A TALE OF TWO AFRICAN AGRICULTURAL FUNDS

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INTRODUCTION

"Agriculture has done more to reshape the natural world than anything else we humans do, both its landscapes and the composition of its flora and fauna. Our eating also constitutes a relationship with dozens of other species—plants, animals, and fungi—with which we have coevolved to the point where our fates are deeply entwined."

\- Michael Pollan: The Omnivore's Dilemma

Imagine for a moment that you are a South African family office investor who is tasked with integrating agriculture into the family portfolio. The family that you represent is interested in diversifying their financial portfolio and capitalising on the financial returns in agriculture, as well as creating access to basic livelihoods in their impact portfolio. You have been asked to look for investment opportunities that will achieve above market returns with a sustainable impact in Sub Saharan Africa.

As their advisor, you have reviewed the options. One option is to invest in futures or single stocks in publicly-held agriculture businesses, but while this would be an easy choice, it seems rather risky. As an alternative, you have been reviewing private equity funds that specialise in agricultural investments and seem to have an acceptable financial return track record and are also generating social impact. There are a few funds that focus on Sub Saharan Africa, however their strategies seem to be very different. You have narrowed down the choice to two funds, but you can only choose one because of the minimum investments required by each of the funds.

You have had your analyst draft up a one-pager on each of the funds and you have now sat down to review the work that she has done. Within an hour, the family representative will be arriving at your office to look over the options: what will you advise?

INVESTING IN AGRICULTURE

Agriculture is one of the oldest industries in the world and perhaps one of the easiest to understand: investment in agriculture is, in many ways, a simple economic case of supply and demand. As the world population continues to grow, there is a growing demand for food. At the same time, arable land is decreasing as the world population becomes ever more urbanised. Food demand increases at a faster pace than population growth, since dietary patterns shift as incomes increase. Demand for certain crops have also increased due to advances in biofuel technology.

Therefore, investments in agriculture often follow the pattern of investing in increased capacity for food production, or in the services and technology that increase food production. Investments in agriculture can offer portfolio diversification as they generally have low to negative correlation to equities and bonds, as well as resistant to inflation with less economic sensitivity. They also allow for investment across a variety of asset classes, including debt, equity, and real assets.

However, there are unique risks associated with agricultural investment. Short-term investments are subject to weather, commodity prices, environmental considerations, and dietary fads; long-term investments, particularly those in emerging markets, are subject to political risk if land ownership is under dispute. Some sub-sectors of agriculture are less formalised than other sectors, with a lack of historical performance, indices and reporting that are available to other industries.

Investing in agriculture has many inroads. Investment can be taken at several levels, including primary production (land development, farming, livestock), secondary (milling, processing, refining and packaging), and tertiary (services and infrastructure). Investment returns are gained from a variety of sources, including real asset appreciation on land development, increased capacity and productivity gains from implementation of best practices and technologies, and value-added products and services that capitalise on the world's insatiable appetite for more and better food options.

IMPACT CASE

According to the United Nations Food and Agriculture Organization (FAO), investing in agriculture "is one of the most important and effective strategies for economic growth and poverty reduction in rural areas" and "GDP growth in agriculture…[is] twice as effective in reducing poverty as growth originating in other sectors."[i] However, investing in agriculture with a lens toward basic livelihoods is as much a question of how as how much.

Investment in agricultural productivity adds to food security in a variety of ways: increased food availability leads to lower prices, contributing to food accessibility by consumers, who then supplement with greater variety and better nutrition. Increases in world food stocks reduce susceptibility to supply shocks, and create greater stability worldwide.

Agriculture is also a fundamental source of employment, particularly in developing countries. As of 2009, agriculture employed over one billion people worldwide and these workers were far more likely to be poor, female and unskilled.[ii] Therefore, agricultural investment is a large driver of rural employment, which in turn generates further demand for goods and services in rural communities.

However, not all agricultural investment is beneficial to communities. In the last 10 years, increasing foreign direct investment has focused on acquiring prime agricultural land in poor countries to secure natural resources for export. This type of investment has been criticised in particular for decreasing the food security of local communities, relying on imported labour and technology, and not contributing to the sustainability of local economies. Investing in agriculture, therefore, needs to take into account both global and local perspectives, and provisions need to be put in place to ensure that livelihoods, particularly of rural and subsistence farmers, are secure.

CHOOSING AN INVESTMENT STRATEGY

With more than US$80 billion per year in investment needed to meet world food demand by 2050, and increasing prices for food worldwide, you know that there is sufficient case for investing in agriculture. The question is, how?

The funds in front of you have very different strategies, financial returns, geographic coverage and socio-economic impact. You know that the family you are representing has an investment mandate to improve their capital position, while also improving basic livelihoods in Sub Saharan Africa. You are tasked with maximising both financial and impact returns simultaneously.

