CASA
Commercial Agriculture for Smallholders and Agribusiness

Sourcing from Smallholders: Complex Challenge or Commercial Opportunity?

Perspectives from Investors and Agribusinesses

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TechnoServe
Business Solutions to Poverty

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Sourcing from Smallholders: Complex Challenge or Commercial Opportunity?

Perspectives from Investors and Agribusinesses

This study seeks to add to the body of knowledge on the commercial and development impact potential of smallholder-sourcing agribusiness models by:

Quantifying the share of investment flowing specifically to agribusinesses sourcing from smallholder farmers within the broader category of agriculture.

Capturing investor perspectives on the commercial viability and development impact of companies that source from smallholder farmers.

To achieve these objectives, the paper draws on knowledge and insights from the Commercial Agriculture for Smallholders and Agribusiness Technical Assistance Facility (CASA TAF), existing research and quantitative and qualitative insights from stakeholders in the agricultural sector, including in-depth interviews with 15 investors and four smallholder-sourcing agribusinesses.

Executive Summary

Agriculture is key to rural livelihoods, employing 70% of the labour force across low-income countries worldwide. While the poverty reduction and employment potential of the agricultural sector is well-established, smallholder farmers, who make up the majority of producers in Asia and sub-Saharan Africa, are increasingly recognised as representing a lucrative market and supplier base for firms. Although interest in the sector is growing, there is still a $170 billion global investment gap for smallholder finance, presenting untapped opportunities. Clearly, many challenges exist alongside these opportunities.

Investment in smallholder sourcing agribusinesses

The investment gap in agriculture and, in particular, for small and medium-sized enterprises (SMEs) is well documented. However, quantifying the size of investment flows to smallholder sourcing-agribusinesses specifically proved more challenging than originally anticipated. Investors do not consistently track or categorise their investments in a way that allows for this type of aggregation and, as a result, our analysis is largely qualitative.

Of the 9 investors who were able to provide data, we find that over a third (34%) of the value of aggregated agriculture portfolios is invested in companies that source from smallholder farmers.

[1] Townsend, et al. Future of Food: Shaping the Food System to Delivery Jobs. World Bank Group: 2017. http://documents1.worldbank.org/curated/en/406511492528621198/pdf/114394-WP-PUBLIC-18-4-2017-10-56-45-ShapingtheFoodSystemtoDeliverJobs.pdf, 5.

[2] IFAD. Examining the Climate Finance Gap for Small-Scale Agriculture. November 2020. https://www.ifad.org/documents/38714170/42157470/climate-finance-gap_smallscale_agr.pdf/34b2e25b-7572-b31d-6d0c-d5ea5ea8f96f, 3.

[3] ISF Advisors and the MasterCard Foundation Rural and Agricultural Finance Learning Lab. Pathways to Prosperity: Rural and Agricultural Finance State of the Sector Report. November 2019. https://pathways.raflearning.org/, 8.

Investor perspectives on commercial opportunities and challenges

Our interviews with investors found that there is a wide diversity of opinions on smallholder-sourcing agriculture, making generalisations on investor perspectives potentially misleading. Nevertheless, several common perceptions were uncovered:

The most common reasons to source from smallholders are access to greater supply volumes, reductions in purchasing costs and higher sales prices. Being able to demonstrate development impact may also in itself drive commercial value, by allowing agribusinesses to access lower cost of capital or certification price premiums.

The most common perceived challenge of smallholder sourcing is ensuring sufficient quantity and quality of raw materials, where inefficient aggregation models present major bottlenecks; and, where an efficient sourcing system can be complex, costly and/or risky to set up in the short-term. Investors highlighted the key role of rigorous due diligence and specialist technical expertise in developing cost-efficient inclusive sourcing models as a necessity rather than a bonus.

Crop-unit economics also stood out as a key success factor, with high-margin export crops benefiting from more flexibility and cash flow to invest in upstream support and deep relationships with fewer smallholder farmers. Conversely, low-margin staple crops may allow for profitable smallholder sourcing as long as an agribusiness maintains high operational efficiency, purchases at sufficient scale and adds substantial value to the sourced crop.

Five-, seven- and even ten-year horizons remain a constraint for many agribusinesses, who require more time to realise returns on both the agronomic maturity of certain crops (particularly agroforestry and tree crops) and the time it takes to realise benefits from implementing an inclusive sourcing model.

Finally, investors highlighted the key role of trust in making a smallholder sourcing model successful. Whilst more direct smallholder relationships can bring significant benefits, well-designed intermediary sourcing models can work as long as there is careful selection of efficient intermediaries, adequate skills development and clear, consistent agreements and incentives for intermediary participants.

Reflecting on these takeaways, we identified five specific opportunities for investors, agribusinesses and development partners to support investment in smallholder-sourcing models.

1

Investors should map the investment gap through systematic classification and tracking of smallholder-sourcing agribusinesses to provide greater clarity on this 'asset class'. This can improve guidelines on the blend of capital and Technical Assistance (TA) required to boost effectiveness.

2

Agribusinesses should invest in thorough upfront analyses, including supply chain, context and end-market analysis, before implementing a smallholder sourcing model. In-depth analyses (ideally pre-investment or early investment stage) can help manage the complexities of sourcing models, pinpoint where private capital should be deployed when commercial gains are evident and target public funding where it is needed. Existing examples of this type of analysis include TechnoServe's Inclusive Business Plans which are carried out prior to advising on and implementing TA and IDH's work on Service Delivery Models.

3

There is a continued role and need for partnerships between investors, donors and agribusinesses to support provision of critical upstream support services to smallholder suppliers, where inclusive TA has the potential to sustainably improve smallholder sourcing operations and de-risk investments. Investors need a critical mass of profitable, inclusive sourcing examples to ensure that there exists a path to scale and exit. Similarly, public funders want to see evidence of meaningful development impact to support further funding of private sector initiatives. Routine TA provision and impact monitoring can help to build the pipeline of scalable smallholder-sourcing businesses.

4

Investors should consider establishing agricultural investment vehicles with longer investment horizons than the typical Venture Capital or Private Equity timeframes. An example of such a structure is a Permanent Capital Vehicle (PCV) which has no set time for exiting an investment. PCVs provide the time and flexibility for investments to generate returns at their own rate which can be an agronomic necessity.

5

Agribusinesses and investors should leverage monitoring and impact measurement to improve business operations and integrate impact data into existing management systems. Impact measurement can assist in streamlining processes and leveraging digital technologies can enable data-driven decision making. This type of monitoring can also direct TA efforts and inform the set-up of future smallholder sourcing schemes.

While our list of opportunities is not exhaustive, they showcase a set of key considerations for effective investment in smallholder sourcing. The next learning paper in this series will focus on dynamics at the agribusiness level through the lens of inclusive TA, diving deeper into the specifics of the sourcing models, including conditions and implications for commercial viability.

Commercial Agriculture for Smallholders and Agribusiness

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CASA TAF and TechnoServe

Funded by the UK Foreign, Commonwealth and Development Office (FCDO), the Commercial Agriculture for Smallholders and Agribusinesses (CASA) programme aims to make the commercial and development case for investing in agribusinesses that source produce from smallholders. TechnoServe, a non-profit, economic development organisation that works with enterprising men and women in the developing world to build competitive farms, businesses and industries, operates the £8 million CASA Technical Assistance Facility (TAF) to support agribusinesses that have received impact investor financing to extend and deepen their smallholder impact.

The facility provides grants and TA to agribusinesses that have received financing from a Development Finance Institution (DFI) or an impact/patient capital investor for projects which will increase the volumes of purchases from smallholders and bring new smallholders into business supply chains. The TAF works with these businesses through interventions such as aggregation models, farmer extension, access to inputs, mechanisation and climate-smart agriculture. The CASA TAF aims to benefit over 100,000 smallholders and increase their income by a total of £13 million. Over its five-year life cycle, the CASA TAF will also collect data on the impact of inclusive TA, not only at the farmer-level, but also at the portfolio company and investment fund level. The objective is to learn and to influence DFIs, impact investors, commercial investors and technical assistance (TA) providers on the significance of generating compelling evidence to track commercial and development impact metrics, thus demonstrating the value of inclusive TA.

List of participants

Investors

- Acumen Capital Partners
- AgDevCo Limited
- Barak Fund
- Capital 4 Development (C4D) Partners
- CDC Group
- Ceniarth
- eco.business Fund
- Farmfit Fund
- FMO
- Maris Africa/Agris
- Pearl Capital Partners
- Phatisa
- Sahel Capital Agribusiness Managers Limited
- United States International Development Finance Corporation (DFC)
- Zebu Investment Partners

Agribusinesses

- DeHaat, India
- Kentaste, Kenya
- Minimex, Rwanda
- Moablaou, Burkina Faso
- Wakulima Tea Company, Tanzania

Key Terms Used in this Report

Agtech: 'Use of digital technologies — such as weather stations, soil sensors and digital disease surveillance — for a variety of agricultural use cases to drive smallholder farm transformation, including digitally-enabled advisory services and market linkages, supply chain management and macro data decision making.'[4]

Blended finance: 'Structuring approach that allows organisations with different objectives to invest alongside each other while achieving their own objectives (whether financial return, social impact, or a blend of both).'[5] Blended finance may involve concessional capital, guarantees and/or technical assistance.

Bottom of the pyramid (BoP): The largest but poorest economic group of the world's population. They make up a considerable proportion of many enterprises in developing countries either as customers, distributors, suppliers, or employees.

Commercial/private equity investor: Company that invests in businesses 'with a goal of increasing their value over time before eventually selling the company at a profit.'[6]

Core Business Development Services (BDS) TA: 'A focus on reducing risk and catalysing growth of the business. This type of TA provides businesses with sector-specific and functional business support (i.e. strategy, finance, marketing and legal). This type of TA can have positive impacts on low-income communities that supply or source from the business; however the main focus of the TA is the business, its systems and processes; impact is typically mostly quantified at the core business level.'[7]

Development finance institutions (DFIs): 'Specialised development organisations that are usually majority owned by national governments. DFIs invest in private sector projects in low- and middle-income countries to promote job creation and sustainable economic growth. DFIs can be bilateral, serving to implement their government's foreign development and cooperation policy, or multilateral, acting as private sector arms of International Finance Institutions (IFIs) established by more than one country.'[8]

Hub-and-spoke model: A model in which suppliers ('spokes') are linked to a warehouse or storage centre ('hub') to provide inputs such as fertilisers and seeds to smallholders who lack access to these materials.

Inclusive business: A business that includes people at the bottom of the pyramid by making them part of the value chain of the company's core business, for example, as suppliers, distributors, retailers and/or customers to provide goods and/or services on a commercially viable basis.

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4 ISF Advisors and the Mastercard Foundation Rural and Agricultural Finance Learning Lab. Pathways to Prosperity: Rural and Agricultural Finance State of the Sector Report. November 2019. https://pathways.raflearning.org/, 18.

5 Convergence. 'Blended Finance.' Convergence Website. Retrieved 23 Feb. 2021: https://www.convergence.finance/blended-finance.

6 PitchBook. 'What is private equity?' PitchBook Blog. 15 July 2020. https://pitchbook.com/blog/what-is-private-equity.

7 TechnoServe. A Review of Inclusive Technical Assistance in Agriculture Deployed by Development Finance Institutions. 2020. https://www.casaprogramme.com/wp-content/uploads/20200630-CASA-TAF-Review-of-DFI-Inclusive-TA.pdf, 1.

8 EDFI. 'About DFIs.' https://www.edfi.eu/about-dfis/what-is-a-dfi/.

Impact investor: Company that makes investments 'with the intention to generate positive, measurable social and environmental impact alongside a financial return.'[9]

Inclusive technical assistance (TA): 'A focus on enhancing direct impact around investments specifically towards low-income communities, quantifying impact and the benefit beyond the businesses. The focus of the TA can be at the business level (to ensure viable and impactful inclusive model design and implementation) and/or focused towards low-income communities (e.g. smallholder or micro-enterprise capacity building, access to finance or market linkages).'[10]

Ingrower scheme: A system in which farmers conduct all cultivation on land owned by an agribusiness, such as tenant farming and sharecropping.

Outgrower scheme: 'Systems that link networks of unorganised smallholder farmers with domestic and international buyers. Also known as contract farming, these schemes provide benefits to players along the supply chain. Buyers can improve their control over crop supply, often at pre-agreed prices, as well as crop quality standards. And farmers can access more secure markets, often receiving technical and financial support by cultivating within outgrower schemes.'[11]

Smallholder farm/farmer: While a smallholder farm is generally defined as a family-owned business that manages crops and livestock on two hectares of land or less, some countries expand this definition to more than 10 hectares.[12]

Smallholder-sourcing agribusiness: The definition of a smallholder-sourcing agribusiness varies. Some companies consider themselves smallholder-sourcing agribusinesses if they source directly from smallholders, while others believe that an indirect relationship qualifies. Furthermore, some businesses must reach a certain threshold of smallholders in order to consider themselves smallholder-sourcing agribusinesses. For the purposes of this paper, we allow investors to self-report which of their portfolio companies source from smallholder farmers.

Technical assistance (TA): 'Advisory services that enable a project or enterprise to function more effectively and efficiently, creating the potential for long-term commercial sustainability, systemic impact and ultimately improving investment viability.'[13]

[9] GIIN. 'What is impact investing?' thegiin.org. https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing.

[10] TechnoServe. A Review of Inclusive Technical Assistance in Agriculture Deployed by Development Finance Institutions. 2020. https://www.casaprogramme.com/wp-content/uploads/20200630-CASA-TAF-Review-of-DFI-Inclusive-TA.pdf, 1.

[11] TechnoServe. 'Outgrower Schemes: A Pathway to Sustainable Agriculture.' TechnoServe Blog. 26 September 2014. https://www.technoserve.org/blog/outgrower-schemes-a-pathway-to-sustainable-agriculture/.

[12] IFC. Working with Smallholders: A Handbook for Firms Building Sustainable Supply Chains. World Bank Group: July 2013. http://documents1.worldbank.org/curated/en/284771480330980968/pdf/110543-Handbook-Working-with-Smallholders.pdf, 2.

[13] Coussa, G., et. al. What Small And Growing Businesses Need to Scale Up: the Case for Effective Technical Assistance. Spring Impact, Numbers For Good, Argidius: March 2018. https://www.springimpact.org/wp-content/uploads/2018/03/SpringImpact-NfG-Report-singles.pdf, 55.

List of Acronyms

AMCOS	Agricultural Marketing Cooperative Societies (in Tanzania)
AUM	Assets Under Management
CAGR	Compound Annual Growth Rate
CASA TAF	Commercial Agriculture for Smallholders & Agribusinesses Technical Assistance Facility
CSAF	Council on Smallholder Agricultural Finance
CSR	Corporate Social Responsibility
DFI	Development Finance Institution
FCDO	Foreign, Commonwealth and Development Office
GIIN	Global Impact Investing Network
IFI	International Finance Institution
LMIC	Low- to Middle-Income Country
PE	Private Equity
PCV	Permanent Capital Vehicle
RUBUTCOJE	Rungwe Busekelo Tea Cooperative Joint Enterprise
SME	Small and/or Medium-Sized Enterprise
SDU	Smallholder Development Unit
TA	Technical Assistance
TATEPA	Tanzania Tea Packers
WATCO	Wakulima Tea Company Ltd.

