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Agribusiness off-takers Report

CEO Briefing Report

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Show me the buyer

With contract farming on the rise in Africa, is power shifting from the co-operative to the smallholder? **Africa investor** reports on the developments taking place

The problems that smallholder farmers face in Africa are manifold. They find it difficult to access markets and, even when they do, face disproportionately high transaction costs. Banks often won't lend to them, making it difficult to obtain agricultural inputs like seeds and fertilisers, which could raise productivity. Their subsistence nature means that they work on a short-term basis and can't afford to look to long-term growth.

This is where off-take agreements can help. Under such an agreement, an investor typically agrees to provide some upfront investment to the farmer in return for a share of the harvest. Gerard van Empel, Managing Director of Dutch banking group Rabobank's development arm, which promotes investment in rural communities, says well-constructed off-take agreements can significantly shorten the supply chain, leading to a better income for the farmer and cheaper credit.

"In a supply chain, the product moves from the producer to the consumer, but the price mechanism works in reverse," says Van Empel. "The consumer pays a price, everyone takes a profit and whatever is left goes to the farmer."

By linking companies directly to local farmers, explains Van Empel, the supply chain is shortened, resulting in a fairer price for the producer, whilst at the same time the company benefits through increased production and better traceability of products.

"For many farmers, the off-take

> "For many farmers, the off-take industry is the only way that they can grow their business"

industry is the only way that they can grow their business and so it's crucial that we see more of this kind of integration," he says.

A growing number of agribusiness investors are seeing the benefits of working with smallholder farmers, resulting in more and more off-take agreements being negotiated. But there is a problem. For most commercial companies, dealing with thousands of individual smallholders is simply not feasible. It is much easier to deal with a single entity, which can guarantee a consistent supply of good-quality produce.

A central hub

AgDevCo is an agricultural investment company, which works through large commercial farms – principally in Tanzania, Mozambique, Zambia and Ghana – in order to boost the capabilities of smallholders. The model works by negotiating an off-take agreement with a large commercial farm, which then sources produce from a number of smallholders. AgDevCo looks for commercial farms that can increase local productivity by providing technical know-how and access to better inputs, such as high-yield seeds and fertiliser. The cost of these inputs is then deducted from the farmer's revenue at the end of the year.

Such outgrower schemes have been employed within the agricultural sector for a number of years, but Chris Isaac,

Attracting the buyer

The off-take industry can bring obvious benefits to the smallholder farmer. However, off-take contracts are not suitable for all crops. In particular, the fear of side-selling means that buyers tend to stay away from mass-produced staple crops, such as maize, which can be brought to market fairly easily. Nicholas Minot, a research fellow at the International Food Policy Research Institute (IFPRI), thinks that perhaps less than 5% of farmers in Africa have contracts, although the number seems to be growing.

Off-take agreements are most suited to products that have high initial input costs, are high-value (so the off-taker can justify the costs of coordination), are perishable (so the delivery times need to be coordinated) or are unfamiliar to farmers. Some of the crops that in the past have proved most popular with off-takers include: horticulture for processing or export, tea, tobacco, cotton, seed, dairy, poultry, rubber, palm oil and cocoa. Off-takers sometimes take coffee, but in many countries this product is sold through the spot market instead.

Off-take contracts usually work better when the buyer is significantly bigger than the farmer, since the buyer then has better access to credit, inputs and know-how. The destination market for produce purchased in this way will typically be willing to pay a premium for higher quality. A large number of buyers come from Europe and America, with a growing number emerging from China and India.

Amit Agrawal, from Olam, offers some advice about how smallholders should go about attracting buyers for their produce. Trust is very important, he says – farmers must respect contractual clauses and steer clear of side-selling. Farmers should be committed for the long-term, and be willing to share regular information. In some cases, it makes sense for smallholders to organise themselves into farmer groups, since scale can make the relationship more viable and therefore more attractive to the buyer.

The amount that farmers can earn from off-take agreements varies significantly throughout the region. Agricultural consultant David Raad says that it is impossible to give a specific figure for how much an off-taker might be prepared to pay a farmer, since this depends on a number of different factors: the region, the commodity, the producer's place in the value chain and the consumer (whether retail or wholesale).

