INVESTOR OUTLOOK

Financing Africa's Food Systems

Introduction

The Agribusiness Dealroom organized an Investor Roundtable aimed at better understanding the challenges and opportunities from the investors perspective in serving the "Missing Middle". For this purpose, the Missing Middle was defined to be the financing needs of agri-Small and Medium Enterprises (SMEs) ranging from USD 50k to USD 500k.

The roundtable discussed most pressing challenges including return expectations, risk mindset, the role of Investment Committee (IC) members, as well as incentive structure challenges (potential grant dependency of SMEs vs. mission drift of funds).

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Investors Perspective

THE CHALLENGE

1. **A mismatch between supply and demand**

There is a consensus that the lack of financing is not the reason that the missing middle is not being serviced. The main question is what needs to be in place to channel the available funds to reach the agri-SMEs who need funding.

One global funder of funds mentioned that they have over USD 5 billion in grant funding available (e.g., to be potentially used for de-risking facilities) but received not a single proposal from African institutions. They further mentioned that when talking to investors, they say they do not see any bankable projects, while when they talk to project developers, they say they cannot access capital.

How do we customize in order to deploy capital to the African continent?

2. **Poor coordination**

The funds are available but they are not flowing into the African agriculture sector. Furthermore, new investment funds are regularly established, but they remain relatively small with significant overhead costs. All these funds compete for the same handful of investable SMEs, who have a risk profile in line with most financiers' investment criteria. As a result, the investors's impact remains limited.

How do we meet the needs of all SMEs?

3. **Heavy regulation of traditional debt providers and high risk classification of agricultural loans**

Deposit taking financial institutions are heavily regulated and limited in the risk they can be exposed to even with blended risk facilities. This gap can be filled by NDFIs such as impact funds, private equity and venture capital, however, these capital providers have smaller agriculture portfolios due to the their limited access to de-risking facilities, therefore limited capacity to expand exposure.

How do we de-risk non traditional lenders?

4. **The risk, return, and impact perspective**

In straightforward risk management, one benchmarks against other sectors. The double-digit returns, which can be achieved in sectors such as construction, are not realistic in the agricultural sector.

One participant thought that financiers need to take a strategic view of risk management in agriculture, and that means taking on more risk.

The feeling was that investors avoided this risk and asked for relatively high securities and/or numerous requirements from agri-SMEs to offset it. There is a need for a more systemic view on financing agriculture and there are examples we can learn from. A policy perspective needs to be developed, including a long-term view of which commodities need to be scaled up.

Should investors in agriculture look at risk-return differently?

5. **Lack of an investable pipeline**

There was a resounding view on the lack of a strong investable pipeline, where the gaps ranged from agri-SMEs not being investable, others not investment-ready and others lacking transparency and standards.

On the other hand, because most development programs are mission driven and tend to award these SMEs grants, the TA provided tends to be misaligned with the investors needs and the grants given create SME-Donor dependency. There are examples of SMEs who say they would rather not opt for a loan as it is also possible to receive a grant. "A grant is preferred as we do not need to repay a grant".

From an investor's point of view, the outcomes of development programs that invest a lot of funds in TA are difficult to assess on their added value by investors.

From the enabler's point of view the need was expressed to reflect on themselves and why they are not building an effective pipeline of companies.

What is required to improve the quality and investability of pipeline?

6. **Financing reforms to incentivize commercial banks**

Investment funds aim to service a part of the market, but majority of Ag-SMEs are more suitable for commercial bank capital. In Africa, the role of commercial banks in the sector is relatively small. In 2011, only one per cent of the balance sheet of the commercial banks in Africa was invested in agriculture. Now in 2023, it is estimated to be between 3% and 6% (with some exceptions like in Tanzania where it is much higher). There needs to be other incentives (other than impact) to convince the commercial banks to invest more.

Investors also highlighted the need for the central bank review of its definition of 'agriculture'. Agriculture, as defined today is focused on the production side and its attendant risks, this means that actors further upstream the value chain are either classified as manufacturing or are subjected to an erroneous risk base if classified as agriculture. There is need to review the overall classification and to categorize the central bank risk weighting by sub-sectors.

Can policy incentives unlock increased capital flow to the sector?

Investors Perspective

THE SOLUTIONS

Investors in the room also provided a range of solutions that could be explored to turn the tide and accelerate deal flow to the agriculture sector in Africa.

