GATSBY

AFRICAN AGRICULTURAL CAPITAL

OCTOBER 2011

In 2005, Gatsby joined the Rockefeller Foundation and Volksvermogen, a Belgian investor, to establish a new East African company: African Agricultural Capital. A pioneer in the impact investment field, AAC now has $42m under management which it invests in growing small and medium-sized enterprises (SMEs) who play a vital role in East Africa's agricultural markets.

East African agricultural markets are often uncompetitive and lacking innovation, which has a detrimental effect on the smallholder producers who depend on them. A shortage of growth capital for high-potential SMEs is a major cause of the problem.

AAC is a venture capital fund which invests in these businesses. The growth capital provided allows them to expand and benefit farmers who depend on them for markets, inputs or services.

AAC is tasked with achieving commercial returns in order to prove investment in this segment can be profitable, with the ultimate aim of crowding in private sector investors to further scale impact to transformative levels.

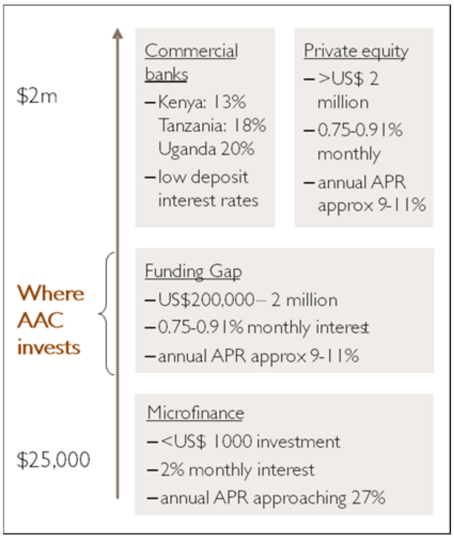
Avocado plantation at Africado, Tanzania

A SHORTAGE OF CAPITAL

SMEs have a critical role to play in stimulating the growth and development of agriculture in East Africa. They provide access to markets for smallholder farmers by stimulating new value chains, adding value to agricultural products and connecting smallholders with buyers and customers. And they provide the "last mile" of distribution for inputs, allowing smallholders to access the improved seed and fertiliser which drive up productivity.

Unfortunately, these SMEs are struggling to find the credit they need to expand. Large-scale commercial banks in the region, having suffered high levels of loan write-off in the agriculture sector in the past due to political interference, are now extremely reluctant to lend to SMEs in the agriculture sector. On the other hand, microfinance institutions mostly make individual loans of less than $1,000, which are wholly unsuitable for business finance.

Gatsby, with the Rockefeller Foundation and Volksvermogen, a Belgian impact investor, capitalised AAC with $7m to explore a solution. AAC was tasked with investing debt or equity in high-growth SMEs, achieving a commercial return which would crowd in other investors, while impacting large numbers of smallholder farmers by bringing them into markets.



THE OPPORTUNITY

The companies in which AAC has invested cover three models of agribusiness. Inputs companies provide farmers with the tools to be productive: mostly improved seed, but also small "acre packs" of fertiliser and chemicals. Since 2009 such businesses, which reach very large numbers of farmers, have also been the focus of the African

Seed Investment Fund (ASIF), a dedicated fund run by the AAC management team on behalf of AGRA with a total of $12m to invest in seed companies across East and Southern Africa. Secondly, market off-takers provide farmers with higher prices for their produce, or open up new categories of product for which no market previously existed. Examples at AAC include avocado and honey businesses. Finally, service businesses add value indirectly: certification for high-value exports, for example.

In order not to constrain these SMEs, AAC has a range of financial products suitable for different business models at different stages of growth. In some cases loans are the most useful and secure form of finance, but both equity stakes and quasi-equity royalty or profit share products are also used. AAC is typically the only willing investor in companies which have exhausted all existing forms of finance, and often rely on the entrepreneur's personal resources.

In addition to finance, management support is provided on financial, strategic and operational issues. This is highly valued by management teams, and viewed as a key driver of strong market performance.

DEMONSTRABLE IMPACT

AAC recently conducted an in-depth case study of its impact, profiling five of its investees who comprise around 30% of the portfolio by value and between them cover all the types of business described above. The sample saw significant business growth arising from investment, with total turnover across the five businesses increasing 30% since investment. Profits and customer numbers were also up sharply. All have since gone on to raise third party investment.

> "Post-investment growth: 30% turnover increase, 170% profit improvement and 15% growth in customer numbers"[1]

Direct social impact has been significant. The core activities of the five investees has had a positive impact on 1.4m smallholder farmers, mostly through sales of improved

Insectary at Real IPM, Kenya

seed. Companies buying from smallholder outgrowers offer alternatives to farmers whose traditional crops are in decline, or in post-conflict areas where income-generating opportunities are limited.

> "In a sample of just five businesses, over 350,000 *additional* smallholder farmers have benefited since AAC's original investment"[2]

Perhaps most importantly, however, AAC demonstrated how individual company investments can grow entire markets. Naseco and Western Seed now have respective market shares of 25% in Uganda and 30% in Kenya's mid-altitude market. Bee Natural has helped commercialise the East African honey industry; Africado is northern Tanzania's only large-scale avocado exporter; and Africert is the dominant certification provider in East Africa, driving up production standards across the continent.

SCALING UP

AAC was established with the intention to prove a concept. To attract additional capital, however, the right corporate structure was needed to offer an attractive opportunity for new investors. After consultation, it was decided that a closed-end private equity fund, with its guaranteed timeframe for return of capital and its transparent fee structure, was more appealing to the investor community than the existing limited company. AAC has therefore been restructred with the management team setting up Pearl Capital Partners (PCP), a new fund management company. After two years of fundraising, a new $25m fund (the AAC Fund) has recently been closed, with investment from the Bill and Melinda Gates Foundation and JP Morgan in addition to the Rockefeller and Gatsby Foundations.

A SUSTAINABLE FUTURE

This new Fund will continue AAC's original strategy of SME investment. However, in doing so it will aim to learn lessons from AAC's experience – two in particular. Firstly, as in any Western market, an investee's success is related to its ability to command strong market share within its industry segment – the new Fund will focus on such businesses. Secondly, a good business needs to be turned into a good return on capital. AAC has had a number of success stories where it did not capture the value created by its investment.[3]

The new Fund will also take a more explicit approach to measuring social benefit. Deals will be screened up front by an "Impact Committee", and then at least a proportion will be formally evaluated so that the impact of SME finance on smallholders can be better understood.

AAC has been a pioneer of impact investment in East Africa and remains the region's only investor focused on SMEs in the agricultural sector. Gatsby is now working to ensure that the new AAC Fund has a similar commitment to social impact, so that smallholders continue to be the main beneficiaries of the initiative.

1 "Understanding financial and social impact of investments in East African agricultural businesses", PCP (2011)
2 "Understanding financial and social impact of investments in East African agricultural businesses", PCP (2011)
3 As a result, its gross ROI is only expected to be around 9% where the new Fund is targeting 14-15%.

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