

CASE STUDY

AgDevCo in Malawi: A case study of the higher costs – and notable impact – of investing in challenging contexts

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Firms and investors face high risks and costs when entering and operating in challenging environments, but their investments can provide considerable social and economic benefits. AgDevCo's investments in Malawi demonstrate these dynamics and motivate the case for public funding to be used to offset the costs of pioneering in difficult settings.

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1 Introduction

Formal firms operating in challenging environments are critical for creating decent jobs and they form an important tax base for government, providing revenues to fund provision of goods and services for citizens and firms. However, formal firms face considerable challenges entering and operating in difficult environments, particularly ‘first movers’ or pioneers – firms that create and diversify markets and have the potential to generate high positive impacts in terms of creating jobs, promoting stability, and establishing more conducive environments for investment and private sector growth.¹ As a result, there are often few formal firms in challenging contexts, and even fewer *large* formal firms, limiting the scope for scale and specialisation so critical for firm productivity and growth.

Pioneers face high overhead and start-up costs, including navigating unclear regulatory frameworks, training labour, and establishing supply chains. Ticket sizes are frequently small, so high overhead costs constitute a disproportionately large share of project costs, a dynamic that often sinks what could otherwise be viable projects. To succeed in difficult environments, firms need specialised support, including technical assistance and investment on favourable terms, as well as other successful firms to help develop supply chains, markets, and the broader agglomeration needed for a thriving private sector.² Effective support from donors and development finance institutions (DFIs) is critical for early-stage firms in these settings.

This case study explores the work of AgDevCo, a specialist investor in African agribusinesses, in Malawi, one of the poorest countries in sub-Saharan Africa. This example outlines the challenges faced by firms and investors, particularly first market entrants, when entering and operating in challenging environments. It also demonstrates the considerable social and economic benefits that investments in these contexts can achieve, as well as the positive spillover effects they may have on the broader economy, motivating the case for public funding to be used to offset the additional costs faced by pioneering firms. Scaling up blended finance and other financing mechanisms that compensate pioneers for the additional costs and risks they take on is essential if they are to enter undeveloped markets and catalyse private sector development in challenging environments across the world.

1 Collier, Gregory & Ragoussis (2019). It must be noted, however, that pioneering firms, and private sector development more broadly, do not always have positive impacts in challenging environments. Firms just as often contribute to or benefit from fragility and conflict. Ensuring that private sector development is a positive force requires, among other things, careful regulation and monitoring of the distribution of benefits, such as jobs.

2 Collier, Gregory & Ragoussis (2019).

2 Malawi economic overview

Malawi has been peaceful and relatively politically stable since achieving independence in 1964 and its democratic institutions have gradually strengthened since the mid-1990s. Despite Malawi's peace and stability, it is among the poorest nations in the world, with an annual GDP per capita of around US\$ 412 in 2019.³ Before the Covid-19 pandemic, almost 51% of the population lived below the poverty line, half of whom lived in extreme poverty.⁴ GDP growth rates were around 3.5% and a population growth rate of 2.6% was eroding much of the country's small economic gains.⁵ The economic shock of Covid-19 has undoubtedly worsened the situation and pushed countless people deeper into poverty.

Malawi's economy is heavily dependent on agriculture – an estimated 80% of the population works in the sector, primarily in subsistence farming, and agriculture contributes around 26% of GDP.⁶ Agricultural commodities comprise over 80% of exports, with tobacco alone constituting 50-60% of exports every year.⁷

Malawi has few other drivers of growth, being both landlocked and limited by a lack of natural resources. Being landlocked substantially raises transportation costs associated with imports and exports, with transportation from ports in neighbouring countries sometimes costing more than US\$ 3,000 per container.⁸ These high transportation costs limit Malawi's competitiveness in international markets and make manufacturing, which tends to rely on imported inputs, less viable. Energy access is also extremely limited, with only 18% of the population having access to electricity, and supply is both intermittent and expensive, further constraining industrial activity in the country.⁹ As a result, less than 14% of Malawi's workforce is employed in the industrial sector as a whole.¹⁰

Although relatively small in employment terms, the services sector – comprising tourism, communications, transportation, education, etc – currently brings the greatest value addition to the economy, constituting 56% of GDP.¹¹ Most of these services are non-tradable, however, with the services sector contributing only 8% of exports.¹²

Malawi's heavy reliance on agriculture – particularly rain-fed agriculture – makes the country's economy, and the livelihoods of all who work in the agricultural sector, extremely vulnerable to climatic shocks and volatile agricultural commodity prices. In addition to undermining income generation and standards of living, shocks to the agricultural sector threaten the country's food security.

