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AFRICA INVESTMENT FUND - FOOD & AGRIBUSINESS

FOOD & AGRIBUSINESS PERSPECTIVE # 7

FOOD & AGRIBUSINESS PERSPECTIVE # 7 - A ROLE FOR PRIVATE EQUITY IN YOUR FOOD/AGRIBUSINESS?

As the prospect of a private equity shareholder in their business is still a relatively new concept for many business owners in Agri-Vie's target market, the investment team often has to explain the role that such an investment could fulfil in their business – as done in the following article.

Company owners in the food & agribusiness sector of Sub-Sahara Africa are experiencing a growing range of business financing options. Investors and financiers are becoming increasingly aware of the growth potential of the sector and the African geography. Increasingly, private equity investors are approaching company founders and owners with a view to participating in their businesses. As this is a relatively recent trend, it is useful to reflect on the characteristics of private equity investment and the role it could play in your food & agribusiness. These considerations apply equally wherever your business is positioned in the food & agri value chain: from farming through to processing, distribution and marketing.

"Private equity" (PE) is the technical term for money invested in the equity securities of businesses that are not listed on a securities exchange. The term is usually used with reference to "private equity funds" (PE Funds). These fund structures pool capital from passive investors ("limited partners") for active investment management by an experienced private equity investment manager ("general partner"). The fund manager or general partner forms the interface with investee companies while the passive investors do not have any direct interaction with them.

Interestingly, general feedback from business owners who have included PE in the capital structure of their businesses, suggests that this has had a distinctly positive impact on their business. For instance, a 2009 survey of businesses by the South African Venture Capital & Private Equity Association and the Development Bank of Southern Africa (DBSA) *, found that over the period 2005/6 – 2008/9:

- 64% of respondents confirmed that their businesses would have developed less rapidly without PE investment;
- 47% of respondents stated that their businesses would not have survived without PE investment;
- Businesses with PE shareholders on average register 18% annual turnover growth against the average 16% registered by businesses listed on the Johannesburg Securities Exchange (JSE);
- Businesses with PE shareholders on average achieved 16% per annum growth in operating profit against the 14% registered by JSE listed businesses.
- The export of businesses with PE shareholders grew on average by 31% per annum as against the national norm of 24%.

* *Economic Development Impact of Private Equity Investment – Survey Report, SAVCA, 2009*

Understanding what PE brings into a business also clarifies why businesses with PE shareholding often have a competitive edge over others:

Creating a stronger balance sheet to support renewed growth and to share risk

Growing businesses need cash for working capital and capital expenditure. Founding shareholders' ability to continuously fund successive equity rounds inevitably becomes stretched. Debt funding possibilities become equally limited as the company goes into higher levels of gearing. A PE injection can 'rebalance the balance sheet', reducing the founder's risk levels and unlocking further debt funding capacity to fuel the next growth stage.

Intelligent capital: PE investment provides more than the risk capital. With the capital comes the commitment and experience of an investment team who has lived through the growth cycles of numerous other companies with similar growth pains as yours. The investment team typically does thorough research on the sector within which your company operates before investing. Investment teams at PE funds are typically staffed with professionals with deep experience in industry, in transaction management and in corporate governance. All of this knowledge and experience as well as the accompanying networks become accessible through the PE shareholder and its participation in the company's board. This occurs even more so through the informal working relationships that develops with time. Founder shareholders effectively get a 'friendly co-pilot' through the non-executive directors being made available by the PE fund to participate in the company's board. In this manner, founding shareholders and directors are now able to bounce ideas and to avoid mistakes made in other companies in the management of business cycles.

Patient capital: The PE investor is in the business for the long haul. They understand that the surpluses of growth companies need to be re-invested into the business and that dividends are unlikely to flow for some time after the investment. They don't charge interest like banks do. They are interested only in the sustainable, profitable growth of the company.

Total alignment of interests: PE investors' interests are totally aligned with the other equity holders in the company: the profitable, sustainable growth of the company and the creation of shareholder value. The PE fund manager and its investment team are also incentivised on this basis. In addition, being a financial rather than a strategic investor, the PE shareholder does not bring other or competing business interests into the company. Accordingly, there is no conflict of interest; all stakeholders are focused on the same long term goal.

A succession solution: Founding shareholders, often the first or second generation of family businesses, sometimes find that natural succession is not forthcoming. However, they may be steering companies with significant further development potential while they do not necessarily wish to keep working at the same pace forever. A PE investor can step into this situation – by buying into the business the fund takes some of the risk away from the founder while together they can chart the future path of the business according to the founder's vision. At the right time, the PE shareholder will help to introduce professional managers who can take over the day to day operations within a strategic framework agreed among the shareholders.

Realising shareholder value at the right time: A major part of the reward which PE shareholders seek comes through the realisation of their shareholding over time at the best possible value. If the founders are intent on exiting from the business at the same time, this creates a powerful focus on building and realising value for shareholders. PE investors have the corporate skills and experience to help chart and implement the best way of realising this value – whether through a listing on a stock exchange, a trade sale or other ways. If the founding shareholders do not wish to exit their business in the same time frame as the PE investor, appropriate mechanisms can be built into the joint exit plan to ensure alignment of interests.

Taking your business to the next level: PE investors often bring with them a highly professional and corporate level approach to your business. Whether on an operational/financial level or at the board level, PE adds value through providing further structure within the company. Large companies and governments often seek smaller companies that are structured in this manner in order to fulfil purchase requirements or tender contracts. Additionally, international companies also seek to do business with more structured domestic companies that are a good fit for their own internal structures, policies and requirements. PE investors assist business owners in adding these kinds of structures in a gradual and effective manner.

What to look for in considering a PE partner:

Founding shareholders have found the following criteria helpful in selecting a PE partner:

Experience and track record: A major part of the value that a PE partner brings to the business has to do with the knowledge and experience that the fund's investment principals can contribute in addition to the risk capital. This has more to do with the individuals involved than with the institutional history of the fund manager as a corporate entity.

Industry focus: Business shareholders and executives know that there are certain factors peculiar to success in their particular sector. Only PE funds with demonstrated experience in the sector concerned are likely to fully appreciate how to deal with these issues.

Corporate values: It is worth understanding the values that the fund's investment team work and live by, in order to assess alignment with your own approach.

Networks: Is the PE partner likely to bring and open valuable networks in your industry or among financiers such as banks?

Personal chemistry: As in the case of any other business partnership, there needs to be personal chemistry between the founding shareholders and the investment principals of the PE fund. Without this, going into a long term relationship is risky.

A following article will address the criteria by which PE investors typically evaluate investment opportunities and what they expect from their prospective future partners in the business.