another way of perpetuating subsistence) or more recently they have begun to invest in various funds which make private equity style investments. These funds almost exclusively seek to invest in established existing medium and large businesses operating in downstream activities. *Primary agriculture and start up businesses are explicitly or implicitly avoided and deemed too risky.*

Yet there is strong evidence from Africa and elsewhere that the most robust and innovative growth is created by encouraging SMEs. These businesses are the platform for the most able entrepreneurs that develop new and attractive business models that best fit their local markets. We believe in the context of African agriculture it is imperative to support SMEs. Success begets success and more viable SMEs will give rise to more African entrepreneurs (as is evidenced by the vibrant and growing African internet and technology start up sectors within Kenya and Nigeria). They will be the source of businesses that best understand local markets and which are wedded to their local communities. They are the most likely to produce goods for local consumption rather than purely for export.

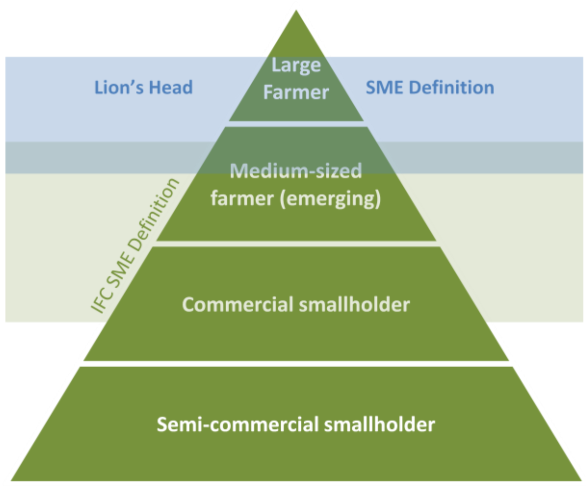
Yet so many DFIs find this sector too risky. This is counterintuitive because risk on its own is meaningless. Risk relative to returns is the metric that should drive decision making. A DFI setting out to promote African agriculture should find the blended return between financial and development payback very compelling. If DFIs don't give extra weight to development outcomes, then they are no different than other institutional investors.

Similarly, it is all very well to set up funds to invest mainly in downstream businesses, but there is an equal or greater need to build local sources of primary production. Without reliable primary businesses it is difficult to conceive of robust value chains that can benefit anyone – let alone Africa. Once again the DFIs and foundations deliberately shy away from primary agriculture, shifting instead the burden of producing food onto smallholder farmers. They are coming up short in an area where they could play a leading role.

Defining SME

There is sometimes confusion over the term SME. We advocate moving beyond the narrow definition proposed by the IFC and others which considers this sector to be just above the smallholders. Such businesses are likely to be subscale and remain difficult commercial propositions.

Figure 1: IFC Definition of SMEs (IFC, 2011)



Lion's Head SMEs | IFC SME Definition

IFC Definitions	Large	Medium	Commercial Smallholder	Semi-Commercial
Land	>500ha	2-500ha	2-20	<2ha
Labour	Skilled	Family/external	Primarily family	Family
Technology	Mechanized	Partly mechanized	Minimal mechanization	Low technology
Resources	Bank/ external	Limited access to bank loans	Informal finance	Limited resources
Production	Commercial	Largely commercial	Cash/food	Subsistence
Value Chain	Well positioned	Weak	Dependent on group	Vulnerable

Our alternative definition is illustrated in Figure 1. We advocate using a definition that embraces businesses that are slightly larger on the basis that providing them with growth capital can be hugely beneficial for African agriculture. These are farms that are big enough to use the latest farming technology, are mostly set up by local entrepreneurs and importantly, attract a range of service providers (inputs, equipment, logistics, etc.) that create the supporting infrastructure that is essential for systemic change.

Many will argue that because they operate on commercial principles they have access to commercial funding. This is clearly not the case – the dearth of commercial SMEs is a result of no institutional market for risk capital and the DFIs' unwillingness to engage with early stage, primary agriculture businesses. <u>We argue that commercial SMEs are the missing middle that has true transformational potential</u>.

Sustainability Matters

There is no doubt that agriculture is too sensitive (socially, environmentally and politically) to be solely governed by market forces. In Europe and the US we have the benefit of tight regulations and established support systems for farming communities. In Africa, the legal environment and enforcement of regulations are often weak. Capital providers can play a role in enforcing certain standards. We can observe in Latin America and South East Asia how operating commercially without any checks and balances, especially on a very large scale (20,000ha+ farms), often leads to practices that ignore the wellbeing of other stakeholders or the environment.

Capital can seek to enforce certain standards; however, the best practices are implemented by operators on the ground. Arguably, the commercial SME operators are the most likely to preserve the environment and treat their stakeholders with consideration. By contrast the subsistence farmer is locked in a daily battle for survival and can often not afford to consider externalities. He will frequently plant in riverbeds, cut down bush-land and employ other environmentally damaging practices as long as they promise a return in the short term. The commercial smallholder (as defined by the IFC), whilst more attuned to his environment, often does not have the wherewithal to apply the latest technology such as zero-till farming and other conservation practices.