3 World Development Indicators.

4 World Bank, Malawi country overview.

5 World Bank, Malawi country overview; World Development Indicators, World Bank.

6 USAID, Malawi Agriculture and Food Security; Global Finance Magazine, Malawi GDP country report.

7 FAO (2015).

8 Figures extrapolated from MINEACOM and IGC (2017).

9 Energypedia (n.d.).

10 World Development Indicators.

11 International Trade Centre, Services Snapshot: Malawi.

12 Ibid.

Without alternative promising drivers of growth, agriculture will remain critical for Malawi for the foreseeable future. Efforts towards greater commercialisation and diversification of the sector offer considerable gains in terms of job creation, income generation, community development, and increased resilience. A step change in the functioning of its agricultural sector is vital if Malawi is to achieve greater economic growth and structural transformation, necessary to pull millions of its citizens out of poverty.

3 Firms face higher costs entering and operating in challenging environments

To commercialise Malawi's agricultural sector and enable more farmers to produce for sale in markets, rather than only on a subsistence basis for household consumption, requires achieving greater productivity and yields. Diversification necessitates expanding into more varied crops, higher value crops, and greater value addition activities, such as agri-processing. Both commercialisation and diversification efforts need considerable investment, including in irrigation systems, improved inputs, and stronger management. Energy access will also need to be scaled, as poor energy access limits returns on other investments, such as irrigation systems and cold storage facilities. Although costly, these investments have the potential to generate considerable social and economic benefits.

Pure market-led forces are unlikely to drive the investment needed to make this shift in Malawi's agricultural sector, due to firms being wary of taking on the higher costs and greater uncertainty associated with investing and operating in such environments. Although all early-stage firms and investors operating in these contexts face these challenges, they are most prominent with first movers or pioneering firms.

3.1 Higher costs of doing business

In less developed economies with weaker government capacity, greater difficulties are involved with business-related activities, such as obtaining licenses and permits, importing goods, navigating customs and tax authorities, and accessing affordable, high-quality services and logistics – with constraints to electricity access being particularly limiting. Restrictive trade policies, stringent labour requirements, and other regulatory barriers are also common.

Pioneers may be the first firms to navigate undeveloped regulatory and legal frameworks in the country, suffering bureaucratic obstacles and having to support on regulatory development. Pioneers also frequently need to train labour and establish supply chains for new markets – from sourcing inputs to identifying suitable markets for products. The time and resources these basic business activities require are very costly and undermine firm productivity and profitability. This especially affects smaller firms that are less able to absorb additional costs.

At the same time, the improvements to the business environment that pioneers generate are positive externalities that, while disadvantaging pioneers, benefit all firms, including successive market entrants. Without a mechanism to compensate pioneers for undertaking these activities, however, no firm will take on the challenge of being a first mover – and this hinders private sector development and the country’s economy more broadly.

3.2 Scale is harder to achieve

Scale is essential for profitability, yet it is generally difficult for firms to secure the financing needed for scaling in these contexts, not least because domestic banking services and credit facilities are either non-existent or less developed. Where finance can be secured, loans are often relatively short-term, particularly in more unpredictable environments. Loans in the agricultural sector make up only a small part of banks’ lending portfolios and few banks have the in-house expertise to accurately assess the potential of agricultural investments. Banks are often reluctant to lend to agribusinesses and, when they do, they frequently demand excessive collateral. Where loans are secured, they tend to be for only one to three years, with a focus on working capital. The major financial constraint for early-stage agribusinesses is the lack of longer-term capital, especially more equity-like capital, which could be used for productive investments that could expand operations.