However Agrawal gives some ballpark figures. He says that, for cashew or cotton products, the farmer will typically get around 50-60% of the CIF value (the costs in bringing the product to market). Comparing farmer income to the final price of the product, a fairly common amount for a farmer to receive seems to be 10% of what the end consumer will pay – and off-takers report that this is an amount that they are happy to pay. One smallholder in South Africa says that this is what he receives for the plants he grows, which eventually end up in medicinal products. However, for his vineyard, the price is much lower: just 5% of the final shelf cost; barely enough to cover expenses.

AGRIBUSINESS OFF-TAKERS REPORT

Director of Business Development at AgDevCo, says that big business has only recently started to see the benefits of long-term investment in the supply chain.

"This model is gaining traction as people see the sense of commercialising small farmers in this way," he says. "For the first time, we are seeing big agribusiness firms signing long-term purchase agreements, where they will explicitly pay a premium over and above what it would cost to import the raw materials, in order to invest in the supply chain."

An alternative to going through a commercial farm is to bring local farmers into a single co-operative structure, and then to negotiate agreements directly with the group. This approach has also been growing in popularity, and is the one favoured by SABMiller, a South African brewer.

"We see smallholders very much as part of the solution rather than part of the problem for agriculture in Africa," says Gerry van den Houten, Technical, Supply Chain and Enterprise Development Director at the firm's South African operations. "Smallholders need to be drawn into mainstream agriculture and the question has always been: how do you give them the skill and resources that they need?"

SABMiller sources produce from both commercial farmers and from smallholders, although the exact proportion that comes from each varies from crop to crop. For a crop that can be easily cultivated and doesn't require a lot of specialist expertise, such as cassava, as much as half might come from the smallholder. But for more technical crops – barley, which requires a lot of irrigation, is one example – it is often necessary to source more from commercial farms.

Binding farmers together in a co-operative structure has a number of advantages, such as facilitating better access to credit and helping to develop a long-term relationship with smallholders.

"If farmers are part of a club, we can help arrange preferential financing for them," says Van den Houten. "Banks normally wouldn't do business with smallholders because of the high risk and the lack of collateral. But if we go to the bank and say that we guarantee the crop, then it's a lot easier for the banks to extend finance to farmers. Moreover, if farmers feel part of a club, they are less likely to sell their produce elsewhere, once we have put all the effort into arranging an off-take agreement."

Product specific

When properly designed, off-take agreements can provide a win-win situation for both sides, boosting productivity for the local farmer whilst at the same time improving market conditions for the off-taker. But off-take agreements suit some agricultural products better than others, and this has influenced how the industry has developed.

For products that are relatively easy to cultivate and sell – maize is an obvious example – there is a very real danger that, once an off-take agreement has been established, the local farmer may decide to sell the produce to someone else, possibly for a better price. Although investors usually have some sort of legal protection, Amit Agrawal, head of agribusiness company Olam International's Ghana office, points out that few investors would be comfortable pursuing farmers for breach of contract.

"If a farmer decided to sell on the side, we would of course be able to seek legal redress under the terms of our off-take agreement, but this carries with it huge reputational risk," he said. "If we were to take away the farmer's property and his land, we'd be perceived as shark lenders. This is not what we do. We're in the business of giving money and buying crops."

This is why companies such as Olam go to such huge lengths to prevent farmers from reneging on their commitments in the first place. For certain crops that require further processing before they can be used – such as rubber, cotton and cocoa – or for perishable goods that need to be used quite quickly – such as cassava and milk – the issue of side-selling doesn't tend to arise. But for goods that can be quickly brought to market – such as maize or rice – then the danger that a farmer may not fully deliver has made some investors more cautious.

SABMiller, for example, does not ask farmers to grow maize for fear of side-selling, but instead purchases this on the open market. For the other crops that it sources, the South African brewer hopes that binding smallholders together in co-operative structures is enough to compel farmers to live up to their commitments.

Although Agrawal agrees that the risk of side-selling can be a disincentive to the growth of the off-take industry in certain sectors, he says that companies are now developing innovative ways of tackling this problem, increasing the viability of off-take agreements across all sectors.

"For the first time, we are seeing big agribusiness firms signing long-term purchase agreements"

Who are the main off-takers?

Perhaps the largest negotiators of off-take agreements on the continent are the National Food Reserve Agencies, particularly those in Nigeria, Tanzania, Mali, Zimbabwe, Zambia and Ethiopia. The World Food Programme (WFP) is also a large contract buyer of crops throughout Africa.