Table of Contents

Section 1

Introduction

Background

Continued importance of small-scale agriculture in Low- to Middle-Income Country (LMIC)

Agriculture is key to rural livelihoods, employing 70% of the labour force across low-income countries worldwide.[14] In sub-Saharan Africa and South Asia, smallholders contribute to 80% of food production, whilst globally, smallholder farmers comprise 95% of all farms.[15] The poverty reduction and employment potential of the agricultural sector is well-established, with opportunities in primary production, processing, transport and distribution, retailing and upstream services.

The 500 million smallholder farmers worldwide represent both a supplier base and a market for firms and advances are being made on how to integrate this segment of farmers into formal value chains.[16] Development finance institutions (DFIs) and impact investors observe the unique potential of the agriculture sector to not only drive export and job growth (and therefore economic transformation), but also to provide inclusive economic and food security benefits to farmers throughout the value chain. Integrating smallholder farmers into commercial value chains via inclusive business models, which integrate the poor as consumers, distributors, suppliers, or employees, is thus gaining traction in both the development and commercial sectors.

Trends in integration of smallholder farmers into commercial agriculture

The commercial and international development sectors are becoming more attentive to the imperative of developing inclusive business models for smallholder farmers that are also profitable. It represents a move beyond corporate social responsibility (CSR) side projects to promoting smallholder welfare in core business models. This has been driven by both increased attention from investors and consumer demands for environmentally sustainable, socially responsible and traceable supply chains. At the same time alternatives to smallholder production models, such as plantations, carry their own unique operational risks and costs that smallholder sourcing can mitigate. More inclusive sourcing models are thus increasingly recognised as having the potential to strengthen agribusinesses' long-term health and profitability, whilst generating financial benefits for smallholder farmers.

However, to achieve this potential, agribusinesses typically require some support in developing cost-efficient, inclusive business models that ensure continuity of quality, raw material supply and sustainable smallholder participation. Investment in smallholder agriculture is becoming more accessible due to the rise of 'ecosystem connectors and intermediaries' that advise public, private and philanthropic partners on knowledge sharing and sector coordination.[17]

A number of organisations are working to strengthen inclusive business models so that these are able to ensure income and development gains for smallholders while remaining commercially viable. These models may engage with smallholders as suppliers or as customers, facilitating access to a spectrum of support

[14] Townsend, et al. Future of Food: Shaping the Food System to Delivery Jobs. World Bank Group: 2017. http://documents1.worldbank.org/curated/en/406511492528621198/pdf/114394-WP-PUBLIC-18-4-2017-10-56-45-ShapingtheFoodSystemtoDeliverJobs.pdf, 5.

[15] IFAD. Examining the Climate Finance Gap for Small-Scale Agriculture. November 2020. https://www.ifad.org/documents/38714170/42157470/climate-finance-gap_smallscale_agr.pdf/34b2e25b-7572-b31d-6d0c-d5ea5ea8f96f, 3.

[16] Graeub, et al. 'The State of Family Farms in the World.' World Development 87 (November 2016). https://www.sciencedirect.com/science/article/pii/S0305750X15001217

[17] ISF Advisors and the Mastercard Foundation Rural and Agricultural Finance Learning Lab. Pathways to Prosperity: Rural and Agricultural Finance State of the Sector Report. November 2019. https://pathways.raflearning.org/, 18.

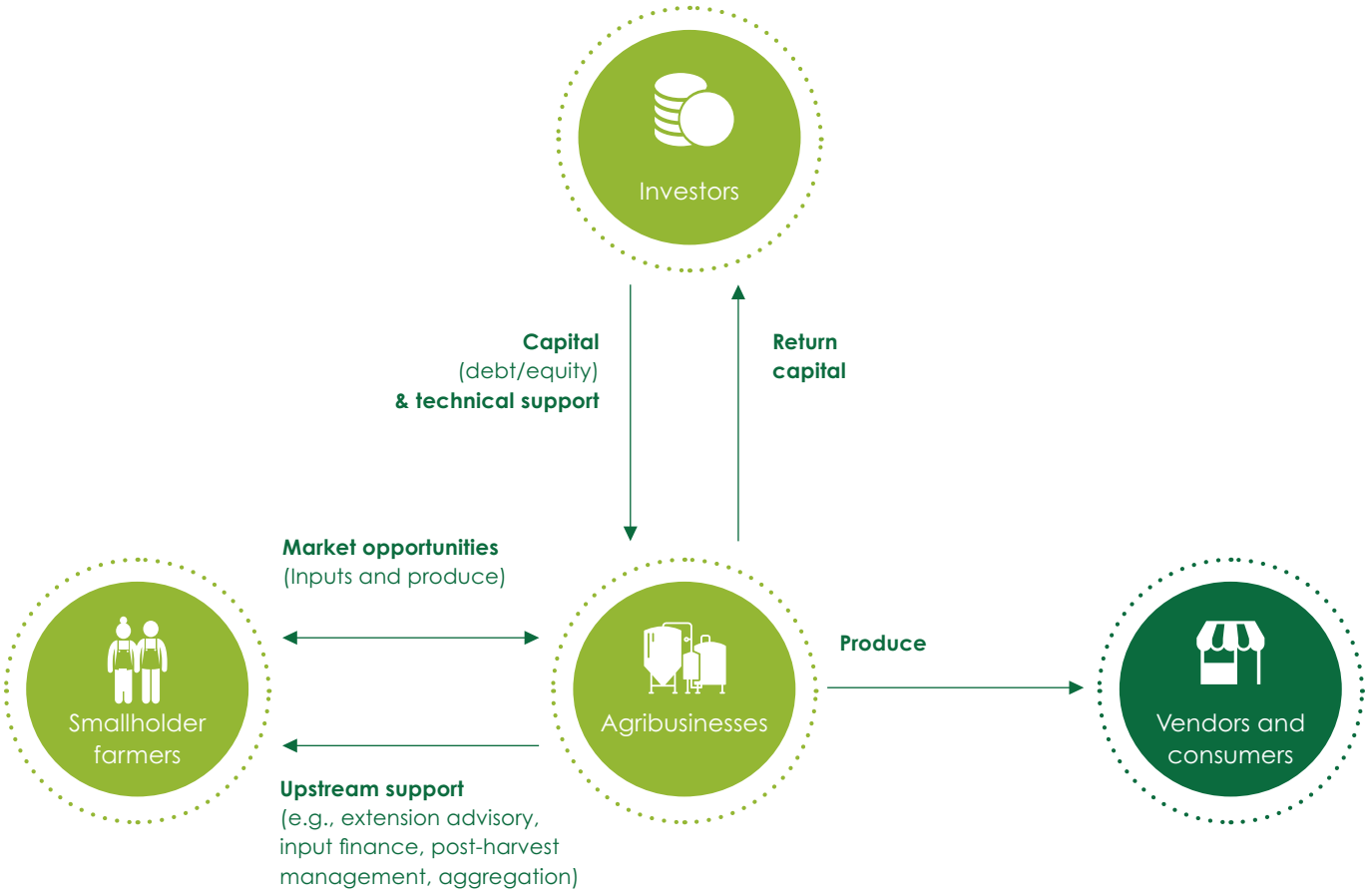
services including finance, training and TA, inputs and market access. Examples of organisations working and disseminating knowledge in this field include IDH Farmfit and their work on Service Delivery Models; Bain and Company, who have recently published about Farmer-Allied Intermediaries; and TechnoServe and their work on inclusive supply chains. These same organisations, along with ISF Advisors and the Mastercard Foundation Rural and Agricultural Finance Learning Lab, have begun advancing typologies to best understand business and sourcing models in the context of their value chains. Lastly, the rise of digital financial services and agtech is also facilitating the potential to scale inclusive business models more broadly than ever before by lowering transaction costs.

Purpose of the study

This study seeks to add to the body of knowledge on the commercial and development impact potential of smallholder-sourcing agribusiness models. This study has two main objectives:

- To quantify the share of investment flowing specifically to agribusinesses sourcing from smallholder farmers within the broader category of agriculture (Section 2)
- To understand investor perspectives on the commercial viability and development impact of companies that source from smallholder farmers (Sections 3, 4 and 5)

Investment in agribusinesses sourcing from smallholders



Specifically, this paper seeks to understand investor viewpoints on the potential commercial opportunities of smallholder sourcing for agribusinesses (Section 3); business-level factors that positively or negatively influence the ability to realise those opportunities (Section 4); and investor-level factors, including investment strategies and constraints, that influence the ability to realise those opportunities (Section 5). We then reflect on the benefits and challenges associated with sourcing from smallholder farmers and investing in smallholder-sourcing agribusinesses (Section 6). This study focuses solely on agribusinesses that have a sourcing relationship with smallholder farmers, or in other words, have smallholder farmers in their upstream supply chain. Companies that exclusively sell goods or services to smallholder farmers, though an integral part of the agribusiness ecosystem, are not within the scope of this study.

This paper is the second in a series of five learning papers broadly focused on inclusive TA. The first learning paper, *A Review of Inclusive Technical Assistance in Agriculture Deployed by Development Finance Institutions*[18], contributed to the knowledge base about technical assistance provided by DFIs; quantified the split between core and inclusive TA provided to agribusinesses; and summarised qualitative issues raised by DFI respondents related to the provision of inclusive TA. While this paper comments on the landscape of investment in agribusinesses sourcing from smallholders, the next paper in this series will focus on dynamics at the agribusiness level through the lens of inclusive TA, diving deeper into the specifics of the sourcing models, including conditions and implications for commercial viability.

Research scope and methodology

We used a combination of primary and secondary research for our analysis. While we conducted desk research to quantify the share of agricultural investment that flows to smallholder-sourcing companies, most of this information was not publicly available via investor websites and annual reports. Therefore, we predominantly relied on primary research through in-depth interviews in English and French with investors and agribusinesses to collect both quantitative and qualitative data. Our analysis largely focuses on qualitative insights, as quantitative data is privately gathered and not shared readily by firms in the sector. A list of investors and agribusinesses interviewed are included under List of Participants on page 7.

We employed purposive sampling to contact 21 potential investors who finance agribusinesses for semi-structured interviews and 15 investors agreed to participate. Given our small sample size, our analysis is limited, but still provides valuable insights about the broader investment landscape. The investors ranged from having small to large portfolios and had varying investment strategies.

The 15 investors included:

Impact investors

Commercially-oriented private equity and private debt funds

Development finance institutions (DFIs)

[18] Available to download at: https://www.Casaprogramme.Com/evidence-details/?Pan=20208400071

Although the analysis was not explicitly limited by geography, our findings are biased towards sub-Saharan Africa due to the profile of investors who participated. However, several investors whom we interviewed have investments in South and Southeast Asia and Latin America. We prepared verbatim transcripts for each interview and coded transcripts for thematic analysis using qualitative data analysis software NVivo. The majority of the findings presented in this paper, except where cited otherwise, draw from these interviews.

We also employed purposive sampling to contact four agribusinesses, which were recommended to us by investor interviewees out of their portfolio companies. The agribusinesses interviewed have smallholder sourcing as a core component of their business models. We prepared verbatim transcripts for each of these interviews and integrated our findings throughout the paper as well as in case studies.

Section 2

Landscape of investment in smallholder-sourcing agribusinesses

Historic and emerging agricultural investment trends in LMICs

Investment in agriculture in LMICs has historically been low, particularly in sub-Saharan Africa, due to perceptions of high risks and low returns. According to a 2019 ISF report, there is a $170 billion global investment gap for smallholder finance.[19] Additionally, there is an estimated $80 billion shortfall in debt available to agribusinesses earning less than $15 million a year in sub-Saharan Africa, according to Bain and Company.[20] Furthermore, only 10% of impact capital flowing into the region is earmarked for agriculture.[21]

Agriculture makes up a small minority of investors' portfolios worldwide, including those of DFIs and impact investors. CASA TAF's first learning paper, A Review of Technical Assistance in Agriculture Deployed by Development Finance Institutions[22], quantified the percentage of DFI investment in agriculture as of 2018. Among the 13 primarily European DFIs sampled, the proportion of investment in agriculture ranged from 2%-21%, with an average of 7%.[23] The Global Impact Investing Network (GIIN) Impact Investor Survey 2020, which included 294 impact investors worldwide, found that 9% of assets under management (AUM) were in the food and agriculture sector.[24]

Several factors contribute to a reticence to invest in agriculture, including perceived high risks and low returns; a substantial informal market; and local political and economic uncertainty. According to a recent report by Aceli Africa, investing in agriculture is twice as risky as investing in other sectors in Africa.[25] Relatedly, Bain and Company estimates that 60% of investors cite agricultural returns in Africa as 'lower than the 15% net internal rate of return expected.'[26] In addition to low returns, a high percentage of informal agribusinesses in Africa, which often do not meet investor standards, contributes to a 'lack of investable pipeline.'[27] Inadequate local infrastructure, price controls and inconsistent tariff policies, as well as exogenous factors like weather and fluctuating commodity prices, discourage investors from prioritising agriculture.[28]

Nevertheless, there is new evidence that investment in agriculture is trending upwards. The GIIN Impact Investor Survey 2020 found that portfolio allocations

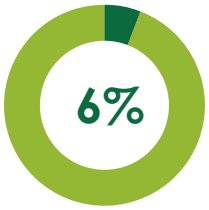
[19] ISF Advisors and the Mastercard Foundation Rural and Agricultural Finance Learning Lab. Pathways to Prosperity: Rural and Agricultural Finance State of the Sector Report. November 2019. https://pathways.raflearning.org/, 8.
[20] Tam and Mitchell. How Farmer-Allied Intermediaries Can Transform Africa's Food Systems. Bain & Company: 2020. https://www.bain.com/globalassets/noindex/2020/bain_report_farmer_allied-intermediaries.pdf, 11.
[21] Ibid., 12.
[22] Available to download at: https://www.casaprogramme.com/evidence-details/?pan=20208400071
[23] TechnoServe. A Review of Inclusive Technical Assistance in Agriculture Deployed by Development Finance Institutions. 2020. https://www.casaprogramme.com/wp-content/uploads/20200630-CASA-TAF-Review-of-DFI-Inclusive-TA.pdf, 5.
[24] GIIN. GIIN Annual Impact Investor Survey. 2020. https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf, 19. To note: The GIIN Annual Impact Investor Survey reports Food and Agriculture together, so it includes companies that operate in food and beverage production but do not practice primary agriculture. Additionally, Forestry is listed as a separate sector from Agriculture, comprising 10% of survey respondents' AUM.
[25] Aceli Africa. Bridging the Financing Gap: Unlocking the Impact Potential of Agricultural SMEs in Africa, Summary Report. September 2020. https://aceliafrica.org/bridging-the-financing-gap-unlocking-the-impact-potential-of-agricultural-smes-in-africa/, 6.
[26] Tam and Mitchell. How Farmer-Allied Intermediaries Can Transform Africa's Food Systems. Bain & Company: 2020. https://www.bain.com/globalassets/noindex/2020/bain_report_farmer_allied-intermediaries.pdf, 57.
[27] Ibid., 56.
[28] Ibid., 57.

in the Food and Agriculture Sector among repeat survey respondents grew at a 22% compound annual growth rate (CAGR) between 2015 and 2019, from $3.7 billion to $8.3 billion.[29] According to GIIN, investors also indicated increasing interest in the sector, with 54% planning to increase their agriculture portfolio allocations in the next five years, the highest share among all sectors included in the survey.[30] Among Council on Smallholder Agricultural Finance (CSAF) lenders, investing increased by 6% in 2019.[31] However, there was significant variation depending on the region. In sub-Saharan Africa, lending increased by 12%, while in South and East Asia, lending decreased slightly by 0.05%.[32] The average loan size among CSAF lenders increased from $803,000 in 2018 to $850,000 in 2019, suggesting that resources allocated to agriculture are generally increasing.

