anita.davis@incisivemedia.com

China's farms show growth potential

Buoyed by rising domestic consumption and policy support for rural industries, China's agricultural sector is generating interest from private equity

GOT MILK? OLYMPUS CAPITAL HOLDINGS Asia certainly has – more than 72,000 tons of it, in fact. The private equity firm, with co-investors Mueller Milch Management and unnamed existing investors, last week took an undisclosed significant minority stake in Chinese dairy company Huaxia, which owns around 7,200 cows, each capable of producing more than 10 tons of milk per year.

The deal reflects growing investor interest in China's farming and agriculture sector, an area expected to prosper from rising domestic consumption as well as strong policy support for rural industries.

Anson Wang, co-founder and managing director of CMIA, which earlier this month launched a $200 million China fund largely focused on agriculture, says that the Chinese government currently allocates 18% of its budget – around $150 billion – to agriculture. Under the 12th Five-Year Plan, a policy document released earlier this year by the central government, the money has been earmarked for land acquisition, utilities, warehousing, processing, transportation and marketing.

"Agriculture has always been a huge part of the economy, and its influence is only going to increase with China's affluence and the demand for quality food," Wang says. "Today, agriculture is about 11% of China's GDP, and 40% of China's labor force is employed in the sector. This really is quite substantial, and not just in terms of food – there's feed and fuel and everything moving down the production line. There are real opportunities here."

Cultivating private equity

Pete Cimmet, a senior advisor at Olympus Capital, avers that agriculture is attractive to private equity because it is fragmented and only now slowly segueing into a consolidation phase. Rural land in China is allocated by local officials based on household size, with each family farming a small plot and selling their produce to distributors who move it in bulk down the supply chain to processors and eventually retailers.

About 40% of China's labor force is in agriculture

In some cases these plots of land have been consolidated – either directly by local governments and corporates or indirectly through farmer cooperatives that market produce collectively – but the industry is still far removed from the kind of large-scale farming seen in the West. Experts say that 98% of the vegetable market is still made up of small farms, each about one acre in size. The average size of a farm in the US is 5,000 acres.

Change is inevitable, and Olympus Capital cites three factors that will expedite it. First, food safety and the push for transparency in production processes. The 2008 dairy scandal exposed China's supply chain weaknesses as dangerous chemicals were added to milk as it was ferried from farmer to collection agent to processor, leading to death of at least six infants. Huaxia sources milk from its own cows, creating a more vertically integrated and secure system.

Second, the demographics of rural China are altering – older farmers are approaching retirement age while many of the younger generation are migrating to cities. Not only is the labor force shrinking, it is also losing value as individuals who might have offered certain expertise find work elsewhere. Consequently, productivity gains are minimal.

Third, and most significantly, the central government has improved regulations and initiated a land consolidation drive. As Joachim Drewitz, head of financial sponsors & bank coverage at Rabobank Asia, points out, China is home to more than 20% of the world's population and only 7% of its arable land – and Bejing continues to adhere to a longstanding but increasingly challenging policy of domestic food sustainability. It is under pressure to preserve what farmland remains, and maximize its yield.

Land leasing is the preferred option for fruit and vegetable farming, whereby individual farmers rent their holdings to other families, investors or government bodies. Neighboring plots are then consolidated, allowing farmers to reap economies of scale and build up capital to invest in their business.

According to Scott Rozelle, the Helen F. Farnsworth senior fellow at the Freeman Spogli Institute for International Studies at Stanford University, approximately 20% of China's farms are leased out, mainly in the suburbs of coastal urban centers as opposed to the more impoverished central regions. "If a farmer is making RMB300 ($46) from his plot and you say that you'll give him RMB500 ($77) without him having to do anything, you'll find a lot of people happy to take the deal," Rozelle says.

This approach is well suited to capital intensive processes such as livestock and dairy farming, or even the cultivation of plantation fruits, but Rozelle is dubious as to whether it also applies to standard fruit and vegetable farming, which tends to be labor intensive. "In vegetable and fruit produce, corporations are never going to make it because farming is a family institution," he says, adding that, if the pressure to feed their immediate family is off workers' minds, efficiency will decrease.

Private equity funds have their eye on corporate fruit and vegetable farming, but more towards the high end, where margins are likely to be wider.

Cimmet says that Olympus focuses on the "upstream value chain," or the very beginnings of the agriculture process – animal feed, seeds, fruit cultivation and plantations. After CMIA guided state-owned vegetable processor China Minzhong Food Corp. through a management buyout in 2004, Olympus participated in the second round of fundraising five years later. Olympus and Government of Singapore Investment Corp. (GIC) together took control of the company, which listed on the Singapore exchange in 2010, raising $170 million.

CMIA has also backed mushroom and fungi producer and processor Emerald Asia Group as one of the seed investments of its new fund. This is a cultivation play, much like China Minzhong, but Wang says the fund also sees potential in wider scale processing, equipment and technology in the dairy, poultry, seafood space.

