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Barriers to entry and inclusive growth: policy recommendations for agro-processing

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Introduction

There have been a number of major competition cases in agro-processing, mainly relating to cartel conduct. Substantial penalties have been imposed on firms by the competition authorities. However, as with the economy as a whole, it remains very concentrated and there has been little progress in terms of the entry of blackowned businesses, in particular. Our research indicates the continued impact of strong social networks amongst insiders, low levels of entry and participation by black-owned businesses at requisite scale, and anticompetitive conduct that protects insiders and excludes new entrants.

This policy brief draws on the CCRED sector study on barriers to entry and inclusive growth in agro-processing, which focused on three value chains: poultry, dairy, and milling of maize and wheat.[1] In this brief we draw out main insights with regard to practical steps which can be taken to encourage entry and facilitate rivalry at the processing levels in these three value chains.

In understanding barriers to entry and the growth of smaller firms in agro-processing it is critical to appreciate that these are value chains characterised by successive levels of processing and value addition. Linkages between the levels and different types of vertical integration are important to coordinate access to inputs and investments at the different levels. The ability to participate depends on fitting into a value chain and how the overall chain is governed, typically by lead firms. There are also substantial scale effects and time required to build production capabilities.

These characteristics imply that addressing barriers to entry must be considered as part of the agriculture and industrial policy framework and that there are no 'quick fixes' here.

[1] The research was funded by National Treasury, and is reported in a project working paper, available on www.competition.org.za .

In the poultry sector, there are critical inputs in the form of breeding stock and animal feed, and scale-intensive operations required, especially at the abattoir and breeding levels. Vertically integrated broiler producers may no longer explicitly tie animal feed to the sale of critically important breeding stock (following competition cases), but the general practice of providing animal feed 'specifically formulated' for a particular breed has a tie-in effect.

Maize and wheat milling had been subject to farreaching cartel conduct. However, new and potential entrants suspect that the control of industry associations over accredited training programmes is used as a mechanism to frustrate new entrants. The insider networks developed during earlier regulated periods and sustained during the collusive period appear to be maintained to the exclusion of entrants. There is also a range of other issues relating to access to inputs and to retail outlets which we discuss below.

In the dairy sector, concerns about the power of processors over farmers remain and is the primary reason given by new processors such as Coega Dairy and Dairy Day for entering the processing level. However, significant capital costs and the inefficiency of building a milk processing plant that can handle peak capacity but remains underutilised in low seasons, means that further entry into UHT production is unlikely. There are three key insights relating to steps to support entry.

Participation at discrete levels of the value chain is not enough for effective entry: interventions must work through the chain and work to achieve scale

There has been entry across all three value chains in recent years, but the scale of entry in poultry and milling is insufficient to create true rivals to vertically integrated incumbents. In poultry, CBH entered in the early 2000s and required a competition case to be able to integrate backwards to the breeding level, while GFC entered more recently in 2010, leveraging from its main shareholder (VKB) being involved in maize and soya production (for animal feed).

By contrast, many small black farmers have entered into existing value chains as contract growers for larger vertically-integrated incumbents. Entry at discrete levels of the value chain does not lay the foundation for structural transformation, nor for true rivalry. These contract growers remain vulnerable due to their dependence on large incumbents for key inputs (breeding stock and animal feed), processing capacity (abattoirs), and routes to market. Effective new entry must take place at multiple levels or at sufficient scale to give new entrants bargaining power in concentrated input markets. Successful entry into dairy processing took place when farmers collectively entered into processing, thus ensuring security of supply and greater control over margins across the value chain.

New entrants in milling are similarly reliant on the supply of grain from silos owned by agroconglomerates who are either integrated into milling or grain trading themselves, or have long-standing relationships with larger incumbent millers. Smaller and new millers have expressed concern about the difficulty of doing business with these silo owners, their inability to invest in trading capabilities to use the SAFEX system optimally and having to tie up significant working capital as 'deposits' against which they purchase grain from silo owners.

Funding entry in agro-processing will be ineffective unless processors have access to inputs on the same terms as incumbents, and have access to consumer markets. And, funding and support directed at building a black industrial base in agro-processing must be informed by an understanding of the competition bottle-necks across the entire value chain.

