

AGRIBUSINESS and CHANGE

Remarks by RB Halaby

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To the

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Ladies and Gentlemen:

I am deeply honored to be asked to address the Atlantic Seedsmen Association.

AgriCapital has been a proud member for many years. With all that's going on in the world of agribusiness and in the seed industry, one thing remains constant: John Baylor. People come and people go, but John goes on forever. Congratulations to you, John, and your lovely wife on your 50th anniversary. What a wonderful achievement!

Change and Agribusiness

I was flattered when Joe Butwin called me last summer and asked me if I could speak at this meeting. I mulled over what I should say and decided I would like to share my insights based on my experience over the past twenty years in agribusiness and the seed industry. But, also, more importantly what I see in the next decade. I will address change and how it drives agribusiness in general and the seed business in particular.

AgriCapital was founded on change. After a background with large firms in investment banking and investment management, I decided, in 1981, to forge ahead on my own. My first two clients happened to be agribusinesses, so was my introduction to this sector. Working for those two clients, I began to see a need for an investment bank specializing in agribusiness. I saw a huge sector of the U.S. economy about to experience wrenching change with few investment banks equipped to help agribusinesses cope with that change. Where some people saw disaster, I saw opportunity.

As I am sure many of you remember, the 1970's was a golden age for U.S. agribusiness. Note that I said "a golden age," not "the golden age" since I am confident we have not seen the last "golden age." The 1970's were the culmination of three decades of relative tranquillity and prosperity in a sea of change. During the 50's, 60's and 70's, agriculture was lulled into a false sense of security. Farmers prospered with relatively low interest rates, easy credit, rising land prices and expectations that exports would expand perpetually. Historically speaking, this period was an exception, not the norm. This "golden age" of agricultural prosperity was rudely interrupted in the 80's, when U.S. agriculture awoke to a financial crisis unlike anything seen since the Great Depression. Interest rates soared, land prices plunged and thousands of farmers went bankrupt. This chaotic period set the stage for the revolution we are now seeing in agricultural financing and production.

The seed business is an integral part of agribusiness and as such did not escape being buffeted by the same forces. One has to look at the face of today's seed industry and compare it with that of twenty years ago to see the massive effect.

Winston Churchill once said, "The affairs of state are long periods of turmoil interspersed by quick periods of peace." That thesis fits well with agriculture. The escalating climate of agricultural change obvious since the early 80's is perhaps a much more normal pattern than the relative calm experienced in the 30 years prior. In fact, change is accelerating at an astonishing pace, leaving those unwilling to adapt in the dust.

Take for example, Land O' Lakes, arguably one of the U.S.'s best-managed cooperatives. The organization's president, John E. Gherty, remarked a few years back that the most challenging force shaping agribusiness today is the accelerating pace of change, which is being fueled by improved technology and liberalized trade policies. But it is no longer enough for agribusiness to simply to accept change. Gherty believes that "time itself has become a strategic factor. Just doing what is right is not enough. To win today, you must do what's right and do it faster than your competition."

Starting with a smile and an idea, I decided to specialize in providing investment banking services for agribusiness in general and the seed business in particular. Since our inception in the early 80's, we have been involved in over 305 assignments on behalf of some 225 clients, covering the spectrum of agribusiness from animal health to wineries. About half of our work, however has been seed related, reflecting the tremendous need in the seed industry for our type of service.

As some of you know, our services include negotiating mergers and acquisitions, arranging financing, and providing consulting services. We differ from most of our competitors in that our services are all provided on a professional, private, agency basis. We do not "broker," that is try to pressure people to buy or sell. We approach our work as agents, "guns for hire," to help companies meet their challenges.

What were the drivers that created this need? I see three major factors:

1. Pressure among the multi-nationals to acquire the proverbial "window" to agriculture. This came in three waves, the oil companies, followed by the pharmaceutical companies, followed by the agrochemical companies. These companies have been heavy investors in research and viewed the acquisition of a seed company as a way of capturing value at the very beginning of the chain of production.
2. The fear, real or imagined, by many seed companies of being left out of the technology and genetics game.