"We see interest in beef and pork, but that's also something we stay away from. It's a lot more complex in terms of hygiene – I would stick to vegetables," Wang says. "The one area that is a bit more difficult for private equity is the wheat, rice, corn and other staple grains, because the government controls that area and you see a lot more subsidies."

A key player within that segment has branched out to capitalize on the shifting agricultural landscape. In April 2010, China's largest grains and oilseed trader, China National Cereals, Oils and Foodstuffs Corp. (COFCO), recruited CCB International Holdings, Ant Capital Partners and Louis Dreyfus Commodities to form an agriculture-focused private equity fund, with target size of $1 billion. The vehicle focuses on farm products, processing and similar foodstuffs.

Private equity firms looking for opportunities in farming do so in the knowledge that there is no shortage of exit options. According to Rabobank, the total market capitalization of listed Chinese food and agriculture companies totaled $174.8 billion last year, up from just $35.1 billion in 2000. Trade sales are also viable as institutional players look to enter the sector. In March, a senior official from International Enterprises, a Singaporean government body that promotes investments, reportedly said that a collection of Gulf states were collaborating with Singaporean companies on potential investments in China's agriculture market to ensure food security.

> "We're talking about farming in China, which is unlike the Western style of agriculture."
>
> – Anson Wang

Wang's target exit point is an approximate 30% return on CMIA's investment, or 2-3x the company's annual return.

Cost and quality

While returns have been apparent for the early movers in the space, the sector is getting more expensive to enter. According to AVCJ Research, private equity investment in China's agriculture and wider consumer product sectors came to just $59 million in H1 2011. This compares to $877 million in 2009 and $749 million in 2010.

Researchers attribute this drop to rising costs. China's consumer price growth came in at 6.4% in June, the highest level in three years. Food prices, which account for one third of the overall consumer price index basket, rose 14.4% year-on-year, a level not seen since July 2008.

The Chinese government remains highly concerned about inflation and its potential for sparking social unrest in a country where imbalances between rich and poor are all too apparent. Earlier this year, Unilever was fined for sparking a panic-buying spree after it announced plans to raise prices. And in July, these tensions spilled over into private equity when it was reported that Blackstone exited an investment in the parent company of a vegetable trading firm, after being warned that its involvement would complicate moves to raise prices.

Blackstone sold the holding back to Dili Group in the first quarter of this year for a 16.5% premium on the buying price. About one year earlier, the private equity firm paid $194 million for around 10% of Dili as part of a consortium – including Warburg Pincus, Capital International and Atlantis Investment – that took a 30% stake for around $600 million.

The presence of Blackstone – which is well known in China for being one of China Investment Corp's less successful investments – was essentially seen as a public relations accident waiting to happen. Other private equity firms risk the same fate when dealing with an emotive issue such as land acquisitions.

Any approach to land consolidation in China must be managed carefully because the plots at stake represent farmers' long-term livelihoods. Corporate farmers traditionally enter the market through relationships with local governments, which are responsible for land use zoning. It is not uncommon for central government directives to be ignored or manipulated by local authorities and a number of high-profile cases have seen farmers evicted by officials who take pay-offs from property developers to switch land from agricultural to residential or industrial use. Earlier this year a farmer in Hunan province set himself on fire to protest a forced eviction.

"The national government encourages rental, which is legal. It's local governments who are misguided, just like Hong Kong investors are often misguided when they enter this space," Rozelle says.

While each of these areas are difficult to navigate, Wang says the best course of action is to be genuine, fairly valuing what land is worth and acting in a manner that serves the best interest of the local government, farmers and business partners.

"We're talking about farming in China, which is unlike the Western style of agriculture," he says. "They're not farms that require a lot of heavy equipment or machinery – these are basically small plots of land. You just have to invest in expertise and consultants whom you can really rely on to make good judgments."

Top Five Agriculture Deals in China (2007-present)

Date	Investment Value (US$m)	Investee	Stake	Financing Stage	Investor
Nov-10	199.5	Asian Citrus Holding	14.5	PIPE Financing	Anta Capital; FIL Investment Management; Fuh Hwa SITE Asset Management; Hopu Investment; Martin Currie Investment Management Ltd. (United Kingdom); Temasek Holdings; Undisclosed Investor(s) (Hong Kong); Value Partners; Wellington Management
Nov-08	181.0	China Modern Dairy Holdings	44.9	Expansion/ Growth Capital	CDH Investments Management; Kohlberg Kravis Roberts & Co.
Mar-07	170.5	Sino-Forest Corporation	14.0	PIPE Financing	Temasek Holdings
Aug-08	60.0	Shanghai Homeby Group - pig farm	30.0	Mezzanine/ Pre-IPO	Deutsche Bank
Jun-09	45.0	China Forestry Holdings Group	10.1	Mezzanine/ Pre-IPO	Carlyle Asia (United States); Partners Group

Source: AVCJ Research