Another constraint to agribusinesses scaling in undeveloped markets is a lack of a reliable supply of predictably priced raw materials for production. This is common in predominantly informal markets where local production is unpredictable, commodity exchanges are missing or underdeveloped, and regional trade is often disrupted by import or export bans. This leaves processors operating significantly below capacity, sometimes below 30% capacity utilisation, which impacts their cost efficiency and undermines return on their investments. Unreliable and costly electricity services also impact processors’ ability to operate efficiently or at scale.

Given the higher costs of working in challenging environments, operating costs eat up a disproportionate share of revenues. Firms in these contexts struggle to reach the scale, productivity, and standards necessary to compete on international markets, which restricts them to producing primarily for domestic markets, which are of more limited size and generally have lower purchasing power. Consumers in poor countries are seldom able to afford processed goods, so those that cannot be exported can usually only be sold locally at very low cost. These limited market options further constrain firm growth and profitability.

Less competition, at least in the short-term, can benefit first movers, but is generally insufficient to offset the additional costs these firms face. This results in a net negative drag on financial returns for both the pioneering firm and its investors and, consequently, a higher failure rate of early-stage firms.

Since market-led forces have not yet led to firm growth and productivity gains in challenging contexts, and are unlikely to do so, a new approach is required. Specialist support and investment that is suited for these more difficult settings could be a game changer. It is in this context that AgDevCo’s role in investing in and catalysing food production and agribusiness in Malawi is so important.

4 AgDevCo and investing in challenging environments

AgDevCo is a specialist investor in early-stage African agribusinesses, providing growth capital through debt and equity for commercial investment, as well as specialist technical support to high-potential agribusinesses. Their investments range between US\$ 2 million and US\$ 10 million of debt and equity and target primary food production and processing firms where their investments offer the greatest impact. They invest across the agricultural value chain, from inputs to logistics, and are open to investments in any sub-Saharan African countries except those with middle-income status.

AgDevCo's model is based on the recognition that creating viable commercial agribusinesses is a long-term commitment, since new agribusinesses can take more than ten years to reach maturity. Specialised technical assistance and financing on an affordable, long-term basis are key elements of their investments. In countries with less developed economies, large investment opportunities are extremely rare; recognising this, AgDevCo is willing to take on smaller investments where projects have promising commercial and development impact.

AgDevCo has initiated five investments over the last six years in Malawi, totalling US\$ 11.3 million. These investments span production and processing of peanuts, macadamia nuts, poultry, and sugar, and are expected to create 4,000 jobs and link almost 20,000 smallholder farmers to markets, significantly increasing income generation opportunities in the country. In 2019, AgDevCo's investees made payments to employees and local suppliers of more than US\$ 2.4 million.

However, fund investors such as AgDevCo face similar difficulties in investing in challenging contexts as their investee firms do in operating in these settings:

- 1 Their investees incur higher costs of doing business, as outlined above. While this constrains investees' profitability, it also upsets the risk-return equation for investors.
- 2 There are few firms large enough and operating at sufficient scale in these environments to enable large investments. As a result, fund investors often have to make more, smaller investments, targeting small and medium-sized enterprises (SMEs) rather than larger firms. However, since transaction and monitoring costs for a smaller investment of US\$ 1 million are similar in absolute terms to those of larger investments of US\$ 10 million or even US\$ 20 million, operating costs end up being disproportionately higher for smaller investments, and this reduces fund-level profitability. Fund investors that are willing to support smaller investments, such as AgDevCo, therefore suffer diseconomies of scale and have to work that much harder just to break even.
- 3 Local firms in these contexts often don't have sufficiently strong management capabilities and practices to drive effective firm functioning and growth, requiring investors to spend additional time and resources to support strengthening investees' management capabilities and practices.

- 4 Scalability is far harder to achieve for fund investors as there are fewer big wins that bring sufficient returns to make fund-level portfolios profitable. In sectors such as agriculture, scale is attained very slowly due to constraints in market size, skilled labour, and regulatory shortcomings, so profitability takes a longer time to achieve. This limits fund growth and, by extension, restricts future investments.

How these challenges play out in actual investment projects will be explored by looking at three of AgDevCo's investments in Malawi in the peanut, macadamia, and sugar sectors.