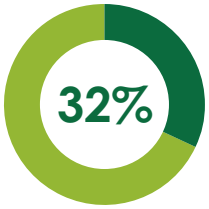
Blended finance, which 'allows organisations with different objectives to invest alongside each other while achieving their own objectives (whether financial return, social impact, or a blend of both),'[33] represents a promising funding mechanism for agriculture. According to data from Convergence, a global network that tracks blended finance activity, agriculture has steadily represented approximately 15% of blended finance transactions. Additionally, from 2017 to 2019, median transaction sizes for blended finance in agriculture increased substantially from $35 million to $46 million.[34] While agriculture represents a minority portion of investors' profiles, an increase in investor interest presents an opportunity for agribusinesses to develop and expand.

Investment in smallholder-sourcing agribusinesses as share of agricultural investment

As noted above, secondary source material on investment flows to smallholder-sourcing agribusinesses was rare. According to the Convergence Blended Finance Database, as of January 2021, 6% of agricultural blended finance deals target smallholder farmers as direct beneficiaries, while 32% of deals target smallholder farmers as indirect, or secondary, beneficiaries. Direct beneficiaries receive the benefits of a financing deal or intervention personally and/or as a result of a direct interaction with the investment or intervention, whereas indirect beneficiaries are not directly connected to the intervention and may benefit indirectly through positive changes in the community, local economy or enabling environment.



of agricultural blended finance deals target smallholder farmers as direct beneficiaries



of deals target smallholder farmers as end beneficiaries

Beyond these blended finance statistics, there is little information publicly available. Additionally, quantifying the amount of investment in smallholder-sourcing agribusinesses as a subset of agricultural investment is challenging as most investors do not tag investments by

[29] GIIN. GIIN Annual Impact Investor Survey. 2020. https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf, 35. To note: As noted earlier, the 22% CAGR includes non-primary agriculture food sector companies.
[30] Ibid., 34.
[31] CSAF. State of the Sector 2020. https://csaf.org/wp-content/uploads/2020/07/CSAF_State_of_Sector_2020_FINAL.pdf, 15. To note: CSAF has 13 lender members worldwide and 655 borrowers.
[32] CSAF. State of the Sector 2020. https://csaf.org/wp-content/uploads/2020/07/CSAF_State_of_Sector_2020_FINAL.pdf, 15. To note: CSAF has 13 lender members worldwide and 655 borrowers.
[33] Definition from: Convergence. 'Blended Finance.' Convergence website. Retrieved 23 Feb. 2021: https://www.convergence.finance/blended-finance.
[34] Convergence. The State of Blended Finance 2020. https://www.convergence.finance/resource/1qEM02yBQxLftPVs4bWmMX/view, 21.
[35] Convergence Blended Finance ©. Historical Deals Database. January 2021.

whether they source from smallholders. Many investors tag investments by whether they positively impact smallholder farmers but this tag often includes indirect and direct impacts and does not capture the nature and direction of the relationship (e.g., upstream or downstream). The definition of a smallholder-sourcing agribusiness also varies. Some companies only consider themselves smallholder-sourcing agribusinesses if they source directly from smallholders, while others believe that an indirect relationship qualifies. Furthermore, some businesses may impose a certain threshold of smallholders before considering themselves smallholder-sourcing agribusinesses. For the purposes of this paper, we allow investors to self-report which of their portfolio companies source from smallholder farmers.

Smallholder-Sourcing Companies Among Surveyed Investors

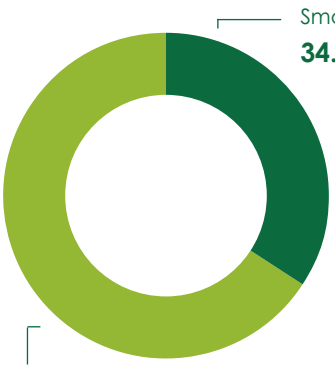
For this study, we surveyed the 15 investors listed at the beginning of this paper about the proportion of their agricultural portfolio companies that source from smallholders. Our sample consisted of seven impact investors, five commercial investors and three DFIs.

Twelve investors provided quantitative portfolio data. These 12 investors collectively manage over $51 billion[36] in assets, with 8.4%,[37] or $4.3 billion[37], allocated to agriculture. Based on the self-reported data of these investors, we found that, on average, 44% of each investor's portfolio agribusinesses companies source from smallholders, with the median percentage being 33%.[38] For a subset of 9 investors, we found that 34.4% of their portfolio agribusinesses in aggregate source from smallholder farmers.[39] Measured in dollar terms, 29.2% of the value of their aggregate agriculture portfolios, or $1.1 billion, are invested in companies that source from smallholders.[40]

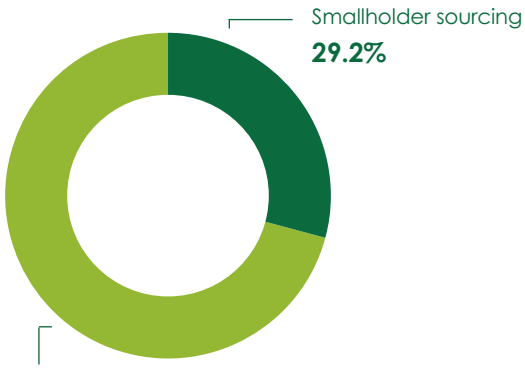
This sample may be biased and show a higher rate of agricultural and smallholder agriculture investment than the market at large due to the presence of some agriculture-specialised funds and the inclusion of DFIs and impact investors, together comprising two-thirds of our sample. Our sample of investors also has a geographic bias toward sub-Saharan Africa, which has the highest rates of smallholder farming in the world.

Agriculture Allocation in 9 Sample Investors' Portfolios

Percentage of Portfolio companies/investments



Percentage of Dollar Value of Portfolio

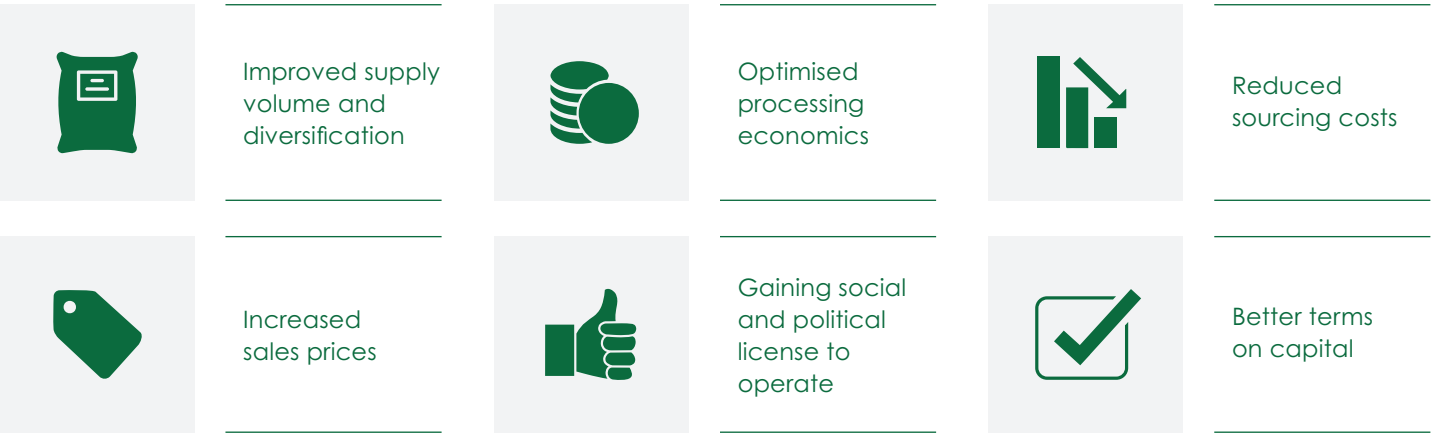


[36] Portfolio figures given in euros were converted to USD at the 31/12/20 rate of 1 USD = .8187 EUR.
[37] Eleven investors are represented in this figure. Due to privacy reasons, some investors declined to share all of the data points requested in our survey, so the number of investors represented in each summary statistic is noted in footnotes.
[38] All twelve investors are represented in these percentages.
[39] Nine investors are represented in this percentage.
[40] Nine investors are represented in this percentage and dollar value.

Section 3

Opportunities in smallholder sourcing for agribusinesses

The sheer prevalence of smallholder agriculture and sizable share of smallholder land holdings, particularly across much of Africa and Asia, can make smallholder sourcing a necessity in some value chains. There are, however, a myriad of opportunities to be realised in sourcing from smallholder farmers, including for agribusinesses that do not presently do so. Such motivations may be frequently divided into a 'commercial case' and an 'impact case,' speaking to a broader takeaway from our first learning paper, that development impact-oriented activities have often been seen as being in tension with, rather than in service of, commercial objectives. Our discussions with investors suggested that the impact case for smallholder sourcing is increasingly becoming part of the commercial case, as companies find that being able to demonstrate impact can help commercially. Investors cited numerous business reasons for smallholder sourcing among their portfolio agribusinesses, which are summarised below.



Supply volume and diversification

Including smallholders in the supply chain may be used as a means of securing new volume for agribusinesses as a part of business expansion. This is especially true in contexts where available land is hard to come by and simply expanding a business' own plantation is infeasible or prohibitively expensive. Even in cases where land access is not a concern, expansion of plantations can entail massive upfront expenses. Turning to existing small-scale farmers may allow an agribusiness to increase volumes while circumventing many of these costs.

Investors in our sample also pointed to instances of smallholder sourcing being used not to expand volumes, but to bolster security of supply. In some cases, this was discussed as an attractive strategy to protect supply volumes for agribusinesses otherwise dependent on imported inputs and operating in politically volatile or less connected markets.

Smallholder sourcing can also mitigate other supply chain risks, including from threats like disease that can quickly devastate a single plantation or ranch. These risks are exacerbated by climate change, increasing the likelihood of droughts, floods, pests and soil infertility. These become particularly important in sub-Saharan Africa and South Asia, which are expected to be among the hardest-hit regions globally.[41] A geographically dispersed smallholder supplier base may serve as a form of hedging and risk diversification. In the case of one company — an agribusiness sourcing tree crops with high upfront time and effort investment and long planting and harvest horizons — geographical dispersion helped to insulate supply from localised pest infestations and extreme weather events.

Processing economics

While smallholder sourcing can present a strategic opportunity to increase or guarantee security of supply in the long term, it may also be undertaken as a more immediate-term, tactical decision. This was discussed most frequently in the context of optimising downstream asset utilisation. For agribusinesses engaged in primary processing, turning to smallholder farmers can address issues of processing facilities operating under capacity. This becomes particularly important given the serious implications that unutilised capacity can have for unit economics in an industry where margins may be thin to begin with. In such cases, smallholders can present an opportunity to resolve this issue directly and, most importantly, quickly.

One private equity investor recounted the example of a dairy producer supplying entirely from its own cows. After losing nearly the entire herd to a disease outbreak, the company was left with processing facilities operating far under capacity and successfully turned to smallholder cattle farmers to replace its lost throughput. Another investee agribusiness, also a dairy producer, undertook the same strategy not as a response to a shock, but upon realisation that while its own farm was at capacity, its processing facilities were not. Turning to surrounding pastoralists allowed the business to quickly improve downstream economics without need for a costly and time-consuming expansion of its own farm.

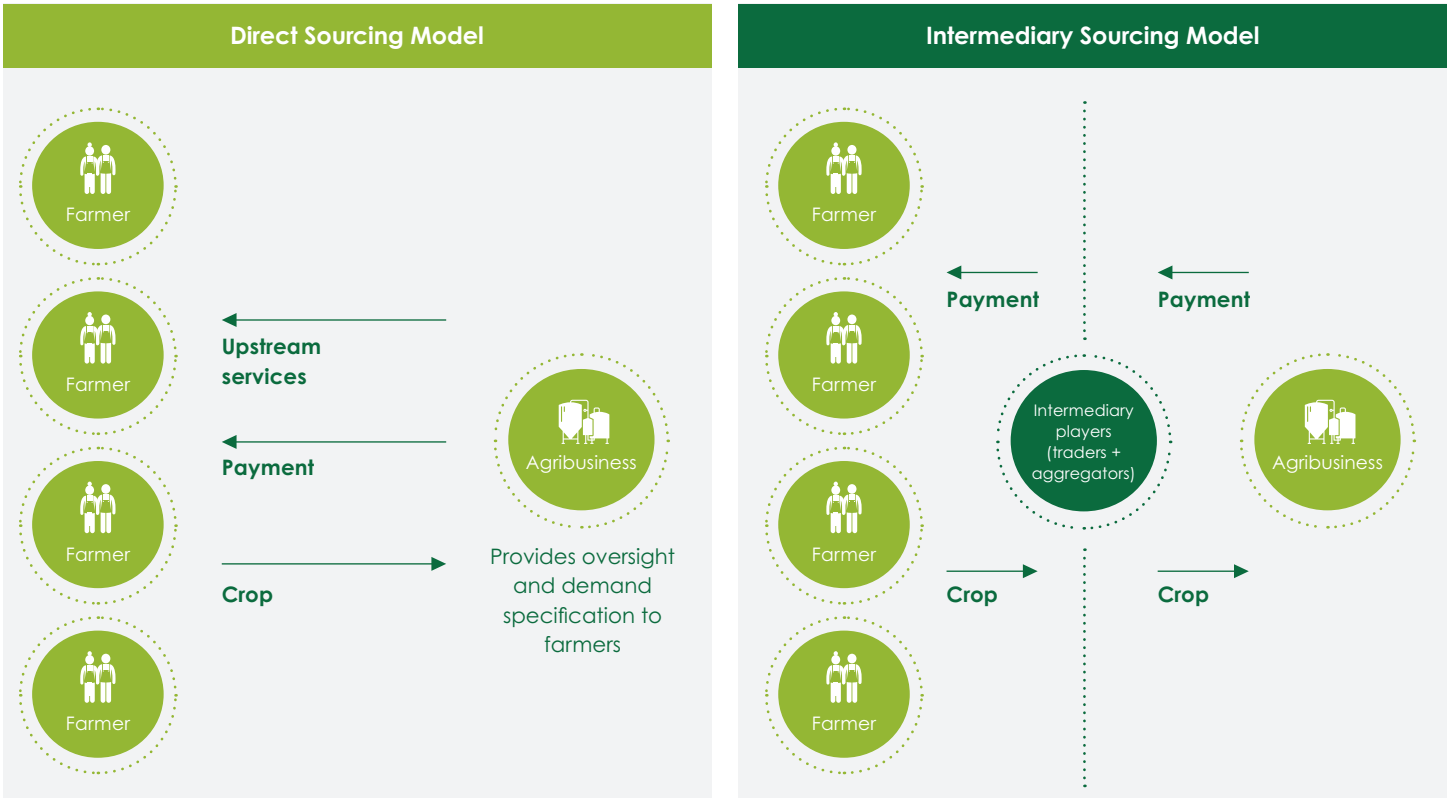
Sourcing costs

Other investee agribusinesses have used smallholder sourcing as a means of bringing down purchasing prices. One recurring theme in discussions was the difference in supply elasticity between smallholder farmers and commercial farmers. Commercial farmers, often with substantial storage capacity and more leeway to hold on to supply, are able to demand higher prices than smallholders whose supply is more inelastic. Smallholders may also have lower production costs than commercial farmers, particularly with regard to labour, which for smallholders may comprise entirely workers from within the family. In other cases, smallholders presented an opportunity for lower unit cost relative to importing. At least one investee agribusiness turned to smallholder sourcing as a successful cost reduction strategy in the face of newly imposed import limitations on a key input crop.