1. Improved co-ordination

- An Africa agriculture depository that includes ideas, data, and information so we understand the different actors, where they are and how they can engage. There is a need for more collaboration and sharing of instruments and information. A more integrated view is needed.
- An African agribusiness fund that merges the fragmented landscape of investment funds into a one large consolidated fund, so it is easier for those parties who do have a pipeline with bankable agri-SMEs to find financing. The fund will have to develop different types of financing tailored to the diverse needs of SMEs at different stages of development. Supply and demand side constraints need to be addressed simultaneously. Currently, the market is too fragmented. Information is not being shared resulting in duplication in some cases and limited scale in other cases due to the fragmented approach. When speaking of scale, a plea was held to stop thinking that every market or country is unique. Some issues need to be addressed across the continent.

2. Innovations to stimulate the market

- A Pan-African equity exchange for SMEs. It would help the market choose the SMEs that can scale up. Also, an equity exchange for SMEs would help the many investors who are struggling to realize exits. The current markets are not intermediating the capital flow in the way that is needed.

3. Broader based blended facilities

A review of blended facilities, introducing new structures and instruments that are teered to where blending is most effective.

- Establishing blended facilities with non deposit taking financial institutions (NDFI's) such as impact funds and private equity firms. The blended facilities would focus on incentivizing the NDFIs to take part of the risk so that lower returns on impact investing are acceptable.
- Apart from the usual risk-sharing structures, Technical Assistance (TA) can be provided to agri-SMEs as well as capital providers to help lower the risks involved.
- There was a plea for more patient capital and more open-ended vehicles, such as vehicles that can recycle capital. This would give investors the time to find out which structures work and adjust their way of working to incorporate the new lessons learned.

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Some examples of working incentives were highlighted:

- **Regulatory incentives - Tanzania:** A good example of where such incentives have resulted in an increase in the agriculture portfolio is in Tanzania, as was recorded in the AGRA Agribusiness Outlook Report 2023. In Tanzania, the central bank introduced an incentive for commercial banks, where a bank that extends credit to agriculture is eligible to a reduction in SMR amount, equivalent to the loan extended, as long as also, the interest premium on the loan is below 10%.
- **Democratization of sector information:** Subsidizing the costs of data and information gathering around strategic value chains to reduce the due diligence costs of banks. The banks have costs of looking into SMEs because of the lack of sector information. It is important to see how can we generate information for them to make a well-informed decision.
- **Liquidity and capital base support for agriculture banks:** Some banks are facing liquidity issues. If the banks receive funds that bridge this gap, these issues can be addressed. First loss structures helped banks to graduate and launch an SME program. The further TA support helped them to complete this process and make it a success. More examples showed that finance alone is not enough. Risk in agriculture is not always understood by commercial banks. Providing grants to commercial banks for first loss together with an integrated TA fund addresses this problem.

5. Standardizing due diligence assessments

A major disincentive in agri-finance is the cost of transaction vs marginal profit margins. Adding transparency and uniformity on how to assess the investability/bankability of SMEs measure robustness and progress could help reduce the cost of small ticket sizes.

6. Investor re-orientation on the risk-return trade off

Investors in the agricultural space generally aim for a sustainable business model, balancing between returns and impact, as it is their goal to remain in existence for years to come. With return expectations in the range of 20%, the sector can only be attractive if appropriate donor supported subsidies are in place, instruments like first-loss mechanisms, de-risking structures, or other mechanisms that influence the risk levels making it more attractive to invest. To be successful in creating sustainable returns, investors need to blend the more traditional way of looking at investments with the impact they hope to achieve. Maximize impact with sustainable returns and not maximize returns with some impact.

OUR TAKE AWAY

The solutions and ideas shared boil down to the following elements:

Funding is not the problem; it needs to be channelled.

Donors and their partners need to avoid creating donor dependency

The supply and demand side need to be addressed at the same time to bridge the gap

Creating a pipeline of bankable SMEs is the biggest challenge. There are too few investment -ready organizations

TA needs to be provided to SMEs, as well as banks

TA to SMEs needs to be more result-driven, transparent, benchmarked, and uniform

Return on financing agriculture is lower, and therefore structures to share risk are needed.

Impact doesn't only need to be translated into SDGs.

Commercial banks can help scale up, but they need to be incentivized.

Develop larger markets and exchanges. Financiers and SMEs need to be able to find each other more easily.

Governments need to be part of the solution

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The roundtable was organized by the Africa Agribusiness Dealroom, Advance Consulting, African Management Institute and SCOPEinsight.

For more information on the Africa Agribusiness Dealroom visit www.agribusinessdealroom.org