4.1 Reviving Malawi's peanut industry

As noted above, tobacco dominates Malawi's agricultural sector, but its future is uncertain. Malawi exports 100,000-150,000 tonnes of tobacco annually, which brings in export revenues above US\$ 100 million, about two-thirds of the country's foreign exchange earnings. The industry supports over 1.2 million smallholder farmers and contributes more than 70% of agricultural GDP. However, with tougher international regulations and a global shift away from low-grade burley tobacco, the country is likely to see reduced volumes and prices over the long term.

What crop could replace tobacco for Malawi? Peanuts, traditionally a smallholder farmer crop, are a good candidate. In the 1980s, peanut exports from Malawi regularly exceeded 50,000 tonnes per year, which at today's prices would earn US\$ 75 million. The industry collapsed in the 1990s because of more stringent quality controls that Malawi struggled to meet, in particular to combat aflatoxin, a poisonous mould. While local production of peanuts continues to exceed 200,000 tonnes per year, quality is generally poor and formal exports from Malawi have been negligible in recent years.

However, global demand for peanuts remains strong. With more consumers moving towards plant-based diets, the demand for nut-based snacks, nut butters, and protein-rich plant-based foods is raising global demand for peanuts, with peanuts becoming an increasingly important source of unsaturated fats, proteins, fibre, vitamins and minerals.¹³ Malawi's challenge in exporting peanuts is one of *quality* and meeting required standards for export markets – but if these issues can be addressed, sufficient market demand for peanuts exists and Malawi has a good chance of re-entering international markets.

Consequently, AgDevCo saw an opportunity to revive Malawi's peanut industry by investing in a modern processing facility and working with farmers to improve standards. Since 2016, AgDevCo has invested US\$ 4.5 million into Afri-Oils to develop a cleaning and grading facility on the outskirts of Lilongwe. When first making the investment, AgDevCo recognised that financial returns were likely to be modest, but that the transformational impact could be significant. The investment decision was helped by the availability of a grant from the Dutch government for €1.5 million. Afri-Oils sold nearly 4,000 tonnes of cleaned, graded, low-aflatoxin peanuts in the 2020 season, purchased from 15,000 farmers, two-thirds of whom are women.

¹³ Mordor Intelligence, Peanuts Market.

AgDevCo estimates that farmers receive an additional 30% for their produce by selling to Afri-Oils compared to the prices they could get from roadside traders.

The pioneering project has not, however, been an easy ride for Afri-Oils or its investors, including AgDevCo. A number of challenges have arisen:

- 1** Afri-Oils had to get farmers to produce good quality nuts low in aflatoxin. This involved training farmers on growing practices, building an efficient collections system, and developing new ways of engaging with intermediaries to control for quality.
- 2** Afri-Oils had to develop new routes to market. Finding buyers for Malawian peanuts was challenging as, by reputation, Malawi's peanuts are considered to be poor quality and high in aflatoxin. Initially, Afri-Oils secured a large customer in Zimbabwe manufacturing peanut butter, but order volumes fell when economic conditions in Zimbabwe deteriorated. It took the company three years to build confidence in regional markets, but now Afri-Oils has customers in South Africa, Kenya, and Tanzania.
- 3** AgDevCo had to play a hands-on role managing Afri-Oils, including chairing the board of directors, developing a strategic plan with senior management, overhauling the company's financial management system, establishing trials for new peanut varieties, and helping source new customers. These efforts took a lot of time, with limited potential to recover costs by charging the company because of its relatively small size.
- 4** Peanut farmers in Malawi do not have access to improved seed varieties, particularly larger nuts with a higher oleic acid content, which would command better prices in international markets, including in Europe. Access to new seed varieties is held up by the fact that it takes three to five years to get approval in Malawi for new seed varieties, even those already in use elsewhere in the region.

The above challenges are characteristic of the additional costs incurred by first movers, with pioneers having to develop new supply chains, from sourcing improved inputs through upgrading growing practices and quality control to identifying and securing markets for produce. These activities involve considerable time and resources and, consequently, the financial returns for early investors in Afri-Oils will likely fall below expectations.