The potential for reduction of purchasing prices is particularly strong when done via direct sourcing. Among agribusinesses already sourcing from smallholders, many investors pointed to a growing trend of backward integration, through movement away from intermediary models and toward more direct sourcing, be it from farmgate or from cooperatives and farmer groups. This elimination of middlemen can carry a double benefit in simultaneously pulling down purchasing prices for agribusinesses while pushing up sales prices for smallholders, though it will invariably entail increased operating costs for the agribusiness.

[41] Global Commission on Adaptation. Adapt now: a global call for climate resilience. September 2019. https://gca.org/reports/adapt-now-a-global-call-for-leadership-on-climate-resilience/, 24.

Sourcing model structures



In certain contexts, smallholder sourcing may also be a means of circumventing currency risks. This was cited as a key reason for one investee agribusiness deciding to source commodity grains from smallholders, despite no shortage of large-scale commercial farmers nearby. Sourcing from commercial farms in this case entailed purchasing in dollars. With the agribusiness producing overwhelmingly for the local market, smallholder sourcing in local currency allowed for greater insulation of the company's balance sheet from exchange rate fluctuations.

Sales price

In a number of value chains, smallholder sourcing also offers agribusinesses opportunities for higher sales prices relative to sourcing from commercial farms or cultivating entirely on their own plantation. This is particularly true for a range of export-oriented products, for which growing consumer consciousness has introduced often substantial traceability premiums.

Investors pointed to shifts toward direct sourcing from smallholder farmers in crops such as cocoa, coffee, oil palm and tea. In these value chains, growing global demand for ethically and sustainably sourced products presents an attractive business case for small-scale versus plantation farming. One investor noted that consumer preferences have trended so heavily in this direction that, in value chains such as these, smallholder sourcing is evolving from an added advantage to a requirement for competitiveness. A proliferation of certification regimes like Fair Trade and Rainforest Alliance, meanwhile, brings more concrete benefits to be reaped. As sustainable, ethical and traceable products become more readily distinguishable to end consumers, agribusinesses have greater opportunities to tap into the end-price premiums these products can command.

Social and political licence to operate

Several investors cited reputation management and community buy-in as critical factors in agribusiness success in LMICs and pointed to smallholder sourcing as a valuable tool in this regard. Here, a distinction emerged between 'token' engagement with smallholders and truly mutually beneficial, inclusive smallholder sourcing models. A common sentiment was that while the former can often provide some nominal social licence to operate, the latter can significantly boost an agribusiness' sustainability. Reputation management, importantly, should not be thought of exclusively in terms of crisis management. While news of unethical or unsustainable business practices can seriously damage a company's bottom line, often overlooked is the extent to which socially responsible business practices can bolster it.

Alongside social licence to operate, also discussed was the notion of political licence to operate, which may be more salient in some LMICs than in high-income countries. This entails building credibility and goodwill in the eyes of not just local communities, but also local and national governments. In certain contexts — namely those marked by political volatility or particularly business-unfriendly policy environments — smallholder sourcing was cited as a form of political risk mitigation for agribusinesses. In such instances, being able to point to quantifiable bottom-of-the-pyramid impact served to protect agribusinesses against land grabs and the spectre of expropriation. For agribusinesses expanding into new territories, sourcing from local smallholders rather than relying entirely on own production can also assuage some concerns over sovereignty that may feature prominently in political discourse.

Cost of capital

Capital and operating expenses in commercial agriculture can be substantial. When it comes to securing financing, agribusinesses sourcing from smallholders can, in some cases, benefit from more generous terms, including below-market interest rates, extended loan grace periods, or longer maturities and amortisation schedules.

These cost of capital benefits, of course, depend on the type of investor, though here, too, smallholder sourcing can present an advantage. An agribusiness that sources from smallholders may have an easier time securing financing from impact or patient capital investors than one that does not. It should be noted, however, that even among more commercially oriented private equity firms in our sample, bottom-of-pyramid impact potential was always cited as a component of pre-investment analysis. We did not interview any investors who were entirely impact-agnostic.

Ultimately, while the view that sourcing from smallholders presents opportunities was held unanimously, discussions with investors suggested that seldom will two agribusinesses have the exact same set of motives for doing so. The most frequently cited reasons were access to greater supply volumes, reductions in purchasing costs and higher sales prices, though the precise mix of motives will depend on a business' geographic location, the agronomic properties of its crop and its role in the value chain. Agribusinesses seeking greater supply volumes may differ in sourcing from smallholders as a nearer-term tactical decision or a longer-term strategic decision. Social and political licences to operate may prove critical in some contexts and extraneous in others. The potential for sales price premium is concentrated in a particular subset of value chains and the greatest opportunities for sourcing cost reductions in others still. These nuances — and investor perspectives on their implications for success for smallholder-sourcing agribusinesses — are explored in depth in the following section.

Section 4

Factors enabling or constraining the viability of smallholder sourcing

While sourcing from smallholder farmers can present a range of attractive opportunities for agribusinesses, as outlined in the previous section, investors made clear that these are not guaranteed. A number of factors come into play in determining whether — and to what extent — these opportunities are realised. Investors stressed that optimisation of the business model and the sourcing model depend on both the specific characteristics of the crop and the business' role in the value chain, as well as the broader geographical, political and social contexts in which the business operates. Investors echoed findings from a Bain & Company report regarding the paramount importance of this confluence of factors,[42] underscoring the need for rigorous and holistic due diligence in designing a smallholder sourcing strategy. This section presents investor perspectives on these factors and implications for agribusinesses and highlights instances where certain combinations of these factors have yielded success for portfolio companies.

Crop margin and value chain activities

Among the most frequently discussed factors was the unit-economics of the crop or product being sourced from smallholders and its implications for an agribusiness' role in the value chain. Perhaps unsurprisingly, there was broad agreement among investors that higher-margin crops generally present more interesting investment opportunities. They cautioned, however, that their cultivation comes with its own set of challenges for smallholder-sourcing businesses. A common sentiment among investors was that the right business model in the right context can overcome poor unit-economics, with the inverse also ringing true.

> **We invest across all value chains. Some value chains are more attractive than others because the dynamics work better from an investment perspective. But even in value chains perceived to be less attractive, we've seen companies deliver better-than-expected results. Such performance is due to several reasons, such as having a competitive market advantage or being extremely efficient.**
>
> Deji Adebusoye, Principal, Sahel Capital

While not guaranteed, higher-value crops can translate into higher margins for an agribusiness, particularly for more forward-integrated companies. This, in turn, carries a number of benefits. Higher margins may provide a degree of flexibility for businesses with high overhead or less than perfect operational efficiency, both of which, as investors indicated, can be common among agribusinesses in LMICs. They may also provide greater cash flow to invest upstream in things like irrigation, input provision and training, particularly important for smallholder-sourcing agribusinesses. One DFI investment manager noted that climatic shifts and changing rainfall patterns are making irrigation ever more crucial, but, in said manager's experience, only higher-margin crops make financing smallholder

[42] Tam and Mitchell. How Farmer-Allied Intermediaries Can Transform Africa's Food Systems. Bain & Company: 2020. https://www.bain.com/globalassets/noindex/2020/bain_report_farmer_allied-intermediaries.pdf.

irrigation feasible at scale. Many high-margin crops are also less suited to mechanised harvesting, which can bolster the case for smallholder sourcing. Foregone economies of scale vis-à-vis plantation farming become less of a concern for such crops compared to lower-margin row crops.

A number of investors linked the attractiveness of higher-margin crops to their greater propensity for export. Particularly for agribusinesses sourcing higher-margin cash and commodity crops from smallholders, relative predictability in pricing was cited as a benefit, given the global market for these crops and their lower susceptibility to localised gluts or shortages. One impact investor also underscored the macroeconomic development impact of bringing in foreign currency. Other investors lending in euros or dollars cited foreign exchange liabilities as a reason for preferring exporting companies.

Multiple investors also alluded to greater potential for direct bottom-of-the-pyramid impact when sourcing from smallholders in higher-margin value chains. While lower-margin crops were not discounted entirely in their ability to drive impact, a distinction emerged between impact in terms of depth and breadth. Low-margin and staple crops tended to allow agribusinesses to maintain a larger smallholder supplier base, driving breadth of impact. Success metrics for breadth may be measured through output indicators such as number of smallholders sourced from or linked to the market. Meanwhile, agribusinesses sourcing higher-margin crops, including tree nuts, tree fruits, certain vegetables and cash crops, were touted as having greater potential to drive depth of impact. Success metrics for depth may be measured through outcome indicators like incremental income increases among smallholders in the supplier base.

Investors did, however, offer a number of caveats to sourcing higher-margin crops from smallholders. The fundamental reason why these crops tend to drive depth of impact at the expense of breadth is that their cultivation is frequently more taxing. This came down, in part, to simple agronomy — with more demanding or sensitive crops tending to bring higher margins — and, in part, due to added quality requirements. Higher-margin crops were more frequently destined for export markets, where they are met with both stricter legislation and more exigent consumers. As a result, a common factor among successful smallholder-sourcing businesses operating in these value chains was a relatively limited supplier base. This is due to frequently higher levels of upstream support and more hands-on technical assistance necessary for smallholders growing such crops.

> **“In the traditional model, the classic metric of success has been how many smallholder farmers you’re working with, but that’s not always the right question.**
>
> Erastus Kibugu, Founder & CEO, Onward Resources International

One agribusiness that found success sourcing a high-margin export crop did so by tempering impact aspirations for breadth at the outset, deciding to begin its outgrower scheme with a small cohort of larger, more established smallholders, on whom it could count to receive and implement the rigorous training necessary to grow their delicate crop to export quality. The key factor there was a particularly hands-on relationship with a manageable number of smallholders, with robust extension offerings. Only after securing a stable supply of quality output did the agribusiness begin to slowly expand its smallholder base. There was acknowledgement that this approach excluded the smallest and poorest smallholders, at least at the outset. Still, given the nature of the value chain, this sourcing model was judged to have the greatest commercial viability, itself a prerequisite for development impact.

Although investors demonstrated a clear preference for agribusinesses sourcing higher-value crops from smallholders, a few also pointed to several instances

of successful, commercially viable smallholder sourcing in low-margin crops, while noting that operational efficiency becomes even more important in such businesses. These fit into two general categories.

The first was vertically integrated agri-businesses centred around extensive, high-volume processing, rather than simple aggregation and trading. The key in these cases was that low-margin crops did not translate into low-margin businesses. Sourcing basic staple grains from smallholders, for example, may allow for a reduction in purchasing prices relative to sourcing from commercial farmers. Subsequent value addition through processing into a diversified range of higher-value flours and brans then allows for:

Interest from commercial investors

A premium to be passed down to farmers

The second category comprised livestock producers sourcing low-margin crops from smallholders to be processed into feed. Smallholder sourcing in these cases was considered a means of outsourcing a non-core business component. Still, reliability of supply was cited as a concern in some instances. Investee agribusinesses successfully using this model were engaged primarily in poultry production, while one agribusiness rearing more demanding ungulates (e.g., cattle, pigs) opted to import feed due to supply concerns.

A third example, falling into neither of the above categories and highlighted as an exceptional case, was that of Babban Gona, a Nigerian agribusiness aggregating and trading a low-margin smallholder-grown staple, maize, without meaningful processing and not as a direct input for livestock. In this case, an innovative extension model allowed the agribusiness to both source from a large number of farmers and provide them with robust input and technical assistance, overcoming the usual trade-off between scale and intensity of support. The result was a product of such high quality and of such consistent volume that the business was able to secure offtake agreements with several large multinationals at a premium.

CASA's Value Chain Component implemented by NIRAS, is currently working with a local feed processor in Malawi (Lenziemill Milling Company) to facilitate more direct sourcing of soya and maize from 3,000 smallholders; supporting the company to access the needed volumes at the right time and price, whilst flowing more value to smallholders. CASA has partnered with the Clinton Development Initiative (CDI) to facilitate crop aggregation, leveraging prior CDI successes linking smallholder soya farmers to markets using the Community-driven Agribusiness (CAB) model.

The common denominator in all three cases above was a high degree of value addition. This came downstream of the smallholders in the first two categories and, perhaps more uniquely, upstream of them in the third case. Indeed, substantial value addition was universally cited as the key component in allowing smallholder sourcing to work commercially for low-margin crops.

> **It's important to be mindful of false economy. The smallholder avocado is going to be a lot cheaper than the one you've produced yourself, but if it gets to Europe and it's rejected, it suddenly becomes your most expensive avocado.**
>
> Edward Stiles, Director, Agris[43]

[43] Agris is subsidiary of Maris Africa

Moablaou: A win-win sourcing model in a challenging context

Moablaou S.A. is the largest egg producer in Burkina Faso, having scaled up operations from 500 to nearly 200,000 hens over its three decades in business. Private equity firm, Zebu Investment Partners, which invests throughout the agricultural value chain in Africa, invested in Moablaou in 2014 through its African Agricultural Fund (AAF) and has supported the company's growth in the years since. Operating its own on-site feed mill, Moablaou purchases thousands of tonnes of maize — the main ingredient in poultry feed — each year from some 2,000 smallholder farmers in one of the most under-financed and climate-exposed countries in Africa.[44]

The two greatest challenges that smallholders in Burkina Faso face are a lack of access to input finance — all the more important given degraded soils and increasingly volatile rains — and a lack of guaranteed markets. Both of these are the realities of the low-margin cereals sector in particular, especially when juxtaposed with cotton cultivation in the country, which is supported by a robust state structure with guaranteed offtake by government-backed cotton ginners.

> **'The reason so many smallholders end up turning to cotton is because of the guaranteed market. Maize farmers have no such guarantee and so our partnership aims to provide them with a guaranteed market. With so many hens to feed, we can give our farmers full assurance that as long as they produce, they'll have a buyer.'**
>
> -Abou Simbel Ouattara, CEO and Founder

Moablaou's sourcing model relies on a tripartite structure, developed in collaboration with TechnoServe through the AAF TAF between 2016-2018, to address both of these challenges simultaneously. The company's partnership with a local input provider and an agricultural extension firm provides its smallholders with the means to produce maize in line with Moablaou's exacting standards: the company's hens require homogenous, insecticide-free, high-protein yellow maize with very low moisture content.

The AAF TAF support helped to prove the concept of this type of structured partnership. With access to improved seed, fertilisers and agronomical training — as well as guaranteed offtake from a higher-paying end user (compared to commercial traders) — Moablaou's suppliers are able make a stable income off of what has traditionally been a subsistence crop. Still, price volatility typical of the domestic maize market in Burkina Faso continues to limit the company's ability to consistently cover the costs of the upstream support provided to smallholders, in spite of their best intentions.

Over the longer term, there is opportunity to further develop the local value chain and win-win partnerships to support sustained yield gains and purchases from smallholder farmers. Meanwhile, in the short-term, farmers will continue producing yellow maize as long as the market remains and the foundation has been laid to crowd in new offtakers.