This implies that development finance institutions (DFIs) must either finance entry at multiple levels (i.e. financial support for a new broiler producer must include support for access to existing/new abattoirs and assistance in securing an offtake agreement with customers) or DFIs must identify and support the development of additional capabilities associated with success in processing (e.g. ensuring that millers understand how to trade on a futures exchange).

These challenges are value-chain specific, nuanced, and require intimate knowledge of particular sub-sectors. For DFIs to support effective entry into agro-processing, they need to take a value-chain approach, as we understand the IDC has started to do, and should narrow focus to a few key value chains and offer long-term support.

Funding new entry is risky and payoffs take long: development funds are required for this, potentially from innovative settlements in competition cases

The research re-affirmed the importance of softer (lower interest and long term) loans in funding new entry. Two funds that were particularly instrumental in facilitating entry were the Massmart Supplier Development Fund (SDF), a fund established as part of the Walmart /Massmart merger to develop new and blackowned suppliers in the Wal-Mart supply chain, and the Agro-Processing Competitiveness Fund (APCF), a fund established as part of Pioneer Food's settlement of various collusion and abuse of dominance cases.

These funds were specifically designed to facilitate pro-competitive entry, often into concentrated value chains. They could also be disbursed on less onerous terms than would normally be the case.

Lethabo Milling, South Africa's first fully blackowned maize meal producer, is one of the firms that benefited from the SDF. Lethabo Milling struggled for four years to obtain finance from banks and DFIs. Commercial lenders (which includes DFIs) were unconvinced of the bankability of his business due to concentration at the milling level and the strength of existing brands. These factors (concentration and strength of existing brands) are the very reasons that disruptive new entrants should be encouraged and shows that onerous lending requirements count against new entry and entrenches existing market structures.

Retailers also have a particular role in supporting entry, through providing a route to market and supplier development assistance. Massmart's SDF provides financial assistance in the form of zero-interest non-recoverable grants for equipment and backed guarantees to commercial lenders.

The Massmart SDF has facilitated entry and expansion of 24 manufacturing firms and 139 small scale farmers and farmer co-operatives in its first 2 years of operation. Similarly, the APCF provides affordable loan finance to businesses that would not normally qualify for funding by commercial banks. The latest available information shows that the APCF has funded entry and expansion of 29 enterprises since April 2011 and has created 2 266 jobs.

These funds have been successful in facilitating entry and expansion, particularly into concentrated agro-processing value chains. Cartel penalties could be paid into a DFImanaged development fund, as a matter of course, in order to support entrants.

The Competition Commission should be granted additional leeway and discretion to design alternative remedies that aim to encourage entry, reduce prices, and facilitate competitive rivalry directly.

Incentive programmes are poorly designed, burdensome and difficult to navigate

Firms across all three value chains were critical of the administration of incentives such as DTI's Manufacturing Competitiveness Enhancement programme (MCEP). All firms indicated that they had to hire consultants to apply for benefits under MCEP and that this proved costly and cumbersome. All agreed that the design and transparency of incentive programmes should be simplified and improved.

Burdensome incentive schemes impose an unnecessary cost on firms and changes the potential payoffs of any incentive programme. The design and administration of incentive programmes should be simplified so that there is no need to involve consultants in the process of accessing incentives.

Conclusion

Our research highlights the importance of understanding barriers to entry in terms of a number of different dimensions. These include intrinsic features of the industry or sector such as scale economies (critical in animal feed production for instance), regulatory obstacles to new firms (such as food safety requirements), as well as the conduct of incumbents and how the markets have been shaped by their behaviour and strategies.

To facilitate entry and transformation in the agro-processing sector, we require a deep understanding of the specific challenges that new entrants would face in a particular value chain, the historical evolution of the sector, and the scope for strategic behaviour by incumbents at all levels of the value chain. Focusing on facilitating entry at one discrete level of the value chain will likely fail as it will miss the binding competition bottlenecks elsewhere. Ultimately, addressing barriers to entry requires complementary measures across industrial policies, development finance and competition.