Some of the larger companies negotiating off-taker agreements include South African brewer SABMiller, US retail giant Walmart, British supermarket Tesco, British American Tobacco, Dutch supermarket operator Ahold and Danish biofuels company Verdo.

Some of the bigger agro-processing firms that negotiate off-take contracts include Export Trading Group (based in East Africa), Olam International (an Indian company operating throughout the continent) and Tongaat Hulett (a South African company operating throughout the wider region)

Archer Daniels Midland Company, a US company, is particularly active in the cocoa industry of Ghana and the Ivory Coast.

In Kenya, some estimate that nearly 50% of tea and sugar is produced under off-take contracts. The Kenya Tea Development Agency has one of the largest contract schemes in the world, buying from 562,000 farmers. The Mumias Sugar Company is one of the biggest contractors of sugar in the country.

Dutch company Cheetah contracts 20,000 small scale farmers across Zambia, Malawi and Mozambique in order to produce paprika.

Dunavant, a US freight company, contracts farmers to produce cotton, particularly in Zambia.

"Dealing with side-selling is challenging, but it really depends on how effectively you engage with the farming community and get them to see the value of a continued relationship rather than a one-time default," he says. "We try to explain that any default will mean that we do not partner with them in subsequent years, which will ultimately mean that they lose out."

Agrawal points out that many off-take agreements have been negotiated in the Ghanaian palm oil industry, despite the risk of side-selling.

Beyond the co-operative

Co-operative structures have been used for decades in order to support smallholder farmers, but traditionally they have been a tool used by governments to exercise control over the market. It is only recently that private investors have seen the benefit of using the co-operative approach to group together local farmers. A paradigm shift currently taking place in Kenya may hold some clues as to where the industry is heading.

"Traditional co-operative structures have not resulted in high-quality produce, since it doesn't make sense for a farmer to focus on improving the quality of his product if he is always going to get the same price when he sells through a co-operative," says Alex Mungai, an agriculture specialist at Centum, an East African investment company.

Mungai says that, for certain products, he has started to notice a trend among groups of Kenyan farmers to negotiate contracts directly with off-takers rather than through an existing co-operative. Many of these agreements still rely on a co-operative approach, but the difference is that farmers are being linked together through private, rather than government, initiatives. This has mostly occurred with what Mungai terms "new products" – such as avocados or macadamia nuts – where there is not such a strong co-operative culture. More traditional products, such as coffee and tea, still rely on the co-operatives.

"In Kenya, you're really seeing the benefit of concentrating on one particular product and improving the quality of that product," he says. "A lot of farmers are making more money growing green vegetables on five hectares than they were growing coffee on 20 hectares."

Mungai thinks that other countries – Uganda, Tanzania, Rwanda – may not be far behind. Ai

A growing number of off-take agreements are being negotiated with local farmers in Africa, as a growing number of companies and organisations sense the huge farming potential that the continent offers. The large players that are driving this forward vary from country to country, and between sectors, but the following gives some indication of who the buyers are.

Food Reserve Agencies

The largest negotiators of off-take agreements are usually National Food Reserve Agencies. Not every country has such agencies, but ones from the following countries are particularly active: Nigeria, Tanzania, Mali, Zimbabwe, Zambia and Ethiopia.

World Food Programme

The UN's World Food Programme (WFP) is also a huge negotiator of off-take agreements in Africa, operating throughout the continent

Manufactures and Retailers

Companies that produce and sell consumer products are increasingly setting up structures through which they can buy directly from the local farmer in Africa. This has become particularly popular with European and American supermarkets, but also others. Some of the larger players include South African brewer SABMiller, US retail giant Walmart, British supermarket Tesco, British American Tobacco, Dutch supermarket operator Ahold and Danish biofuels company Verdo.

Agro-Processors

Agro-processors include local millers, feed manufacturers and other companies that turn primary agricultural produce into commodities that can be marketed. Some of the bigger agro-processing firms include Export Trading Group (based in East Africa), Olam International (operating throughout the continent), Tongaat Hulett (operating throughout southern Africa) and Archer Daniels Midland Company (particularly active in the cocoa industry of Ghana and the Ivory Coast).

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