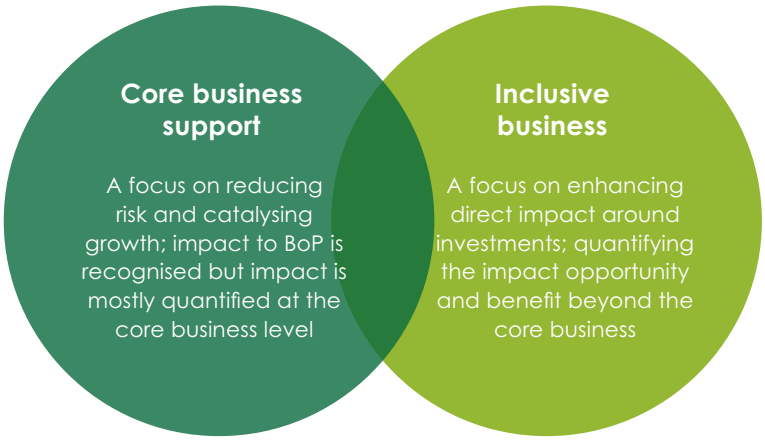
[44] World Bank Group. "Burkina Faso - Priorities for Poverty Reduction and Shared Prosperity: Systematic Country Diagnostic."http://documents.worldbank.org/curated/en/950551492526646036/Burkina-Faso-Priorities-for-Poverty-Reduction-and-Shared-Prosperity-Systematic-Country-Diagnostic

Upstream support

Upstream support was among the most important factors for commercially viable smallholder sourcing for investors in our sample. Upstream support is the provision of training, agricultural inputs, equipment and/or financing to smallholders in the supplier base. The feasibility of providing such support can depend on the margin potential in a given value chain. Numerous investors cited robust provision of upstream support as a make-or-break factor in the success of a smallholder-sourcing agribusiness.

Providing upstream support to smallholder farmers helps agribusinesses achieve the yields and quality standards they need, reduce post-harvest losses and achieve certifications. Utilising upstream support may be a means of ensuring sufficient yields to achieve economies of scale and thereby efficiently utilise downstream processing capacity. It frequently also proves critical from a quality control standpoint, though to varying extents across value chains. Agribusinesses in sectors like horticulture and poultry production may find upstream support to make the difference between usable and unusable output from outgrowers. This point was also stressed heavily in the context of particularly sensitive crops, such as avocado, nutmeg, or vanilla, whose commercial cultivation by smallholders may prove wholly unviable without significant training and input provision.

Simplified Technical Assistance Types



Adapted from: understanding models of Technical Asisstance (TechnoServe, 2019, p.3)

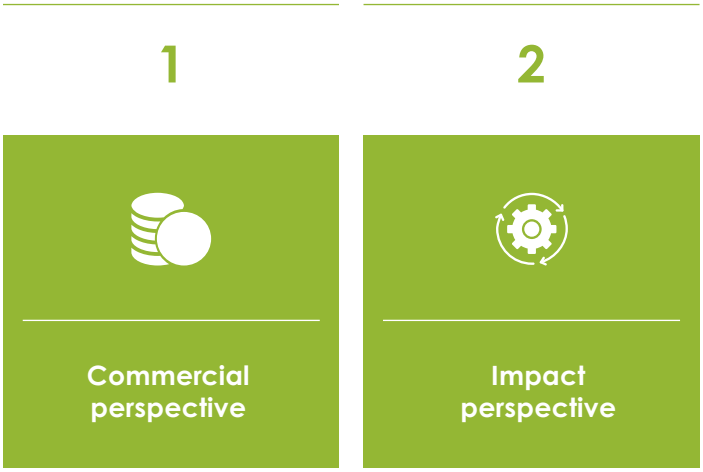
For other, more 'hands-off' crops, upstream support was touted as generating quality increases at the margins, allowing smallholders to grow higher grades. In certain value chains, a considerable degree of upstream support may also be necessary to secure access to certifications, such as Ecocert or Rainforest Alliance, that can open new markets and increase sales prices.

Upstream support is necessary for helping smallholders adapt to climate change and mitigate their environmental impact. Six investors stated that climate change adaptation and mitigation targets were priorities for their portfolios and all investors spoke of the impact of weather-related risks, such as droughts and pests, that are exacerbated by climate change. Helping farmers transition to climate-smart techniques may require training on cultivation practices, provision of improved inputs (such as heat-resistant seed varieties) and investments in irrigation or other infrastructure. Cultivation changes may be on the simpler side, such as intercropping, or they may be adopting completely new practices, such as agroforestry or silvopasture (the integration of forestry and livestock grazing). Agroforestry, in particular, was

cited by investors as a promising new sub-sector of climate change adaptation for smallholders.

Acumen Capital Partners has internalised this by looking for investee companies that understand the importance of and invest in farmer training for climate-smart practices. As noted above, irrigation is becoming increasingly important in the face of more volatile rainfall patterns, but smallholders typically need assistance and training to set up this kind of infrastructure. If they do, though, it not only manages downside risk from crop loss, but can also support yield objectives.

A number of investors stressed heavily the importance of coupling input and finance provision with smallholder training and extension services. There was broad agreement that this type of support is worth the often significant costs it can entail. The reasons for this were twofold.



First, from a commercial perspective, simple input provision was frequently not enough to bring about the yield and quality increases expected. Investors pointed to instances of agribusinesses — particularly those growing crops on a nucleus plantation and supplementing production via smallholder sourcing — overestimating smallholders' ability to replicate their cultivation practices. In one such instance, this sort of overestimation forced an investee agribusiness to postpone plans to move into processing, as depressed throughput from its outgrowers would have had the new facility operating far under capacity. This same business, however, was later able to move forward with its plans after greatly expanding its extension offerings and seeing resulting yield increases.

Second, from a bottom-of-the-pyramid impact perspective, several investors cautioned that provision of inputs and financing without accompanying training can even prove detrimental to smallholders. Farmers without sufficient technical know-how may see little improvement in yields and decreases in net income, while loans for inputs still need to be repaid.

While not in and of themselves determinants, some characteristics of successful extension services among investee agribusinesses stood out. These included delivery of training at set intervals rather than on an ad hoc basis, with the timing informed by the harvest timeline of the specific crop, as well as well-selected extension officers, ideally from within the community being serviced.

While the importance of upstream support was underscored by every investor interviewed, its provision can be prohibitively costly for some smallholder-sourcing agribusinesses, both financially and logistically. In its absence, an agribusiness may find itself in a low-level equilibrium, where subpar yields and quality leave little margin to invest in improving yields and quality.

Given the high costs but high potential return on investment of implementing support, a number of investors have expanded technical assistance offerings to smallholder-sourcing companies. Inclusive TA aimed at optimising sourcing models and increasing smallholder productivity was discussed as a means of de-risking what can be inherently risky investments. One debt investor found that this sort of inclusive TA, constituting a small part of overall capital deployment, had offered considerable protection against non-performing loans.

Kentaste: Direct-sourcing coconuts via bundled services to smallholders

Kentaste is the largest manufacturer of coconut products in East Africa.[45] The company sells virgin coconut oil, coconut cream milk, flour and dried coconut in over 1,000 retail outlets across Kenya and the East African region. Kentaste sources from over 2,000 smallholder farmers, ninety percent of whom are organic and Fair Trade-certified, in the coastal counties of Kilifi and Kwale. Smallholder farmers predominate in coconut cultivation in Kenya, with few or no large-scale plantations.[46] To supply their growing business, Kentaste has built a sourcing model predicated on trust and delivering a bundle of services that farmers value, including credit, training and seedlings.

Kentaste has earned a high degree of farmer loyalty by being a reliable offtaker, paying price premiums for organic and Fair Trade coconuts and providing credit.

Kentaste manages its farmer outgrower programme with a fleet of field extension officers, harvesters and collection centres. Its extension officers provide quarterly training and oversight of the organic and Fair Trade certification programmes. Harvesters collect coconuts directly from farmers' trees; Kentaste began direct harvesting in order to trace every coconut, a requirement for Fair Trade and Organic standards. To complement training and improve yields, the company provides seedlings for free to manage aging trees, many of which are 45-55 years old.

Kentaste has earned a high degree of farmer loyalty by being a reliable offtaker, paying price premiums for organic and Fair Trade coconuts and providing credit. Kentaste commits to buying all of a farmer's crop each season and offers a stable year-round price based on the cost of production, market price and a 10 percent premium for Fair Trade and organic-certified coconuts. The company also offers its suppliers advance payment for their crop, which farmers value highly as it is often used to cover termly school fees. Coconut trees are rain-fed, so yields and farmer incomes change from year to year, but in good years farmers supplying Kentaste have seen their yields increase from 400 to 1,200 coconuts and incomes grow by as much as 120 percent.

Kentaste has driven commercial value in its sourcing model by working with a high-margin crop and processing it into final products with the potential to tap into organic and Fair Trade markets, passing this premium onto its smallholder suppliers. However, Covid-19 restrictions have highlighted the constraints of the company's sourcing infrastructure. To address this challenge, Kentaste plans to establish new coconut collection centres, acquire additional equipment and onboard new field officers. CASA TAF is exploring avenues to support Kentaste with an inclusive business plan in 2021 that will optimise the commercial sustainability of its sourcing strategy and scale-up plans.

[45] DOB Equity, a CASA TAF Investor Partner, as well as Acumen Capital Partners are invested in Kentaste. https:// acumen.org/investment/coconut-holdings/?region=east-africa

[46] Alpex Consulting Limited. National Coconut Sector Survey Draft Report. Mombasa, Kenya: Kenya Coconut Development Authority. August 2013, 61.

Sourcing model structure and backward integration

The structure of a smallholder sourcing model can greatly impact its commercial viability, potential for scaling and the extent to which it meaningfully improves the lives of the farmers involved.

Among investee agribusinesses sourcing from smallholders, the vast majority did so through outgrower schemes, with ingrower models being far less common. Among these outgrower schemes, there was diversity in the organisational structure. Most were one of the following four models: 1) centralised models, where agribusinesses sourced directly from farmers, such as through contract farming arrangements; 2) intermediary models, where agribusinesses sourced from third party aggregators or traders; 3) structured intermediary models, lying somewhere between these first two categories, where sourcing took place through formally subcontracted agents rather than through wholly third party aggregators; or 4) nucleus-estate models, where agribusinesses maintained a central plantation and supplemented production through informal or contracted agreements with nearby smallholders. The boundaries between these categories were not always clear and many investee agribusinesses used some combination of the four.

In interviews, investors pointed to what they saw as a growing trend away from intermediaries and traders and toward more direct, centralised models as a means of backward integration (see also figure on page 22). Doing so, they noted, entails both costs and benefits for agribusinesses, but most investors indicated that in many value chains the benefits typically outweigh the costs. The benefits of running centralised outgrower models included lower purchasing prices through the elimination of middlemen, as well as its frequent corollary, higher sales prices for farmers. The potential for substantial reductions in purchasing prices alone was, in one investor's experience, enough to spur some agribusinesses into pursuing backward integration independent of any other benefits.

Backward integration may also be undertaken to enhance traceability, particularly for value chains in which it can command price premiums. Several investors pointed to marked shifts toward direct sourcing in value chains like cocoa, coffee and tea. While the impetus behind such shifts is typically commercial, spurred by certification criteria or changing consumer preferences, they may carry additional bottom-of-the-pyramid impact potential. As one investor noted, these same value chains have traditionally seen some of the largest discrepancies between end prices and farmgate prices, with the dilution of premiums through a series of middlemen playing no small part in this.

Backward integration was also discussed in several instances as a way to improve quality control relative to third-party aggregators. While intermediaries and aggregators that perform quality checks do exist in a number of markets, several investee agribusinesses found them to be insufficient. In such cases, moving to direct sourcing helped to maximise the share of usable output. In addition to quality increases, quantity increases may also come about as a product of a closer relationship between the agribusiness and its smallholders. Several investors pointed to backward integration as a means of curtailing side-selling, especially in contexts where multiple buyers for a crop exist in a given area. This becomes even more important the higher the degree of upstream support an agribusiness provides, as side-selling may seriously undercut the benefits an agribusiness sees from that support.

Finally, while not typically itself an impetus for backward integration, one added benefit of this strategy can be greater ease of capturing and monitoring impact data. This is especially true of outcome-level data like incremental changes in smallholder income, as well as more granular output-level data, like the number of female farmers supplying crops. Easier data capture through direct sourcing can prove valuable in commercial planning, as well, since an agribusiness may be better able to assess whether — and to what extent — upstream support is generating yield increases and among which farmers.

The view that the benefits of moving toward direct sourcing are worth the costs was shared by most, but not all investors and may not necessarily hold true in all value chains. One DFI investment manager shared misgivings about impractical or haphazard approaches to backward integration, cautioning that the added costs are often underestimated and frequently outweigh the benefits, all while limiting an agribusiness's ability to scale up. Costs of backward integration include higher sourcing and procurement costs and may require imposing a stricter limit on the geographical reach of the supplier base. Higher sourcing costs come through a number of channels, including necessarily larger and more involved sourcing teams, greater expenditures on logistics and transportation and higher supplier acquisition and switching costs. Whether these costs are outweighed by the benefits will depend in large part on the crop and the business's role in the value chain.

> **Backward integration is an art and a science. You need intelligence to build the capacity of the farmer to improve productivity and quality. But if you source through aggregators, then you don't know your farmers directly. In these cases, you can use aggregators to disseminate information.**
>
> Anonymous

The same DFI investment manager recounted, for example, that a number of agribusinesses in value chains like cotton and horticulture had implemented backward integration strategies in pursuit of traceability premiums that never materialised. Another investee agribusiness, meanwhile, evaluated the prospect of moving from indirect sourcing of smallholder-grown grains via intermediaries to sourcing directly from smallholders. Ultimately, as the grains were used to produce animal feed for the company's livestock and thus considered an ancillary business component, doing so was judged to bring more cost than benefit and the company continued to source through intermediaries. Other agribusinesses sourcing lower-margin or staple crops for processing may similarly find more value in the efficiency and scale of intermediary models.

In cases where the respective costs and benefits of full backward integration are less explicit, several investors pointed to agribusinesses pursuing agent or franchisee models as a middle ground between pure centralised or pure intermediary sourcing models. Minimex, a maize miller in Rwanda, uses this model to source part of its supply from intermediaries, which enables the business to access higher-quality grain. These arrangements can combine some of the benefits of centralised models, like greater control over quality and consistency of supply relative to indirect sourcing, with benefits of intermediary models, like lower procurement and staffing costs relative to direct sourcing. Particularly for businesses presently sourcing through third-party aggregators, bringing these in as stakeholders through formalised agreements can create incentive structures that drive performance improvements.

Such experiences underscore the value of a thorough supply chain analysis. This can help determine whether lower purchasing prices and increased control over quality and quantity are worth the costs of backward integration for a given business sourcing from smallholders. In the same vein, a thorough market analysis can help determine ex-ante whether there are meaningful sales price benefits to be reaped from such integration.

Trust and farmer loyalty

Trust and loyalty in the relationship were among the few factors cited unanimously among investors as critical to success in smallholder sourcing, with. A common refrain was that, in the investors' experience, not only are these elements critical, but they are also too often overlooked.

This may be understandable given that trust and loyalty are difficult to quantify and may not carry as much

> **Sourcing from smallholders is not only about farming. It's about relationships, people management, understanding local culture and customs. It's within those circumstances that you then have to optimise for quality and yields.**
>
> Mark Joenje, Partner, C4D Partners

import in conventional business relationships, where power imbalances between parties are less marked and enforceable contracts are more prominent. For smallholder-sourcing agribusinesses, however, investors overwhelmingly agreed that building and maintaining trust is key and it translates into commercial success by securing sufficient quality and quantity of product from smallholders.

Upstream farmer support and backward integration, highlighted above, both facilitate and depend on establishing trust. Backward integration via direct sourcing, investors noted, naturally generates more face-to-face interaction between agribusiness employees and smallholders. This can introduce a personal element to an otherwise purely transactional relationship, while the provision of inputs on fair terms and — especially — in-person training can bolster this.