However, the business is now at the stage where it is substantially de-risked, many of the "learning by doing" costs have been absorbed, and there are good prospects for continued profitable expansion to 20,000 tonnes or more annually. Afri-Oils is now investing in peanut butter and ready-to-use therapeutic food products. This will help put Malawi back on the map as a producer of high-quality peanuts and peanut products for international markets and should encourage other firms to establish similar operations.

Targeted government and donor support to help develop the peanut sector, including by accelerating the process to register new varieties, could speed up progress and attract new entrants into the industry. If that was to happen, there is a good chance peanuts could replace Malawi's lost earnings from tobacco in future years.

4.2 Malawi's first irrigated macadamia plantation

AgDevCo invested at an early stage into Jacoma, a macadamia estate and outgrower scheme in northern Malawi. Jacoma had pivoted away from growing jatropha and had planted an initial 200 hectares of macadamia trees. It had also started a chilli and paprika buying programme. However, the company lacked capital to install irrigation, without which the macadamia farm was not viable. It was also struggling with a top-heavy management structure.

Jacoma operates in a remote part of the country, near the northern town of Mzuzu. Donor-funded programmes had supported planting of macadamia trees over the years, but the varieties were not ideal for local conditions, little follow-up was provided to ensure trees were well looked after, and farmers found they had few opportunities to sell their macadamia nuts for anything but low prices to roadside traders.

In 2016, AgDevCo saw an opportunity to provide US\$ 2 million of long-term debt to Jacoma for an irrigation system, which promised to move the company to viability and create sustainable demand for smallholder production of macadamias, chillies, and paprika. The AgDevCo team provided significant agronomic and strategic advice in developing Jacoma's business model and financial plan, including the design of an improved outgrower scheme.

Two years later, Jacoma's farms had been transformed by irrigation and improved management. The outgrower programme for chillies and paprika had expanded to 3,200 farmers, the majority of whom were women. With a buoyant macadamia market and a strong impact story, AgDevCo was able to help Jacoma attract external capital from CDC Group, the UK government's development finance institution, for a further expansion, including into basic processing. AgDevCo also provided US\$ 2.8 million of preferred equity alongside CDC Group.

Today, Jacoma is producing macadamia nuts across two farms, achieving world-class quality and yields, and has added a solar-powered sorting and drying facility. The company is also rolling out low-cost irrigation schemes for local communities, who can tap water off the irrigation pipes which supply the commercial farms, giving local farmers access to year-round water to grow crops for food production and market. This has had a tangible impact on increasing income generation and food security of local communities, as well as resilience during times of low rainfall.

At full production, the current farms should produce macadamia nuts for export worth over US\$ 15 million annually, with a further US\$ 1 million from outgrower production. A future investment is planned in a macadamia cracking facility, which will enable Jacoma to move up the value chain and help establish northern Malawi as a significant producer in the global macadamia market. Once profitable and operating at scale, Jacoma will become a significant taxpayer, helping replace an expected long-term decline in aid flows.

Jacoma was able to attract further equity from Ulimi, a Malawian fund backed by the African financial services group Old Mutual, for continued expansion of the commercial farm and outgrower schemes. To our knowledge, this is the first time a local commercial investment fund has invested in Malawi's food and agriculture sector. Importantly, AgDevCo stands to earn a reasonable commercial return on the Jacoma investment, which will help to cross-subsidise some of the less profitable investments in its Malawi portfolio.

Key lessons learned from the Jacoma investment include:

- 1 Specialist agriculture and country knowledge is key. AgDevCo was able to assess and guide the Jacoma business model because of their knowledge of Malawi and agronomy, which ensured the company developed a sound irrigation plan for macadamia nuts and closed down some non-profitable parts of its business activities.
- 2 Tackle management issues early. The Jacoma board had identified the need for changes in the senior management team, which were endorsed by AgDevCo and actioned when the investment was made. This led to an immediate improvement in morale and effectiveness among the senior team.
- 3 The role of complementary grant funding. AgDevCo was able to help Jacoma access matching grant funding from the British and German aid programmes in Malawi to expand irrigation for the benefit of local communities, an element of the project that will have a transformational impact on smallholder farmer productivity. AgDevCo is also helping Jacoma make the case for partial grant funding for a farm dam which would be shared with local communities. These examples demonstrate the strategic role that AgDevCo can play sitting between DFIs and providers of development assistance.