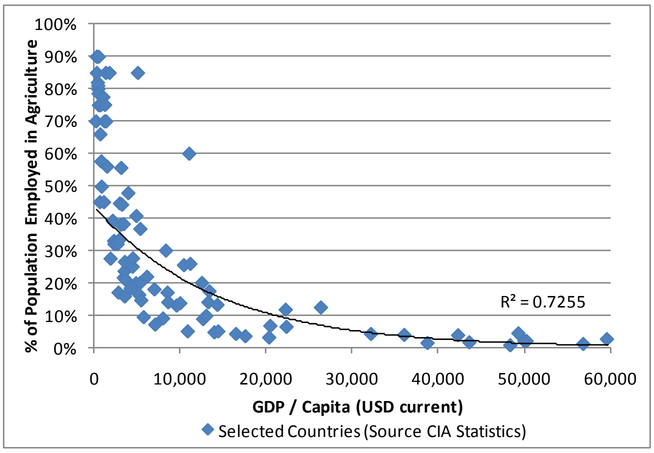
Commercial SMEs are typically set up by African farmers and/or local entrepreneurs. With roots in Africa they appreciate how precious African land is and understand the implications of working with local communities. They are more likely to employ and work with local farmers and focus on environmental preservation than most other farming models.

Structural Change

Developing African agriculture invariably leads to change, a key part of which is a rapid decrease of the population employed in agriculture. Virtually every country has undergone a dramatic transformation of its agriculture sector as part of achieving economic progress. Figure 2 suggests that this negative correlation between GDP/capita and % of the population employed in agriculture is a necessary outcome rather than a choice that governments can make. Agricultural productivity vs.

other industries is one of the key causes. This is of concern for many development organizations and often leads to policies that seek to preserve the status quo.

FIGURE 2: GDP/CAPITA VS. % OF POPULATION IN THE AGRICULTURE SECTOR



Change can be a good thing. The evidence for this is overwhelming given the success of developing countries, including those in Africa, over the past 30 years. Sustainability should accompany change and not seek to prevent it.

THE POWER OF CRITICAL MASS

Over the past few years, agricultural growth corridors have been touted as models to kick start African agriculture. Corridors in Beira, Tanzania, Ghana have been identified as high potential areas. The logic is sound – promoting agricultural activities in conjunction with better infrastructure and services will improve productivity and reduce risks. However, the approach to implementation is often flawed. Too much emphasis is placed on a 'centrally planned' solution and too little trust is put in the transformative potential of commercial SMEs. A strategy that focuses on economic growth delivered by smallholders requires direct top down intervention – which has proven to be costly and inefficient. Supporting commercially sustainable businesses that achieve productivity gains using latest technology and inputs does not require central planning. It needs an enabling environment. In the western world, this entails tax breaks, subsidies and downside protection through insurance. As mentioned above, the vast majority of African governments do not have the tools to channel capital into the sector. Donors can and should step in here and play a catalyzing role. Success is the greatest catalyst and success requires broad-based entrepreneurial activity. The single most important limiting factor in most African countries is the lack of risk capital – of which Donors are amply endowed.

CONCLUSIONS

This paper provides a brief analysis of the major policy issues that surround African agriculture. We believe that for progress to happen, a change in much of the current orthodoxy is needed – in particular the views of the Development Community. The main conclusions we offer are:

1) African agriculture will only progress if policies have a commercial orientation.
2) Capital is the major constraint for this sector. Current policies are failing to allocate sufficient capital to commercial SMEs that can be the engine of growth or to the primary sector, which is crucial for addressing production and food security.
3) Critical mass is one of the most powerful transformational factors. The goal has to be to promote a large number of commercial SMEs, rather than 'picking winners'.
4) Much of the current academic and policy work is based in economic theory. It would benefit greatly from applying more empirical analysis from commercial operators and the financial markets. Financial sustainability is crucial for building sustainable agriculture models.

Lion's Head Overview

Lion's Head Global Partners is a specialized merchant bank based in London focusing on emerging markets and sub-Saharan Africa in particular. We provide financial advisory services across a range of sectors, including agriculture, health care, education, financial intermediation and infrastructure. We assist clients in raising capital and corporate finance transactions, including mergers, acquisitions and divestitures. Our approach is problem focused and solutions oriented. Lion's Head tries to differentiate its offering by looking to deliver tangible outcomes and transactionable solutions.

Lion's Head is also engaged in asset management activities. We have invested proprietary capital in agriculture operations in East Africa and continue to expand our involvement by helping our portfolio companies to grow. Lion's Head furthermore acts as fund manager of the Global Health Investment Fund (GHIF), a Gates Foundation sponsored, healthcare focused investment vehicle. GHIF's mission is to fund late stage trials for, commercialization of and interventions related to drugs developed to combat diseases that afflict predominantly third-world countries.