In this vein, a number of investors pointed to the importance of thoughtful recruitment of sourcing teams from within the community. Investors noted that sourcing teams that engage with farmers in the field each season and connect with their local communities are essential to increasing farmer loyalty and community buy-in. Having local employees who speak the language and understand the suppliers is critical, as well. This was the case for several investee agribusinesses, including Kenyan macadamia nut processor Afrimac, which sources a high-margin export crop in an area with numerous buyers. Even amid this backdrop, the strength of Afrimac's sourcing team and its relationship with smallholders were cited as enabling the business to meet quantity quotas year after year without the need for offtake contracts.

While 'soft' factors like good teams and close relationships were critical, investors also cited several more concrete practices as key in building and maintaining trust, principal among them being transparent pricing and prompt payment.

> **The key success factor to Afrimac sourcing both the right quality nuts and the right volumes from their local communities, is down to really good sourcing teams that are out every season. They know their farmers, they know their local communities. And then providing that bit of extra assistance, whether it's through free seedlings or through training.**
>
> Victoria Crisp, Investment Manager, AgDevCo

Transparent and credible pricing takes on particular importance given the relative precariousness in which smallholder farmers may live. As smallholders frequently lack storage capacity and savings, their supply can be highly inelastic. As a result and particularly in the absence of contracts, an agribusiness may find it feasible to renege on a pre-agreed price in the event that spot prices at point of offtake have fallen substantially. Multiple investors pointed to precisely this scenario as one in which an agribusiness either cements or breaks trust. Breaching that trust in such a situation might boost profits in the immediate term, but may seriously damage a smallholder-sourcing agribusiness's viability in the long term. One investor remarked that, in his experience, an agribusiness may be able to breach an agreement in this way once, or possibly twice, before 'ruining' its sourcing relationship.

Investors noted, however, that pricing is just one piece of the puzzle. Another critical factor in maintaining farmer loyalty was prompt and reliable payment. This, too, stems from the fact that smallholders are fundamentally different from commercial suppliers, for whom a payment delay of one week, for example, may be easily tolerable. A number of investee agribusinesses have moved toward prompter payment by incorporating mobile money, for which a relatively robust infrastructure exists in many African nations, with growing adoption across South Asia as well. One impact investor recounted instances of TA grants allocated specifically for improving payment platforms, in order to allow agribusinesses to pay farmers within 24 hours of offtake. The investor noted that this was considered an investment aimed at increasing and protecting yields in the long run, given how critical prompt payment had proved to farmer retention.

> **Stable payments and quick payments may be the two things that farmers value the most. If you want to lose your farmer fast, take a long time to pay him.**
>
> Rebecca Mincy, Acumen Capital Partners

Wakulima Tea Company:
Using Shared Value to Foster Farmer Trust and Loyalty

As the second largest tea producer in Tanzania, Wakulima Tea Company Ltd. (WATCO) has been exporting tea around the world for more than two decades.[47] WATCO sources from almost 13,000 smallholders who represent 90 percent of its supplier base and 70 percent of all tea smallholders in Tanzania. Several factors contribute to WATCO's success, including its unique smallholder-sourcing model built on shared value[48] and its high-quality production.

WATCO sources from smallholders who are members of the Rungwe Busekelo Tea Cooperative Joint Enterprise (RUBUTCO-JE), which owns 30 percent of WATCO. This model motivates members to view WATCO's success as their own success. In fact, they have an agreement that members can only sell to WATCO and WATCO can only buy from members. WATCO delegates key responsibilities, such as input distribution and payment scheduling, to the cooperative. Through shareholder meetings and collaborative monitoring activities, WATCO maintains a close relationship with smallholders, recognising that a company built on shared value is more successful and resilient.

> **'Our main success is having shared the responsibility with the farmers for business success. The fact that smallholders are 30% shareholders of the company means they have a shared incentive to make the company profitable so they receive dividends.'**
>
> Andres De Klerk, Operations Director, Wakulima Tea Company

With twenty years of experience, WATCO's smallholders have the skills to harvest tea effectively. Therefore, WATCO focuses on monitoring and improving logistics, rather than training, to ensure a supply of high-quality tea. Twenty-nine extension officers oversee RUBUTCO-JE's eight Agriculture and Marketing Cooperative Societies (AMCOS). Using a smartphone application and Excel, WATCO ensures data collection is easy for officers. With help from extension officers, WATCO instructs farmers to harvest before sunrise and directs truck drivers to collect tea early to ensure a fresh product. This strategy is working: post-harvest spoilage has fallen to 2 percent. WATCO also pays smallholders 3 percent above the government price. This gives WATCO leverage to push for higher quality tea and means that farmers are earning an average net income of USD$745 per hectare.[49] Additionally, over 11,000 of its smallholders are Rainforest Alliance Certified, unlocking access to bigger markets and better prices.

By including smallholders as shareholders and prioritising tea quality, WATCO has achieved substantial success with opportunities for future growth.

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[47] Tanzania Tea Packers (TATEPA) is the publicly listed holding company of Wakulima Tea Company (70% ownership). Maris Africa (through Agris) is a majority shareholder of TATEPA.

[48] Porter, Michael and Kramer, Mark. 'Creating Shared Value.' January–February 2011. Harvard Business Review. https://hbr.org/2011/01/the-big-idea-creating-shared-value.

[49] In the case of WATCO, the average smallholder land size dedicated to tea is 0.2 hectare.

Geography and connectedness

Investors indicated that successful smallholder-sourcing agribusinesses are those whose business and sourcing models are appropriate not just for the specific crop or value chain, but also the broader context in which the business operates.

Geography, infrastructure and connectedness can be particularly important factors for agribusinesses, more so than sometimes taken into account initially. Investors recounted instances in which due diligence undertaken by agribusinesses before implementing an outgrower scheme underestimated — sometimes seriously — the extent to which these factors would depress throughput. In one such case, this led to processing facilities operating so far under capacity that the agribusiness found it necessary to establish its own plantation. On other occasions, rather than throughput, it was post-processing transportation of the finished goods for export that was the issue. This was especially true of low-income, landlocked countries.

However, investors noted that 'bad' geography or limited connectedness do not necessarily preclude successful agribusinesses; instead, they create certain hurdles for businesses to overcome. Successful examples of smallholder-sourcing agribusinesses operating in such environments include those involved in high-margin crops with low post-harvest perishability. These factors together can allow an agribusiness to tolerate infrequent or costly transport of the harvested crop, particularly in the absence of year-round roads.

A model operating in a remote region is that of the Babator Farming Company in northern Ghana. This entails an ingrower scheme in which cultivation is done by smallholders on the agribusiness's own farm, mitigating to an extent the logistics costs that sourcing from smallholders' own farms would have entailed. While more remote projects such as this may require more thoughtful planning from a commercial perspective, they could carry a twofold development impact, with potential to not just help the smallholders involved but also to mitigate inter-regional inequality within countries, all while crowding in additional investment in the future. One impact investor referred to this as transformational or catalytic impact, whereby there can be value in investing in under-invested regions, even if initial financial returns — as well as nominal output metrics like number of smallholders reached — might be less impressive.

Political context

Several investors also pointed to a number of specific implications of the policy and political contexts in which a smallholder-sourcing agribusiness operates. This may present challenges in a number of respects, including agronomy: the success of input provision and upstream support in increasing yields, for example, can depend on seed legislation at the national level.

Also pertinent was the prevalence of direct price interventions and regulation. Common across much of Africa and Asia, this brings an added consideration particularly for those agribusinesses considering sourcing from smallholders versus cultivating on their own. Especially in countries where staple prices may be heavily tied to electoral cycles, sourcing these crops from smallholders can increase the exposure of a business's balance sheet to the political environment. One investee agribusiness, engaged in animal husbandry and operating in such an environment, found the increased exposure to be worth the cost savings and continues to purchase grains from smallholders to produce feed. The business does, however, hedge against this risk by maintaining its own plantation to cover roughly a third of its grain needs. The extent of government intervention in staple prices — particularly in countries with a strategic food reserve — was also cited by one DFI as a reason they prefer not to invest in these value chains.

Price regulation was not always cited as a challenge, however. One agribusiness sourcing a crop whose price is set by the national government noted that fluctuations were rare and planning was accordingly

straightforward. Having a clear government-set benchmark, over which it pays smallholders a fixed premium, also gave the agribusiness some leeway to demand higher quality. It stands to reason, however, that this sort of benefit rests on the regulatory body being relatively insulated from political pressures, which is not a forgone conclusion in many LMICs.

Conversations with investors ultimately made clear two things. First, an agribusiness sourcing from smallholders must tailor its model to a number of factors in order to achieve success. High-margin export crops benefit most from significant upstream support and strong sourcing relationships with a relatively limited number of smallholders. Conversely, low-margin staple crops may allow for profitable smallholder sourcing as long as an agribusiness maintains high operational efficiency, purchases at sufficient scale and adds substantial value to the sourced crop. Similarly, geographical and political constraints can in some cases be mitigated, circumvented, or even turned into advantages, by the right business and sourcing models.

Second, while optimising to the specific context is essential, investors universally stressed the role of trust in making a smallholder sourcing model successful. This rests on the acknowledgement that an agribusiness's relationship with smallholder farmers will naturally take on different dynamics than a relationship with commercial suppliers. Providing training and inputs on fair terms, recruiting trusted sourcing teams, making good on pricing commitments and paying in a reliable and timely manner can all help an agribusiness build a mutually beneficial relationship with its smallholders, independent of the value chain or broader context.

Section 5

Investment strategies for smallholder-sourcing businesses: perspectives on 'the deal'

We interviewed investors with a wide range of commercial and impact objectives and varying perspectives on successful strategies for smallholder-sourcing businesses. Rigorous due diligence was among the most commonly cited factors that influenced commercial success; these processes were key for investors to ascertain the required capital structure, appropriate investment horizon and deal size for investments in smallholder-sourcing businesses. Critically, enhanced due diligence on the sourcing component helps to fully understand the sourcing model and identify where additional concessional funding and TA is needed to deliver on the opportunity. Finally, investors highlighted that agtech and impact monitoring are important tools to leverage for data-driven decisions and risk mitigation.

Impact-commercial case

Many investors highlighted the tradeoff between an investment's commercial and impact success, but some investors asserted that the distinction between the commercial and impact cases was outdated. Investors agreed that the commercial and impact cases for smallholder sourcing models are inextricably linked: impact cases cannot be fully achieved if an agribusiness is not financially sustainable. Without a business' ability to scale, any impact on smallholder suppliers' livelihoods is short-lived. The impact-commercial case linkage is underscored by the fact that 67 percent of impact investors surveyed in the GIIN 2020 Annual Impact Survey target risk-adjusted, market-rate returns.[50] However, during the interviews, investors also spoke about the 'investment case for impact' as a distinct objective and the degree to which investors might sacrifice returns to achieve impact depended on the mandates and goals of their funds.

> **'To achieve the kind of deep and sustained impact we want with very marginalised rural communities there are often tradeoffs between impact and financial returns.'**
>
> Harry Davies, Manager of Program Investments, Ceniarth

Companies that source from smallholders can and do provide the commercial returns profile that investors seek. One Africa-based private equity fund expressed that investors do not necessarily have preconceived notions about the returns profile of an investment in a business that sources from smallholders in comparison to large agri-producers; often, firm-specific factors or value chain contexts make generalisations difficult. As discussed in Section 5, in some circumstances (with certain crops or geopolitical constraints), smallholder sourcing is the most economical sourcing model. Still, a few investors found that unique efficiency and optimisation constraints of working with smallholders created tradeoffs between returns and impact.

[50] Compared to only 18% targeting 'below market-rate returns: closer to market rate' and 15% targeting 'below market rate returns: closer to capital preservation'. GIIN. GIIN Annual Impact Investor Survey. 2020. https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf, 4.

Some investors aspire to move past the dichotomous dialogue of returns versus impact and want to demonstrate the mutual economic value of working with smallholders. For example, IDH Farmfit Fund mentioned that a prerequisite for investee companies is their recognition of the economic benefits of service provision to smallholders. Eco.business Fund is another example of a fund with strict environmental, climate-change and biodiversity targets which must be fulfilled along with commercial return. Also, Acumen Capital Partners looks specifically for companies that prioritise farmer training on climate resilience and agricultural best practices. With a thorough pre-investment screening process, investors are able to partner with companies that have aligned impact interests and that are well-positioned to demonstrate the viability of smallholder sourcing models.

> **'We'd like to see market transformation, where smallholder farmer agriculture is seen as a viable market.**
>
> Dominic Strano, Senior Investment Manager, IDH Farmfit Fund

Investors are willing to invest in companies that have significant reliance on smallholder suppliers, as long as due diligence processes show that the business model works and that an investment would help scale up the business further. Finding a business model that works, however, is a complicated task. Research studies may demonstrate successful farming models at the plot level, but it can be difficult to find real-life commercial examples of these models at scale. Investors need successful commercial examples of models to ensure that there exists a path to scale that would provide an exit opportunity. For that reason, some investors feel more comfortable investing in backwards integration for an already-scaled business or in well-established value chains.

Due diligence

Investors need to assess supply chain opportunities thoroughly prior to investment in order to understand the unique requirements of sourcing from smallholders. Working with smallholder suppliers adds complexity to how investors underwrite companies and manage them. One primary feature is an extended working capital cycle, which allows for additional risks between when a crop is harvested and when it reaches its end market. The investor needs to understand the risks associated with the supply chain, quality and payment terms. When business plans underestimate these risks, they restrict the benefits of smallholder-supplied crops outlined in Section 3 of this paper. Through rigorous due diligence, investors can learn to design appropriate capital structures, holding periods, deal sizes and TA projects for maximum impact and returns.

Investor feedback revealed that smallholder suppliers need more hands-on engagement from investors and agribusinesses in order to achieve commercial success. Therefore, investors suggested that, as part of the due diligence process, it was critical to understand the time and expenses required to work with companies that rely on smallholder suppliers. For example, three investors suggested that it is important to provide close supervision of smallholder outgrower programmes through extension services. Smallholder outgrower programmes need very close supervision and offtakers need to be 'on the ground' with the smallholders even in the case of less complicated crops, like tea. Supervision helps offtakers understand what farmers need in order to maximise their yields and supports greater adherence to quality standards, government regulations and environmental and social regulations such as animal welfare and waste disposal.

Effective due diligence relies on a combination of expert skills in finance, agriculture and business operations, as well as familiarity with operating contexts. This includes finding experienced fund managers to oversee agribusinesses that source from smallholders. Investors

commented that agricultural work experience is essential for both agri-entrepreneurs and agri-fund managers. On the agribusiness side, complex outgrower schemes are implemented more effectively by competent and experienced entrepreneurs. Two investors specifically underscored the importance of entrepreneurs who are based locally, rather than in the U.S. or Europe. Agricultural experience is also important on the fund side. One investor noted that fund managers with prior agriculture operating and investing experience are better equipped to supervise complex business models and employ inclusive TA grants to set up smallholder outgrower schemes. Relevant experience, paired with a strong local network, ensures proper due diligence for deals.

> **We're very 'hands-on' in our approach to working with our portfolio companies. We have offices in Johannesburg and Nairobi and spend significant time with our portfolio companies in country to work through solutions to supply chain issues with the management teams.**
>
> Lize Lubbe, Principal, Phatisa

Capital structure

To attract commercial interest in smallholder sourcing models, public funding and other donors play an important role in de-risking and demonstrating the business case. Even strong commercial cases for investing in smallholder agriculture carry inherent risks, so investors such as Ceniarth often rely on higher-risk investment pools within their overall portfolio to support enterprises. Investors also emphasised that blended finance structures are essential for less risk-tolerant investors to commit significant funds to scale up smallholder sourcing models. Smallholder models that intentionally contribute to climate change adaptation and resilience goals can also access 'green funds' or specialised investment vehicles with climate change targets, which serve as another source of blended and concessional capital.