3. The need for capital by many seed companies that could only be met by merging or selling out. This shortage of capital was driven, in turn, by a few engines:
 - a. Many seed companies succumbed to high leverage as they enjoyed the “easy” credit of the 50’s, 60’s and 70’s.
 - b. Many seed company owners structured their operations to minimize income and estate taxes rather than maximize profits.
 - c. Many seed company management teams typically scored A’s in production and marketing, but a “Gentlemanly” C in finance.

Changes in the Next Decade

What change do I see in the next 10 years? In asking myself that question I am really asking myself where AgriCapital should look for opportunities in the next ten years. In my estimation, I see change being driven by the following issues:

- (1) The shrinking distance between the producer and the consumer,
- (2) The influence of technology,
- (3) The globalization of the world economy including agriculture,
- (4) Access to capital by agribusinesses,
- (5) The re-entrepreneurship of certain sectors, and
- (6) The effect of a world population that is growing exponentially.

Shrinking Distance

One of the most obvious changes involving agriculture is the rapidly shrinking distance between producers and consumers. The traditional path between the farmer and consumer is highly fragmented with each segment along the way acquiring a commodity, adding some value to it, and then selling a fungible product to the next segment. Farmers grew corn and sold it to the local elevators. Hog producers fed the hogs and marketed the hogs to their nearby sale barn. Few, if any of the links along the chain of production, were concerned with what happened to the product after it was shipped.

This is changing rapidly and the chain is consolidating. The gap between producers and consumers is shrinking. Tom Urban, former Chairman of Pioneer Hi-Bred, referred to the process in a very interesting speech in Caracas a few years back as the “industrialization of agriculture... the integration of each step in the food production system.” He further defines industrialization as the “process by which consumers’ wants and needs are fed back into a production and distribution system in order to improve desired quality, availability and price, a process by which production was restructured under the pressure of increasing levels of capital and technology.”

How will this shrinking distance between producer and customer affect you as a seedsman? You will see fewer, bigger, more sophisticated farmers demanding far more from their suppliers. In the seed business, there will be fewer entities between the originator of the genetics and/or technology and the farmer. You will see more interaction between the originator and the end user. Given this, there is no question, identity preservation will become a more important factor in farming, although the jury is still out as to the way to sustain this whole system.

You will see selling evolving from being product driven to being driven by the needs of the market. In sitting down with the farmer, the first word uttered by the salesman will not be “Do I have a new variety for you!” It will be more like “What can I do to help you?” *And of course I think that, because this is exactly the approach AgriCapital takes.*

Lastly, the Internet will play a bigger and bigger role. It will never replace the need for face-to-face contact, but can go a long way towards providing the farmer with many intangible inputs, including agronomic advice and marketing.

Technology

The web is one new technology and it will also foster access to other new technologies. Agriculture has always been driven by new science, and it will continue to be an early-adopter of innovations at an ever-accelerating pace. Technology is already making itself felt across the food chain, reducing input costs, improving the efficiency of processing agricultural products, and responding more quickly to consumer needs. And I want to remind you technology is more than just biotechnology and genetic engineering. It runs the gamut of scientific and technological disciplines.

An example is precision farming, which helps the farmer protect the environment and reduce his input costs. Precision farming integrates such disparate disciplines as computer science, which allows the storage and quick manipulation of massive amounts of data, to laser beams that allow the farmer to level his field properly, to advanced diagnostic techniques which allow the farmer to quickly, accurately and inexpensively determine the chemistry of his soil.

Another example is the hog business where meeting consumer demand for lean and inexpensive meat is being made possible by the integration of disciplines ranging from hog genetics, husbandry science, assembly line techniques in the packing plant, to packaging. The hog business will also be affected by several genetically engineered products including biologicals and porcine somatotropin.

BST, bovine somatotropin, has been available to dairy producers for eight years.

Although there has been some public criticism, the product is gaining distribution and has become the number one animal pharmaceutical product in the U.S. American consumers are adjusting to the reality of genetically engineered products, which will help producers move beyond current biological imitations and establish a new productivity threshold in the dairy business.