From an impact perspective, the family has a history of investing in both job creation and food security programs, so they seem to be equally persuaded by these types of impact.

What course of action will you advise to the family, and why?

FUTUREGROWTH AFRICAN AGRICULTURAL FUND

Overview

The African Agricultural Fund (AAF) invests in agricultural land, biological assets, agricultural infrastructure and related farming implements. The fund invests in farmland and infrastructure by purchasing underproductive African land assets and leasing them out to professional operators who increase farm productivity. AAF's investment objective is to outperform the hurdle rate of 12% per annum before deduction of taxes and fees over the fund period of 12 years. Income is reinvested over a rolling 3-year period.

AAF typically follows a J-curve effect (less pronounced than private equity funds due to lease fee income received) and returns in the initial years may be diluted due to capital outlay required for expansion and development of farms.

Fund Manager

AAF is managed by Futuregrowth Asset Management, a South African-based specialist investment company with a 20-year track record of managing interest bearing and developmental assets in an ethical and sustainable way. They are managing the fund in partnership with Fund Advisor United Farmers Fund Agri Asset Management (UFF), a specialist agricultural asset manager.

Investment Thesis

AAF's model is to purchase farmland, lease the land to a professional operator, extend and enhance the value of the farm during the fund term, and then realise an attractive return upon exit 10-12 years later. The fund acquires under-performing farmland at a discounted price, and then leases the land back to a professional operator who uses technology, information systems and marketing and distribution networks to increase the productivity and output of the farm. Additional capital is used to develop adjacent land, as well as improve community livelihoods through investment in education, healthcare and skills transfer. Initial returns are generated through lease fees generally 8% of the farm value, and then profit upon final sale of the farmland. Target exit is through sale of the land to a large scale professional operator or the community at fair market value.

Impact Thesis

The fund seeks to achieve social impact by increasing land productivity, leading to increased food production, as well as employment opportunities and environmental stewardship. The appointed operator is contractually required to maintain the existing workforce so that no jobs are lost in the handover. Furthermore, the operator must maintain IFC environmental, social and safety standards as well as comply with Global GAP certification. Additionally, the fund commits a minimum of 0.5% of invested capital per annum to community improvements, resulting in increased healthcare, education and housing for permanent farm workers.

TABLE: AFRICAN AGRICULTURAL FUND

Investor Type:
Equity and equity related, with up to 10% in debt instruments

Founded:
September 2012

Structure and Domicile:
Luxembourg SICAV

Geographic Scope: Africa;
South Africa fund is used for illustrative purposes

Size:
ZAR 467 million
(~US$39 million)

Average investment size:
Minimum investment ZAR 50 million for an investor. Minimum initial investment per farm by the fund is ZAR 30 million, but the company must be able to expand and consolidate to ZAR 200 million in the short term

Distribution:
Private placement through intermediaries

Fees:
1.75% management fee; 12% in USD as hurdle; carry of 20% of outperformance after management fees, payable on wind-up of fund

ILLUSTRATIVE DEAL: PICKETBERG FARM

November 2011

Acquired by consolidation of three deciduous and stone fruit farms with committed capital of ZAR 83.8 million. Lease fee is 8% with annual CPI-linked escalation. Expansion potential is significant, which will contribute 100 new jobs.

TABLE 1: IMPACT REPORTING (2014)

		Marble Hall	Northern Cape Grape Farms	Piketberg	Eshowe	Total
Permanent employees* (workers with contracts longer than 1 year)	At take-on:	25	94	102	83	304
	At Dec 2014:	**67**	**83**	**127**	**82**	**359**
Seasonal workers*, depending on season	Currently, up to:	450	950	520	440	2360
Projected new jobs (permanent & seasonal), due to expansion	Projected new jobs:	300	465	100	212	1077
Employees with access to pre-paid primary healthcare	At take-on:	0	0	0	0	0
	At Dec 2014:	**66**	**0**	**71**	**104**	**241**
Employees with access to HIV/AIDS services	At take-on:	0	0	0	0	0
	At Dec 2014:	**66**	**0**	**71**	**104**	**241**
Employees receiving adult education	At take-on:	0	0	0	9	9
	At Dec 2014:	**34**	**34**	**7**	**12**	**87**
Employees receiving management training	At take-on:	0	0	0	0	0
	At Dec 2014:	**8**	**3**	**11**	**6**	**28**

AFRICAN AGRICULTURAL CAPITAL FUND

Overview
The African Agricultural Capital Fund (AACF) invests in small and medium sized agricultural companies with the aim of improving livelihoods for smallholder farmers in East Africa. AACF invests in scaling enterprises that provide improved access to goods, services, employment opportunities and markets for farmers. The fund has received investment from the Bill and Melinda Gates Foundation, JP Morgan, the Gatsby Charitable Foundation and the Rockefeller Foundation. The fund's investment objective is gross returns of at least 15%. The fund's social impact objective is to positively affect at least 250,000 smallholder farmers by increasing individual household income by at least US$80 per household per year.

