IN TRANSFORMATION INITIATIVE

LAND REFORM AND RURAL DEVELOPMENT MODELS

UNDERSTANDING THE DRIVERS FOR INVESTING IN AGRICULTURE

(Acknowledgement of the contribution by Russell Du Preez CEO RUSSELLSTONE Group)

INTRODUCTION

1. The report is rooted in, and serves to augment and support, the on-going discussions and continuing work, between the ruling political party and a number of large-scale commercial and emerging farmers to determine those policy principles that will provide policy congruence, synergy and stability in the agricultural sector.

2. This report has been commissioned as part of an effort to identify and develop a range of viable land reform models that can: contribute to South Africa's land reform imperative; improve general food security; and stimulate the economic development of rural communities.

3. Experience has proven that land without ownership in itself cannot generate wealth, alleviate poverty and bring about sustainable rural communities. This is rather achieved through the transformation of the new or emerging farmer activities to those of viable, sustainable commercial agri-business over time. Partnerships in this regard with existing large-scale commercial farmers are therefore key to the enablement of this process. Thus the transfer of land must be linked to the establishment of viable economic units or agri-businesses.

4. The transition of the new or emerging farmer entrants towards their participation in sustainable agri-businesses requires the formalisation of a tripartite relationship between Government, commercial agriculture and the new farmers, as well as measures to incentivise the transformation of the agricultural sector as a whole. This transition requires that the entire spectrum of civil-society, and not just existing commercial farmers, work together to address the issues of land reform and its associated challenges, to alleviate poverty in rural areas, to create decent jobs and enhance agricultural profitability through inclusive institutionalisation of partnering, mobilising and optimising the use of resources, mentoring, monitoring, measuring and assistance.

5. It is clear that the key to successful agricultural transformation lies in the establishment of vibrant and sustainable agri-businesses on the back of ownership in which emerging farmers can thrive. To this end, the role that existing commercial farmers can play must not be under-estimated.

6. Furthermore, the agricultural sector as a whole needs to move from being viewed and managed as a social sector and be evolved into a fully-fledged economic sector within the broader South African economy. This imperative remains part of the national interest and fundamental to South Africa's future security.

7. To this end, a number of successful land reform and rural development projects have been identified for analysis and modelling, with a view to providing proposals in the interests of this transformation.

8. Agriculture has the potential to contribute significantly to job creation, skills development and ultimately social development as long as the fundamentals that drive investments are understood and supported by government. Research indicates that as a rule for every job created in the primary production sector, at least four jobs are created in the secondary and tertiary sectors.

9. It is therefore crucial that development and implementation of government policy must be coherent, responsive and supportive to the specific needs of this sector. If this is achieved, government will optimise the contribution this sector can make to the growth of the national economy.

10. Understanding the fundamental drivers and motivating factors for investment in the primary agri-sector is crucial to the determination of policies that will enhance the process of agri-transformation as a whole.

PURPOSE

AIM

11. This discussion looks at and provides an analysis of some of the main drivers for investment in agriculture, both at the level of the private individual, as well as from an international perspective.

BACKGROUND

12. Investment in agriculture is driven primarily by the promise of the entrepreneurial return on the investment being appropriate and commensurate to the risk taken with the endeavour. To this end, the following five considerations are identified:

    12.1. Firstly, investments are driven by the potential of significantly better returns than those that are realised in the traditional (and mostly stable) bond markets available to investors in first-world economies.

    12.2. Secondly, investments are driven by strategic agricultural commodity requirements at both a national and international level, and the ability to source such commodities to the best economic advantage of those that require them.

12.3. Thirdly, agri-potential investments are selected against a set of risk criteria and measured against a relative rate of entrepreneurial return commensurate to that risk.

12.4. Fourthly, investments are only made where there is sufficient security to ensure the preservation of the original capital should the project fail or underperform. Exceptions to this may occur but are extremely rare.

12.5. Lastly, and to a lesser extent, investments in agriculture may be driven to satisfy a lifestyle or aesthetic requirement of the potential investor (ie: an espoused belief in an idyllic farm lifestyle, or the perceived benefits to family living).

AGRICULTURE AND THE PRIMARY PRODUCTION INVESTMENT SPACE

13. An analysis of the agricultural investment space can be best understood on the back of the broad categories in which investors choose to operate. The basic principles however are common to all categories of farmer.

13.1. Subsistence Agriculture. The first category is the subsistence farmer who seeks to provide food and opportunity at the level of his or her immediate family. The focus is in on meeting the food requirements of the immediate family and it is only the surplus production achieved in these endeavours that would ultimately find its way to the market for general consumption. This type of agricultural production system generally does not meet the requirements of an industrialised or urbanised society.