A case study on Jacoma is available on AgDevCo's website [here](#).

4.3 Sweet success for a sugar cooperative

Smallholder cooperatives have a mixed track record in Africa. Many cooperatives function as basic aggregation and trading entities on low margins for commodity crops such as coffee and cocoa. In Malawi, a number of cooperatives in the sugar sector received grants to install irrigation systems, but poor management and maintenance saw yields falling to uneconomic levels.

The Phata Cooperative scheme, backed by AgDevCo, has demonstrated that an alternative, more successful model is possible. Phata involves 1106 smallholder households in the Lower Shire region, one of the poorest regions of Malawi, where rainfall is often below 500mm per year and temperatures frequently exceed 40 degrees Celsius – an inhospitable climate to grow subsistence crops.

Alongside an EU grant that paid for the bulk infrastructure, AgDevCo provided a low-cost loan to the newly formed Phata smallholder cooperative in 2012 (and a further loan for expansion in 2015) to produce cane sugar for the local Illovo sugar factory on 600 hectares of community-owned land. A pivot irrigation system now supplies water for sugarcane production with areas between the pivots set aside for woodlots and 78 hectares of irrigated food crop production. The cooperative has also built ponds for aquaculture, planted a fruit orchard, invested in beehives, and started sustainable charcoal production with thinnings from the woodlots.

The key differences between Phata and other sugar outgrower schemes are:

- 1 AgDevCo worked with the cooperative to establish effective governance and financial management systems from the outset.

- 2 An experienced farm management company was appointed to manage the sugarcane production.
- 3 AgDevCo ensured all social and environmental issues, such as the allocation of shares to members in return for land contributions, were properly and fairly dealt with.

The first phase was successful – sugarcane yields achieved by the cooperative were higher than on Illovo’s own estates. Following a request from local community leaders, the Phata scheme doubled in size in 2016 thanks to a further EU grant and investment from AgDevCo. Widespread flooding in the Shire valley in 2008 and 2019 left Phata relatively unscathed because of prior investments in flood defence and drainage facilities.

Phata is now regarded as one of the most successful sugarcane outgrower schemes in Southern Africa and has been highlighted by the World Bank and others as a model for replication. It is selling sugarcane worth over US\$ 1.4 million annually to the local factory, with members receiving dividends which regularly exceed US\$ 500 per year, representing a significant increase on their previous earnings from maize and cotton which averaged US\$ 120 annually. The scheme is also Fairtrade certified, which earns premiums that have been used to build a community maize mill, buy an ambulance, install a water purification and distribution system, and bring electrification to the community.

Since Phata members were only required to contribute a small proportion of their land to the cooperative (typically one out of five hectares) they continue to have access to their own land to grow other crops. Some members have invested in their own farms, including buying livestock and irrigation pumps. As one Phata executive committee member noted, people in the area are starting to copy ideas and techniques from Phata, such as growing fruit trees from seedlings.

There is clear and visible development in the local community as households invest in improved housing and new small businesses have sprung up in the community. The secondary school enrolment rate in the area has increased from just 35% before the Phata scheme launched to 95% afterwards.

While the project has clearly been a success for the local community, the small size of the investment, the high level of management input, and a deliberate policy of keeping interest rates low means the net return for AgDevCo will likely be only slightly above break-even. Developing other similar cooperative irrigation schemes in Malawi and the wider region will require a blend of concessional and commercial investment.

“I think it’s phenomenal. Quite honestly, it’s one of the most successful cooperatives I’ve seen” – Managing Director, Illovo Malawi on the Phata Cooperative scheme

A case study on the Phata Cooperative scheme is available on AgDevCo’s website [here](#).

5 Lessons from AgDevCo's experience

AgDevCo's investments in Malawi demonstrate several elements critical to considering the role of pioneer firms and early investors, including DFIs, in fragile and other challenging environments. It also shows what is needed to scale up support for their work, which has the potential to bring much-needed transformational social and economic benefits to these difficult settings.