Fund Manager
AACF is managed by Pearl Capital Partners (Pearl), a specialist agricultural investment firm that has been investing in East African agribusinesses since 2006. Pearl has nine years' experience in SME investing in East Africa. To date, the company has invested in over 30 businesses and has a presence in 7 countries. Pearl is currently managing three SME agri-focused funds: African Agricultural Capital Ltd (AAC), African Seed Investment Fund (ASIF), and AACF.

Investment Thesis
AACF invests in businesses that either (1) buy outputs from smallholder farmers; or (2) sell inputs to smallholder farmers. Pearl has made approximately eight investments under AACF ranging from US$600,000 to US$3.8 million each. These investments are debt, quasi-equity and equity, with an emphasis on equity. The companies have included an integrated poultry farming business, a produce exporter, a floriculture exporter and a dairy processing plant. To catalyse private investment at the inception of AACF, the United States Agency for International Development (USAID) provided a 50% debt guarantee to JP Morgan's investment.

Impact Thesis
AACF invests in companies that can provide market opportunities to smallholder farmers, defined as farms with <10 acres. The aim is to identify portfolio companies that have the potential to grow, thereby procuring more product from farmers and increasing smallholder incomes. Impact is measured by the number of smallholder farmers impacted and the increase in income that the smallholder farmers receive from the investment. The fund screens investment opportunities against its impact thesis and presents the prospective investment to an impact committee consisting of the major investors prior to financial due diligence.

As part of the initial fund capitalisation by the five major investors, USAID also provided funding for a technical assistance (TA) facility to be used to sustain and improve AACF's portfolio companies' capacity. Through this facility, Pearl and USAID jointly determine the need for TA by each investee company, and then identify an expert provider to provide the assistance. Assistance can include agronomic/post-harvest expertise or business development and management support.

TABLE: AFRICAN AGRICULTURAL CAPITAL FUND

Investor Type:
Mixed—Equity, quasi-equity, equity-related and debt

Founded:
2011

Structure and Domicile:
Mauritius

Geographic Scope:
Kenya, Uganda, Tanzania and wider East African region

Size:
US$25 million

Average investment size:
US$1.8 million

Distribution:
Private placement

Fund term:
10 years, 2-year extension option

Fees:
2% of committed capital or 2.5% of invested capital, whichever is greater; carry of 20% of distributions after full return of capital to investors, plus preferred return of 6% per annum

ILLUSTRATIVE DEAL: BIYINZIKA 2006
Biyinzika manages hatcheries and poultry feed processing facilities supporting the sale of day-old chicks and poultry feeds to Ugandan and regional smallholder farmers.

AACF provided loans of US$1.2 million from 2006-2011 which were fully paid by 2011, helping it to become the leading integrated poultry company in Uganda. In 2013 AACF invested US$2.5M in equity. Biyinzika has also recently attracted other equity investors to support further growth.

TABLE 1: IMPACT REPORTING (2014)

The impact assessment for the Fund is summarised under the broad criteria that in aggregate, through growth enabled investments; the portfolio companies will impact 250,000 smallholder households, and estimates that these beneficiaries will realise an increase of at least US$80 in annual income within five (5) years of the relevant investment. Below is a summary update of the impact achieved and expected both in terms of number of farmers and annual incremental incomes.

Company	Invest. Date	Target Impact 2014		Achieved Impact 2014		Target Impact (2015)		Target Impact (5th Year)	
		No of farmers	Income benefit	No of farmers	Income benefit	No of farmers	Income benefit	No of farmers	Income benefit
Company 1	May-12	2,500	116	2,479	11	3,000	141	3,000	167
Company 2	May-12	0	0	0	0	0	0	0	0
Company 3	Dec-12	638	687	500	-1,134	0	0	0	0
Company 4	Aug-13	9,173	387	10,750	618	21,403	557	48,875	677
Company 5	Dec-13	1,782	375	2,040	101	2,176	549	7,713	1,109
Company 6	Dec-13	1,891	388	633	292	700	620	10,613	1,824
Company 7	Jun-14	612	-130	613	-271	4,769	-21	7,443	98
Company 8	Dec-14	n/a	0	n/a	n/a	10,000	86	10,000	341
Sub-total		16,597	228	17,015	-55	42,048	241	87,645	527
AACF Fund	**Sep-11**							**250,000**	**80**

ENDNOTES

[i] Food and Agriculture Organization of the United Nations. “Investment in Agriculture.” Accessed 15 June 2015. http://www.fao.org/investment-in-agriculture/en/.

[ii] Food and Agriculture Organization of the United Nations. Accessed 15 June 2015. http://www.fao.org/docrep/015/i2490e/i2490e01b.pdf