> **If you are investing long term capital in the production or primary/ secondary processing segments of the agriculture value chain and targeting smallholder farmers, consider a blended finance structure that provides downside protection in order to mobilise the scale of investment capital that is likely to be required.**
>
> Investment Manager, CDC Group

> **Our objective is to turn smallholder agriculture-based finance into an asset class. We liken it to how microfinance or renewable energy finance was ten or fifteen years ago. We would really like to see [smallholder agriculture-based finance] get to a stage where it is a viable asset class.**
>
> Dominic Strano, Investment Manager, IDH Farmfit Fund

As part of blended finance structures, funds like IDH Farmfit are mandated to take on the highest-risk positions of investments, with the specific purpose of catalysing additional commercial investment in smallholder sourcing models. With these high-risk investments come expectations of some significant losses for the IDH Farmfit Fund, but commercial investors investing together with the Fund will be more protected. By de-risking these investments for other investors, IDH Farmfit Fund intends to turn smallholder agriculture-based finance into a viable asset class.

Investment horizon

At present, the investor landscape is lacking in funds that allow investment horizons of seven to 10 years or longer. Long-term capital allows TA projects to create sustainable improvements in smallholder yield. Maris Africa and Barak Fund Management spoke of the benefits of permanent capital vehicles (PCV) — which have no set time for exiting an investment — for investing in agriculture. PCVs provide the time and flexibility for investments to generate returns at their own rate. Longer time frames are also an agronomic necessity. Agris, a subsidiary of Maris Africa, provides an example of the benefits of a PCV through its investment in the Equatoria Teak Company in South Sudan. While the company's teak trees are still over twelve years from maturity, Agris is working with the company to pilot vanilla and coffee production through an extensive outgrower programme. Other investors that did not mention PCVs still noted the need for longer-term investment horizons than the typical venture capital or private equity timeframes.

> **In the agri-sector and certainly in [East Africa], holding periods of ten years are not enough because of externalities that we cannot control like elections, weather patterns and economic factors.'**
>
> Anonymous

For some investors, horizons of five to seven years allowed for sufficient time to help agribusinesses implement best practices among smallholders and see yield increases materialise. Still, investment horizons of five to seven years only work in some contexts. Zebu Investment Partners pointed out that in cases where smallholders already have crop expertise, sourcing from them can provide immediate commercial advantages for the company and positive impacts for the farmers. However, if considerable smallholder training is needed to reap these benefits, the expenses and time required for profitability may create too great a risk for the exit price of the investment. With even shorter horizons of three to five years, Barak Fund indicated that TA projects are limited to 'low-hanging fruit' that are short-term in nature.

Although investors noted the need for longer-term financing, there is also a dearth of short-term working capital finance. A nuance that one trade finance investor highlighted is the potential for multi-year engagement on smallholder sourcing because the relationships between investors and businesses can be long-lasting. While individual transactions in trade finance are short (30-120 days), multi-year relationships between agribusinesses and investors allow the agribusinesses to export crops that they procure from smallholders on a seasonal basis. Agribusinesses often return to their financiers each season, be it to manage stock from the previous season or to increase volume of procurement from smallholders in the next season. Therefore, investors engaged in trade finance analyse borrowers on a multi-year basis and are interested in strategising how to support working capital cycles over multiple years. Furthermore, the longer the relationship between the investor and the borrower, the lower the probability of the borrower defaulting, because the investor has a better understanding of how the business works.

Deal size

Investors ranging from DFIs to impact funds noted requisite large transaction ticket sizes as a constraint for impact and some investors reported having to scale back on smaller deals to make the economics of their investment operations work. The constraint stems from the similar due diligence efforts required for small and large deals, making their sourcing costs equivalent. Furthermore, due diligence procedures for family-owned SMEs sometimes reveal unconventional

management structures that are incompatible with investor needs.

DFIs typically reach smaller companies via intermediary funds, but some private equity/impact fund managers have established a lower threshold on deal size. For example, the Yield Uganda Investment Fund, launched in 2017 and managed by Pearl Capital Partners, is mandated to make investments in the range of €250,000 to €2 million. Three investors noted that smaller deals can be warranted when an SME shows high growth prospects and has strong management teams. They also noted that often, the most innovative companies from a developmental impact perspective are smaller and cannot absorb large capital amounts, implying that some 'missing middle' SMEs may still be left behind from private capital pools.

Beyond the economics of transaction origination, one investor advised that ticket sizes below $5 million are insufficient for funding SMEs in general, but particularly for SME agribusinesses that source from smallholders. These businesses are capital intensive and also require sufficient capital (either given to the company initially or reserved in the fund) to manage risks specific to smallholder sourcing models. Concerning SMEs in general, investors have historically underestimated the amount of finance required for capital expenditure, operating expenses and working capital. The investor explained that it is a mistake for investors to provide funding for capital and operating expenditures and then assume that banks will provide SMEs with working capital

Technical assistance for upstream support

Just as investors acknowledge the need to de-risk their investments through core business support, they are increasingly seeing the necessity of investing in TA to strengthen smallholder-oriented supply chains and to de-risk their investments.[51] Eight investors from our sample noted the value of inclusive TA. To invest with confidence and drive attractive returns, a number of investors suggested that agribusinesses require specialised TA on developing cost-efficient inclusive business models that assure continuity of quality raw material and sustainable smallholder participation. TechnoServe typically defines this type of support as 'inclusive business support' or inclusive TA, which is specifically designed to enhance direct impact around investments focused on low-income communities.

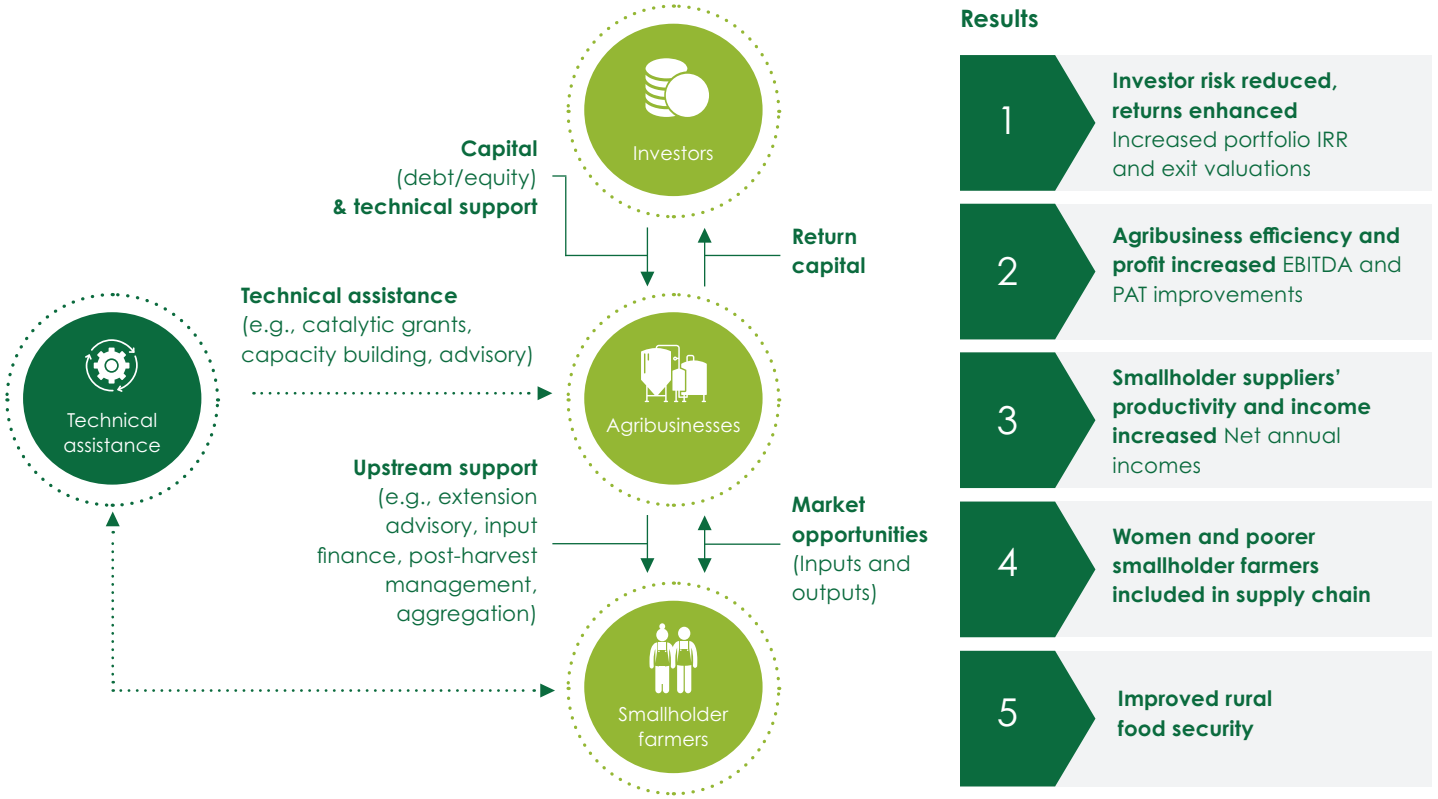
Investors suggested that inclusive TA can offer several routes to increased profitability and impact. Specific assistance to agribusinesses can help to address sometimes significant risks and challenges that can make an efficient inclusive sourcing system complex and costly to implement. These interventions include supporting reliable farmer production and supply through optimal training models; increasing smallholder loyalty; resolving side-selling issues through careful incentive programmes; and supporting increased economies of scale via more efficient aggregation models that bring down prohibitive sourcing costs.

With provision of key support services to farmers, investors suggested that farmers are able to supply better quality products, which enables companies to receive higher price premiums and/or more consistent quality stock and drives up efficient processing capacity utilisation. In addition, access to key technologies such as storage infrastructure can help farmers better manage crop quality and reduce post-harvest losses. Climate resilience training is also an increasingly important focus of TA to support sustainable crop production, as elaborated on in Section 4.

Several investors found that inclusive TA to smallholder-sourcing agribusinesses offered substantial potential for increased return on investment (ROI), so long as the

[51] For more information on the distinction between core business support and inclusive TA, see: TechnoServe. A Review of Inclusive Technical Assistance in Agriculture Deployed by Development Finance Institutions. 2020. https://www.casaprogramme.com/wp-content/uploads/20200630-CASA-TAF-Review-of-DFI-Inclusive-TA.pdf.

Inclusive Technical Assistance Schematic



company buys into the efforts and the TA meaningfully contributes to de-risking the investment. This is more likely to happen when the due diligence stage includes expertise at the smallholder sourcing/impact level, which can help to uncover substantial risks and identify TA needs to support a more robust portfolio management plan.

For example, AgDevCo has found that pairing its investments with TA projects from its in-house Smallholder Development Unit (SDU) has supported efficient capital deployment. When the SDU is crafting a TA project plan, it is already familiar with the business as an AgDevCo investee and the business has already undergone due diligence processes. Acumen Capital Partners also provides TA grants to its portfolio companies to support a range of operations. For example, Acumen Capital Partners is supporting one of its agribusinesses to pilot a better irrigation scheme for their smallholders.

> **The further through the value chain farmers go, there is an increased risk of impaired quality because the farmers don't have the infrastructural capability to properly manage or store that [semi-processed] produce. When an investment is accompanied by some TA to fund technical training to farmers then we see better yields, quality and post-harvest storage practices.**
>
> Kyle Smith, Deal Originator, Barak Fund Management

From CASA TAF's first learning paper, DFIs noted that they expected the provision of inclusive TA in agriculture to rise, citing increasing focus on agriculture investments,

increasingly ambitious targets for development impact from these investments and growing recognition of the role of TA in achieving impact potential as the key drivers of the change.[52] Whilst this was not the focus of this paper, it was clear that there is investor demand to explore opportunities for increasing provision of inclusive TA.

Tools for data-driven decisions and risk mitigation

Agtech

Six investors commented on a sense of growing enthusiasm for how agtech can benefit smallholder-sourcing businesses. Agtech software has the potential to increase the commercial viability of smallholder sourcing on a large scale through improved smallholder management processes. For example, some Agtech software enables digitised smallholder data collection and analytics. The Wakulima case study (see page 35) illustrates how using the cloud-based platform Farmforce to digitise supply chain data has helped Wakulima Tea Company respond to farmer challenges and mitigate risk in their supplier base. Several investors highlighted that digital platforms can reduce agribusinesses' operational costs of sourcing from and providing services to thousands of smallholder farmers, especially when they are widely geographically dispersed.

Also, tech-enabled buy and/or sell platforms such as DeHaat (see case study below) are revolutionising intermediary models in smallholder agriculture supply chains. CDC and C4D cited examples of Asian tech companies that use agtech platforms to connect smallholders to new markets and distribution firms that they would otherwise not have access to. Eventually, niche agtech platforms for specific areas such as aquaculture and horticulture may develop to meet specific farmer needs.

> **Having technology at your disposal, which allows you to improve farm operations, to track the performance of farmers, to digitise supply chains— is a game changer.**
>
> Maurice Scheepens, Fund Manager, FMO

Despite these exciting innovations, investors made clear that the agtech space is still nascent. When discussing investment opportunities for agtech companies, multiple investors described difficulty in finding opportunities for companies that are already at scale. One investor cited technology infrastructure, technology adoption and population density as requirements for tech platforms to scale quickly — not all of which are present in many investors' portfolio company locations.

[52] TechnoServe. A Review of Inclusive Technical Assistance in Agriculture Deployed by Development Finance Institutions. 2020. https://www.casaprogramme.com/wp-content/uploads/20200630-CASA-TAF-Review-of-DFI-Inclusive-TA.pdf.

DeHaat Case Study

The Indian company DeHaat addresses smallholder farmers' challenges in obtaining agricultural inputs, technical knowledge, market linkages and financial services through a single technology-based platform. DeHaat connects Indian smallholder farmers to markets and streamlines the supply chain between input suppliers, farmers and off-takers. DeHaat's unique blend of physical and technological infrastructure gives it an advantage in serving India's massive agricultural sector, which includes about 130 million smallholder farmers. Today, the DeHaat platform reaches roughly 450,000 smallholders, with a goal of reaching 17 million by 2025.

'Increasing the profitability of smallholder farmers is the most important priority in rural India and DeHaat has developed a scalable, sustainable model for doing exactly that.'

Jinesh Shah, Managing Partner of Omnivore

DeHaat's tech-enabled hub-and-spoke model allows their smallholder sourcing operation to efficiently connect farmers to markets. Smallholders sell their produce to DeHaat through their tech platform, bringing their grains, fruits and vegetables to last-mile centres (the 'spokes'). These last mile centres are set up, supported and supervised by the company but run and owned by over 1,600 micro-entrepreneurs. Then, DeHaat uses third-party logistics services to collect, aggregate (at DeHaat-owned 'hubs') and directly supply over 600 commodity bulk buyers, including retailers, e-commerce companies, food processors and fast-moving consumer goods multinationals. Importantly, the hub-and-spoke model minimises intermediaries.

The network of last-mile centres has been key for DeHaat's success in scaling up. When DeHaat was started in 2012, digital maturity in rural villages was low, especially with regard to smartphone penetration. Although smartphone adoption is higher today, DeHaat will continue using the last-mile centres, recognising their importance in building trust with farmers through physical interaction. Plus, the model has allowed DeHaat to supervise processes closely.