- 1 The costs of doing business in challenging contexts are substantially higher than elsewhere. Smaller ticket sizes mean overheads constitute a greater proportion of project costs, a more hands-on approach to investees (that requires investors' time and resources) is often needed, and scale is more difficult to achieve. These factors undermine project profitability and upset the risk-return equation for both pioneer firms and early investors.

In practice, this means medium-sized SME fund managers, such as AgDevCo, operating in early-stage agriculture face fund management costs at least 50% higher than the 2% cost ratio normally seen in venture capital and private equity. Higher fund management costs are primarily due to:

- i Transaction costs pre-investment – notably scarcity of professional advisors (legal, financial, market analysts, etc) which increases the cost of collecting due diligence information, and high costs of engaging and consulting with local communities, particularly on land issues.
 - ii Monitoring costs post-investment – including travel costs to remote rural areas where projects are located, and management gaps that require more active support from investors.
- 2 Higher fund management costs and lower expected portfolio returns means that the economics of investing in agricultural SMEs is very challenging. Whereas venture capital firms in developed markets or in higher growth sectors, like technology, might target net returns at the portfolio level of 15%, a more realistic target in early-stage African agriculture (where average investment sizes are below US\$ 10 million) is around 5%. Even large DFIs are reluctant to make investments with such low expected returns. These investments are therefore hard to justify on the financial returns alone.
- 3 The social and economic value generated by firms and investors operating in challenging environments cannot be overstated – investments support job creation, income generation, greater resilience, increased tax revenues, and act as catalysts for the development of regulatory frameworks, supply chains, and markets. The impact of pioneer firms and early investors is particularly significant, with their investments generating positive externalities (trained labour, improved growing practices, new routes to market, policy reforms etc.) that benefit successive market entrants and support broader private sector development.

Additionally, the knowledge generated by pioneer firms and early investors in these environments are a public good, enabling risk to be more accurately priced in the future, thereby facilitating further investments. Once the upfront costs are absorbed, projects become more attractive and profitable for

subsequent investors, making them more sustainable in the longer-term. The overall enabling environment becomes more conducive for investment and private sector growth and more able to crowd in private capital.

- 4 The social and economic benefits generated by successful pioneer firms and early investors generally outweigh the additional costs these entities face in entering these contexts, particularly when the positive spillover effects and longer-term impacts of market development, agglomeration, increased stability, and economic growth are taken into account. But without a way to compensate pioneer firms for taking on the additional costs of pioneering, few firms and investors are keen to be the first to enter these contexts and incur these costs.
- 5 Given the considerable development impact of such investments, using donor funding to offset the additional costs of pioneering through, for example, blended finance, is a high-impact use of public funding and could mean the difference between pioneer firms and early investors continuing operations in challenging environments or closing down. It would also enable fund investors to overcome the need to chase ‘big things’ to achieve portfolio profitability, instead allowing them to pursue investment opportunities with potentially transformative social and economic benefits but lower financial returns.

It is evident that pioneering investments in challenging environments play a critical role in creating markets, supporting private sector-led growth, and driving structural transformation. With the support of donor funding, more pioneer firms and early investors would be willing and able to take on the risky and difficult work needed to lift millions of people out of poverty in some of the world’s most fragile and challenging environments.

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The **State Fragility initiative** (SFi) is an International Growth Centre (IGC) initiative that aims to work with national, regional, and international actors to catalyse new thinking, develop more effective approaches to addressing state fragility, and support collaborative efforts to take emerging consensus into practice. SFi brings together robust evidence and practical insight to produce and promote actionable, policy-focused guidance in the following areas: state legitimacy, state effectiveness, private sector development, and conflict and security. SFi also serves as the Secretariat for the Council on State Fragility.

AgDevCo is a specialist investor in African agribusinesses. The company supports small and medium-sized enterprises (SMEs) involved in farming, agroprocessing, and logistics, with the aim of creating jobs and income-earning opportunities for African farmers. With debt and equity investments across ten sub-Saharan African countries, AgDevCo is one of the most active SME investors in the African agriculture sector.

Cover photo: Sugarcane growing in the Shire valley, Malawi. Photo by Ashley Cooper

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