13.2. Commercial Agriculture. The second category is that of commercial agriculture wherein the participants aspire to invest and produce for economic or commercial gain. Generally the bulk of commercial farmers in South Africa would fall into one of the undermentioned sub-categories. The concept of the family farm lies firmly within this category. Commercial agriculture is made up of a number sub-categories described below.

13.2.1. The beginner or emerging farmer.

13.2.2. The small-scale farmer.

13.2.3. The large-scale farmer.

13.3. Corporate Agriculture. The third category is that of corporate agriculture wherein the participants generally invest purely for strategic reasons and economic gain. These projects attract both shareholder and investor funding and are driven purely by the potential return on capital invested.

13.4. International Agri-investors. The fourth category is that of international investors who look for attractive investment opportunities to invest, develop, beneficiate and then exit within a defined investment period but leaving behind a sustainable business. Such international agri-investors, normally from Northern America or Europe, seek a balanced investment portfolio. To this end they typically invest approximately 10% of their portfolio in natural resources. Their investment in developing economies is motivated in the potential return they may derive; versus guaranteed but more conservative returns from other investments (see more detailed discussion further below).

UNDERSTANDING INVESTMENT IN AGRICULTURE

14. For some individuals, one of the drivers to invest in agriculture lies in the perception that an attractive or aesthetically pleasing life style can be generated. The longevity of this driver is however always subject to the downstream sustainability of the project as a whole.

15. The vast majority of investors in agriculture however do so to earn a livelihood and achieve economic gain. As such, agri-investments are considered against the aspirations of the individual making that investment, as well as the capability of that individual to operationalise such investments.

16. Clearly there has to be the promise of potential reward in relation to the effort made to operationalise these investments. Thus agriculture must potentially deliver a reasonable, attractive and sustainable return on investment.

17. Potential investors, be they international, corporates or individuals, look for opportunities to invest at a rate of return that is significantly better than the prevailing investment conditions where they are based. They seek a positive return commensurate with the level of risk that they deem acceptable.

18. Thus the following questions are relevant:

18.1. "Why would any investor invest in agriculture?"

18.2. "Why would investments be channelled to South Africa?"

19. In answering the first question, a deeper level analysis of the agricultural investment space indicates three clear pillars within which economic gain can be quantified.

19.1. Capital Gain (Value of Land). This pertains to the appreciation of both fixed and movable assets. By far the most secure element of this pillar is having and maintaining title to the land. Not only does this enable leverage to raise capital to fund operations, but it also provides the security against which the operation is vested. Over the last fifty years, good quality productive land in South Africa has experienced a nominal increase in value of 14% per annum.

19.2. Operating Profit (Cash Yield). Most farming operations seek to maximise the return on funds employed (ROFE) and thus aim to achieve operating profits that deliver a return of between 8% and 12%. Although some high-margin operations may achieve returns higher than this, on average, and under South African climatic conditions, this category of return is often less than 5% per annum and can in fact be negative.

19.3. Tax concessions and incentives. The existence of tax concessions are a significant factor, serving to assist farmers in the continued capitalisation of their operations before-tax as opposed to after-tax. As a third pillar, and combined with the first two pillars, these incentives create the space to build the foundation of the agri-production system.

20. If the above pillars are cumulated, then investment returns over the long term are indeed attractive and provide the investment rationale for the risk and effort. However, should any of the above pillars be tampered with, removed or negated; the rationale for investment is constrained and the overall balance to the investment portfolio is disturbed as depicted in Figure 1.

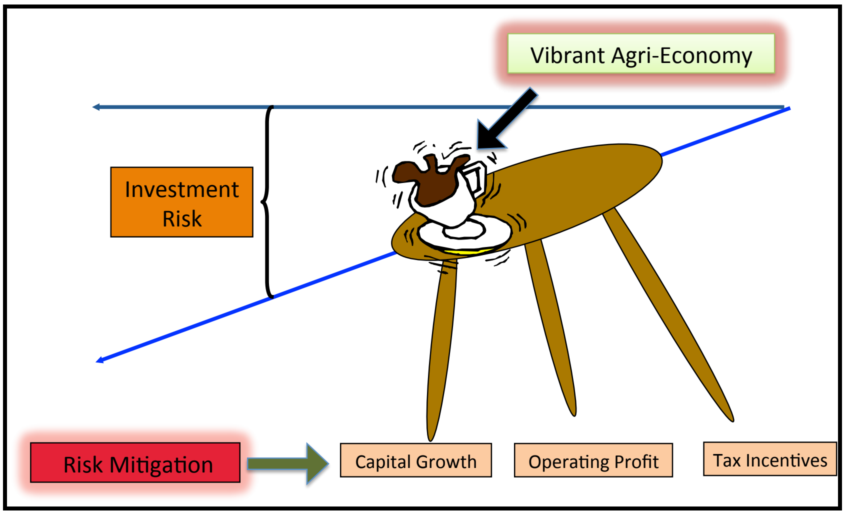

Figure 1: Risk and Agri-Investment

21. Potential investors at all levels assess investments against a number of criteria. One of the main considerations remains the preservation of the original capital at all costs. This then implies measuring the destination or potential investment recipient against a number of criteria.