DeHaat is driving towards full-stack platform status with an entry into fintech services. CASA TAF is currently supporting DeHaat's efforts to develop an input credit scheme that will enable farmers to purchase high-quality farm inputs on credit with repayment linked to the harvest cycle. Between fintech, input, output and advisory services, DeHaat is providing farmers with a one-stop solution for their challenges.

With the CASA TAF technical assistance to introduce the input credit facility, farmers will benefit from an estimated 20-25% yield increase; aiming to impact ~48,000 beneficiaries with an incremental income of £177 per farmer per year by the end of the CASA TAF's project.

Impact monitoring

While impact monitoring is important to ensure that donors meet their mandates, it also has a link to commercial performance and can be an opportunity for data-driven decision making. Leveraging impact metrics for business decisions is more likely when impact metrics are relevant to the business model, commercial performance and future cost of capital. As part of their Development Impact assessment of every deal, CDC looks at: Who, What, How Much and Risk.[53] For companies with smallholder suppliers, the economics of the outgrower scheme is also considered as part of this – for both the company and the farmers. It is in an agribusiness's best interest to have information on their outgrowers, such as the number of smallholders, their yield and locations. These databases allow businesses to record payments to farmers to track the performance of agribusiness staff such as extension officers.

While investors acknowledged that the process of collecting smallholder impact metrics requires additional staff bandwidth and can sometimes be a struggle for short-staffed companies, most reported that their impact data collection processes have become more streamlined and refined over time. C4D Partners indicated that each year that the companies collect impact data for investors, their methodologies for gathering data improve. Some agribusinesses have recognised that impact metrics can also aid in understanding their own operations.

For example, Acumen Capital Partners mentioned that smallholder yield metrics were extremely important for efficiencies and profitability at the commercial level. To maximise efficiency and value of impact monitoring for agribusinesses, impact data can be integrated into regular business monitoring systems. Additionally, Pearl Capital Partners highlighted that agribusinesses benefit from having data on their outgrowers such as total number of smallholders, smallholder yields and farmer geographic locations. Businesses can use impact data to create and monitor metrics relevant to operations such as timeliness of farmer payments and performance of extension officers.

Some investors and companies reported success in streamlining impact data collection through standardised surveys, either developed in-house or sourced externally and by using third-party technologies. Four investors cited successful survey collaboration with 60 Decibels, a customer data collection service, that helped simplify the process of verifying and validating the smallholder impact metrics through short telephone surveys that they receive from companies. Acumen Capital Partners mentioned that they currently utilise a range of bespoke surveys to assess farmer challenges and company-specific needs. Although extremely useful, as third-party digital platforms and custom-built surveys allow for effective smallholder management, they can also be very costly. Strategies to streamline the management of smallholder information over time could reduce cost-benefit inefficiencies in surveys.

> **60 Decibels Lean Data is a useful tool for both us and our portfolio companies, providing independently verified impact data. Importantly, it provides a voice to smallholder farmer beneficiaries to share their perspectives. It is helpful for portfolio companies both internally in terms of understanding their customer value proposition and flagging areas for improvement, as well as adding value externally when interacting with potential funders and investors.**
>
> Harry Davies, Manager of Program Investments, Ceniarth

[53] For further information see: https://www.cdcgroup.com/en/our-approach/our-approach-to-impact/what-impact-means-to-us/

In addition to streamlining impact data collection, investors expressed the need for the flexibility to align impact indicators with business models. Agribusiness managers and investors experience frustration when the impact metrics required by donors are not aligned with a company's business model. One investor gave the example of a company that efficiently sourced a high-value crop from a handful of larger smallholders. In this case, company leaders felt frustrated by an implicit preference in impact metrics for sourcing from high numbers of micro-smallholders, because it was incompatible with their business model. TA projects' smallholder impact metrics may appear low in terms of the quantity of smallholders impacted because some projects are focused on fewer, stronger relationships that lead to deeper impact. Other examples include enduring connections with local communities through employment of local people and improvement of local infrastructure.

In conclusion, thorough due diligence processes are essential for managing the complexities of investments in smallholder-sourcing businesses. By understanding the scope of risks, costs and time associated with these investments, investors can choose appropriate capital structures, investment horizons and deal sizes. In particular, enhanced due diligence on the sourcing component could help identify where additional concessional funding and TA is needed to deliver on the opportunity. As companies increasingly digitise their farmer data and utilise agtech platforms, investors will be able to conduct more thorough data analysis of company supply chains and gain more accurate understanding of how smallholders fit into them. Lastly, when investors thoughtfully align the impact metrics they require with commercial objectives of agribusiness sourcing models, agribusinesses can unlock potential to use impact data to improve operations.

Section 6

Reflections and Conclusions

Evolving landscape of investment in agriculture in LMICs

When we asked investors to reflect on the evolution of agricultural investment in LMICs over the past decade or so, several themes emerged, including increased investment interest in the sector; an enduring mismatch between expected and actual returns; a new emphasis on climate change adaptation and resilience; and the emergence of agtech as a potential strategy to boost efficiencies.

All investors agreed that interest in investment in agriculture was on the upswing, corroborating the findings of the 2020 *GIIN Impact Investor Survey*.[54] Investors specifically pointed to a rising interest in investment in secondary agriculture (adding value to raw produce through processing). One investor described a 'proliferation' of impact- and agri-focused funds at present. Two investors noted that there is growing competition among funds for investment in promising companies, which in turn fosters innovation among agricultural firms.

Additionally, many investors reflected that until a decade ago, there was a sharper distinction between investing in large multinational agricultural firms and investing in smallholder farmers through microfinance and farmer-direct financing. Recently, there has been more interest from development actors to bridge this divide by supporting smallholders indirectly via larger value chain companies. Some investors even noted that reaching smallholders via large, established companies is preferable due to their sophisticated risk management capabilities.

Despite this growing interest in the agricultural sector, investing in this space remains challenging, as available financing vehicles often do not fit the market context in LMICs, especially in sub-Saharan Africa. Agribusinesses in LMICs are vulnerable to macroeconomic or natural shocks and investor expectations about tenor and return are not always compatible with the operating environment. Investors generally noted that available funds and investment horizons are too short-term. In the early 2010s, this mismatch between expectation and reality led many investments in smallholders to not generate returns in line with expectations. Today, however, investors are interested in more innovative, longer-term investment vehicles that enable greater returns and impact among smallholder-sourcing businesses.

> **We're still using the same 'straitjacket' model: the 10-year vehicle. If we could have more innovation in that regard, it would serve the [agriculture] space better than looking at it just from a traditional PE-VC model in which you would yield a return or would show impact.**
>
> Anonymous

Investment in climate change adaptation and resilience was also cited as a major trend going forward, enabled by the rise of donor- and multilateral-supported climate change funds. For example, Acumen Capital Partners focuses on this issue and uses a proprietary tool to score potential investments on how they contribute to adaptation and resilience

[54] GIIN. GIIN Annual Impact Investor Survey. 2020. https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf.

goals, adding a new dimension to the impact case for investment. CDC noted that forestry is a growing area of interest, especially as it relates to achieving net zero carbon goals. However, CDC also observed that while there is a lot of excitement among investors about 'smart,' 'regenerative,' and 'resilient' agriculture, specific opportunities for investment are not yet visible at scale.

Lastly, agtech was cited as an emerging investment trend, as it has the potential to lower operating costs and create new opportunities for commercially viable smallholder relationships. However, some investors noted that they have not yet invested in agtech because there are limited investment opportunities for companies that are already at scale.

Key takeaways: challenges and opportunities

The objectives of this study were to quantify the share of investment flowing to smallholder-sourcing agribusinesses and to understand investor perspectives on the commercial viability and development impact of companies that source from smallholder farmers.

Quantifying the size of investment flows to smallholder sourcing-agribusiness proved more challenging than originally anticipated. Investors do not necessarily track their investments this way and for some investors in our survey, it was a manual exercise to identify which investee companies source from smallholder farmers. As a result, our analysis has been largely qualitative. In order to understand and analyse smallholder farmer linkages to food and agriculture sector businesses, additional tracking of the types of agribusiness in investors' portfolios is needed. Future quantitative research in assessing the 'asset class' of smallholder-sourcing businesses will be important to provide guidelines on the blend of capital and TA required to make them work.

Our interviews with investors made clear that there is a diversity of opinions on this topic and over-generalising about investors' perspectives on smallholder-sourcing agriculture may be misleading. Investors evaluate every potential investee agribusiness on its own merits, considering firm- and context-specific factors. However, our interviews yielded some broadly held perceptions, which are summarised below.

The most common challenge of smallholder sourcing cited by investors was ensuring sufficient quantity and quality of raw materials. Inefficient aggregation models that create bottlenecks are a major contributor to this issue. While smallholder sourcing provides numerous opportunities to strengthen agribusinesses' long-term health and profitability, the initial start-up of an efficient sourcing or aggregation system can be complex, costly and risky to set up in the short-term.

Successful inclusive sourcing models depend on both the specific characteristics of the crop and the business's role in the value chain, as well as the broader geographical, political and social contexts in which the business operates. Inclusive smallholder sourcing models should be tailored to the crop-unit economics. High-margin export crops can benefit from more flexibility and cash flow to invest in upstream support and deep relationships with smallholder farmers, whilst inclusive sourcing models dealing with low-margin crops rely on operational efficiency, sufficient scale and value addition. Our analysis also highlighted that other factors related to geography and socio-political contexts can play a major role. While unethical or unsustainable business practices can damage a company's reputation and consequently their bottom line, often overlooked is the extent to which socially responsible business practices can bolster it. Finally, the importance of trusting relationships and cultural understanding between agribusinesses, farmers and the wider communities cannot be overstated. Trust is critical to persuading farmers to switch from their traditional farming practices, minimising the risk of side-selling and maintaining a social licence to operate.

Inclusive sourcing models, with associated smallholder farmer relationships and support services, do not always look the same. Inclusive sourcing models should

be customised to fit the business context. For example, direct sourcing models, such as backward-integrated outgrower schemes, are gaining in popularity due to their price and traceability advantages, but they will not be the best fit for every business. Carefully designed intermediary sourcing models can work as well. Factors for successful intermediary sourcing are careful partner selection, adequate support for agronomic extension and skills development, formalised agreements and incentive structures that do not place farmers' and intermediaries' interests in conflict.

Thorough upfront analysis of the market and the agribusiness is needed to understand the optimal inclusive sourcing model, what kinds of sourcing model investments can feasibly be undertaken by the business and what kind of investments should be done by other market partners or the public sector. Upfront analysis as part of the due diligence process can help to determine the cost and growth opportunity from making certain investments. However, this type of analysis may be beyond the scope of investment managers' normal due diligence process and often requires specialist expertise.

To address this, inclusive TA is another tool that impact investors and DFIs are utilising to de-risk their investments and increase the likelihood of a successful exit. Developing cost-efficient inclusive business models that assure continuity of raw material supply and meaningful smallholder participation is increasingly seen as a necessity rather than a bonus with these businesses. As noted in Section 1, organisations such as IDH Farmit, Bain and TechnoServe, via the Service Delivery Model (SDM), Farmer-Allied Intermediary and Inclusive Business Plans (IBP) frameworks, respectively, are advancing the sector's understanding of commercially successful smallholder-sourcing models.

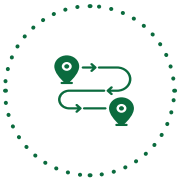
Longer-term and more flexible investment vehicles are needed due to the long returns horizon in agriculture more generally and particularly when trying to build out smallholder sourcing schemes, which take years to optimise. Investors noted that the typical venture capital and private equity horizon and returns expectations do not always fit the needs of growing agribusinesses that are susceptible to commodity, currency and political shocks.

Investors pointed to a need for innovation in the financial offerings available to agribusinesses. More patient capital with longer investment horizons is required for many agribusinesses. Blended finance can play a role in addressing the long-term funding gap and has an important role to play in de-risking investments more generally. Concessional funding is critical to demonstrating unproven business cases and crowding in private capital. At the same time, short-term, flexible working capital that factors in seasonality and other agricultural realities continues to be a major gap.

Key opportunities to support investment in smallholder-sourcing models

Upon reflecting on our key takeaways and analysis, we have identified five specific opportunities for development partners, investors and agribusinesses to support investment in smallholder-sourcing models:

Key opportunities



1

Investors should map the investment gap through systematic tracking of smallholder-sourcing agribusinesses to provide greater clarity on this 'asset class'. This can improve guidelines on the blend of capital and TA required to boost effectiveness.

2

Agribusinesses should invest in thorough upfront analyses, including supply chain analysis, context analysis and end-market analysis, before implementing a smallholder sourcing model. In-depth analyses (ideally pre-investment or early investment stage), such asTechnoServe's Inclusive Business Plans and IDH's Service Delivery Modelss, can manage the complexities of sourcing models, pinpoint where private capital should be deployed when commercial gains are evident and target public funding to where it is needed.

3

Investors and donors should establish longer-dated investment vehicles, including permanent capital vehicles. Five-, seven- and even ten-year horizons remain a constraint for many agribusinesses, who require more time to realise returns on both the agronomic maturity of certain crops (particularly agroforestry and tree crops) and the time it takes to realise benefits from implementing an inclusive sourcing model.

4

Investors and donors should prioritise and refine inclusive TA through ongoing deployment and routine impact monitoring. Increased TA can help agribusinesses to improve operations and de-risk investments. It can also broaden DFIs' and investors' reach by building the pipeline of scalable smallholder-sourcing businesses.

5

Agribusinesses and investors should leverage monitoring and impact measurement to improve business operations and integrate it into existing management systems. Impact measurement can assist in streamlining processes and leveraging digital technologies can enable data-driven decision making. This type of monitoring can also direct TA efforts and inform the set-up of future smallholder sourcing schemes.

Unlocking the opportunities of smallholder sourcing in LMICs requires acknowledging and addressing the constraints in investing in smallholder-sourcing agribusinesses and the challenges in sourcing from smallholders. There is not yet a multitude of real-life, at-scale, commercial examples of successful smallholder-sourcing models. Investors need a critical mass of clear examples of profitable, inclusive sourcing models to ensure that there exists a path to scale that would provide an exit opportunity.

Similarly, public funders want to see evidence of meaningful development impact to support further funding of private sector initiatives. Therefore, not only is there a lack of long-term funding, but there also appears to be a lack of scaled businesses. This reinforces the continued role and importance of partnerships between investors, donors and entrepreneurs to support upstream business development.

Tools such as pre-investment TA and blended finance can go beyond typical due diligence tools, such as feasibility studies, to actively build the pipeline of investment-ready businesses and to support sustainable growth of investee companies. As the landscape of investment in agriculture continues to evolve, so do strategies, such as agtech and inclusive TA, which enable investors and agribusinesses to improve commercial viability and development impact.

While our list of opportunities is not exhaustive, they showcase a set of key considerations for effective investment in smallholder sourcing. The next learning paper in this series will focus on dynamics at the agribusiness level through the lens of inclusive TA, diving deeper into the specifics of the sourcing models, including conditions and implications for commercial viability.

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Commercial Agriculture for Smallholders and Agribusiness

The CASA programme is a flagship programme of the UK Foreign, Commonwealth and Development Office (FCDO) and is intended to increase global investment in agribusinesses which trade with smallholders in equitable commercial relationships, increasing smallholders' incomes and climate resilience.

The programme aims to help agribusinesses to scale up and trade in larger commercial markets. As part of its work CASA generate new evidence and analysis that supports a stronger, fairer and greener agribusiness sector.