21.1. What is the differential between the current investment in bond markets and the destination of the investment?

21.1.1. Internationally, in Northern American or Europe for example, investors can earn around 2% growth without taking any significant risk (available risk-free rate), whilst looking to earn around 10% if risk is taken (rule of thumb: risk-free rate x 4)]. Therefore an investment must yield at least 8 – 10% for an investor to consider the risk feasible.

21.1.2. In South Africa, investors can earn around 5% growth without taking any significant risk (available risk-free rate) whilst looking to earn around 20% if risk is taken (rule of thumb: risk-free rate x 4)]. Therefore an investment must yield at least 18 – 20% for an investor to consider the risk feasible.

21.2. Is thus the entrepreneurial return (10% vs 20%) on the investment appropriate to the level of risk undertaken by the venture?

21.3. Is there freehold or title to the property for security of tenure and can title be traded?

21.4. Is there prospect of long-term security for my investment?

21.5. Is there the rule-of-law present that will both provide title security and protect my investment?

21.6. Is there corruption, and what will be the impact thereof on the investment?

21.7. Will the value of the land appreciate? (The rule of thumb is that a 10% nominal year-on-year appreciation of land value is the threshold incentive for commercial farming.)

21.8. What are the tax incentives to the investment?

21.9. Is the cash yield per annum and the tax concessions/incentives sufficient to sustain the operation?

21.10. Is there potential for multi-year crops or long-term projects?

21.11. Are there incidences of negative value in the recipient country?

21.12. Are they able to invest, develop, beneficiate and then exit and repatriate their investment?

21.13. What downstream beneficiation can be achieved?

22. International investors in agricultural projects more often than not have a tendency to over invest in the development of the project; a benefit that generally lasts long after the project has been sold on. International investors add value in the following areas:

22.1. Have the capital for the necessary development of the project.

22.2. Bring about significant infrastructure development.

22.3. Creation of down-stream jobs in allied industry (transport, goods and service, engineering and agriculture supplies, etc.).

22.4. Discounted off-loading of the project after 8-10 years, depending on their exit strategy.

KEY EXTRAPOLATIONS TO AGRI-INVESTMENTS

23. The following broad-extrapolations are identified as key principles:

23.1. Investments in agriculture are long-term endeavours.

23.2. Investments are primarily driven by return on investment.

23.3. Investments are secured against title to fixed property.

23.4. Sustainable farming is not possible without security of title (ownership or long-term lease).

23.5. Often the return lies not in the yield or the tax concessions/incentives, but in the growth in the value of the land.

23.6. Operational funding (gearing) is leveraged against title to the land.

23.7. Incentives that help mitigate risk are essential in building the capital base of the business.

23.8. Sustainable beneficiation is achieved through long-term strategic partnerships.

23.9. Skills development is achieved through long-term strategic partnerships and relationships.

23.10. Positive policy and responsive program support by government is crucial to the creation of a climate of stability in the agri-sector as a whole.

23.11. Positive incentivisation by government is crucial to the agri-sector as a whole and primarily created through a climate of stability that enhances confidence.

THE POLITICAL DIMENSION TO THE AGRI-ECONOMY

24. Government is an important partner who can stimulate entrants to the agricultural space (or in the corollary can precipitate exit from this space). This applies at the levels of policy, programmes and supporting incentives:

24.1. Policy.

24.1.1. Policies must be supportive to and provide long-term certainty to enhance long-term investments in agriculture.

24.1.2. The development of policy at the national must be unambiguous and coherent between national departments.

24.2. Programmes.

24.2.1. Government programmes emanating from such policy must therefore be developed and applied against a set of clearly defined objectives.

24.2.2. Government programmes must be focussed on enhancing sustainability and beneficiation over the long term.

24.3. Supporting Measures.

24.3.1. SARS, and its concession and incentive regime for agriculture also contributing to a climate of stability, becomes a strategic enabler in the hands of Government.

24.3.2. Other Government concessions and support programmes, such as subsidisation and drought relief, and the application of other DTO supply-side measures must be applied evenly and without favour. **END**