The seed business has been affected by technology just as much as any other agribusiness. In fact, seed is one of the most efficient carriers of new traits and technologies so it has been at the forefront of many changes. Just think: a single kernel of corn, multiplied over seven generations will produce a mountain of corn equal to that produced in the US in a typical year.

Billions of dollars have gone into research, first into input traits, and now increasingly into output traits. You know more about recent developments than I do, but I would like to comment on a few of them:

1. There is a tug of war between the multinationals, the developers of technology, and mainstream seed companies. The developers wanted to capture value early in the chain, prompting them to acquire seed companies. This caused consternation among the independent seed companies, worrying they would be shut out from the flow of new genetics and technology.

2. The tug of war has so far worked out to the advantage of the independent seedsman since the multinationals quickly discovered that in trying to capture value, they are also assuming more risk. The multinationals therefore decided to increase their return on investment by making their technologies available to a wide circle of seed companies.
3. A funny thing happened on the way to the forum, in that the “Greens,” especially the European ones, have stabbed Caesar by creating doubts as to the need for and safety of bio-engineered products. This has totally shaken many of the multinationals, especially the European ones.
4. Lastly, I think things are so unsettled there, I would not be surprised if this will force a restructuring of many of the bio/agrochemical companies, along the lines of Syngenta, which will be a combination of the crop science activities of AstraZeneca and Novartis. *(By the way, I am sure George Bush is not in our business. I would hate to think how he would pronounce all these synthetic names!)*

Having said that, I am optimistic reason will prevail. Look at China. The New York Times ran a terrific article recently on the quick acceptance of bio-engineered seed by the Chinese. The crux of the story was how more environmentally friendly these products are, especially in the case of cotton.

Progress will have a price, though, as it always does. Unfortunately the price of progress is rarely totally foreseeable in advance, and thus we have to move forward before the total cost can be determined. It would be a mistake, however, to give in to the demands of the neo-Luddite movement with its aversion to any risk at all. There is a risk stepping out in the street. There is a risk the roof could cave in. But we are all still here. Living involves risk.

Look at the Wright Brothers and what they unleashed with the airplane. Was that progress, shrinking the globe into a small blue marble? Or should one measure that progress in terms of the cost of the millions who died in air bombing raids? If someone could have predicted what the airplane was going to do in the next ninety years, would its development have been approved?

To all those well motivated do-gooders who are out to save us from ourselves, let me point out a fact of life: progress, like water flowing down a hill can be slowed, it can be controlled, but it can't be stopped. I can talk with some authority about water flowing down hills since I started out as a dam engineer. That's D-A-M, not D-A-M-N!

On a lighter note, my wife and I met a young couple at a resort a few years back. They represented the best and brightest. He was a neurosurgeon and she an anthropologist at a major university. When she found out what I did, she proceeded to rail against the seed industry. Apparently she had done her Ph.D. on subsistence agriculture in Bolivia, and to her the introduction of hybrid seeds was the worst thing that ever happened to Bolivian agriculture. I asked her why and her answer was that hybrid seed allowed the better farmer to improve his lot over the poorer one. Shouldn't Ph.D.s pass a course in common sense before getting their diploma?

Globalization of the World Economy

It is a shrinking world, even in Bolivia, and I believe the trend toward globalization will only escalate. At the same time, I hope the trend towards freeing agriculture from the protective embrace of government will also escalate.

Globalization is a fact of life. Some people will try to slow it, but like the mighty Mississippi no one will stop it from rolling along.

Restricting governments from "helping" people will prove to be harder, for they will jump in to "protect" the farmer at every downturn.

Call me a “cock-eyed optimist” but I think I will live to see the day when national boundaries for agricultural products will disappear off the face of the earth, when every agricultural county, and I mean county and not country, in the world will concentrate its efforts totally on producing what it grows best, free of government interference or control.

The best primer on globalization that I have seen is *The Lexus and the Olive Tree* by Thomas Friedman of the New York Times and I encourage you to read it. Frankly it is a primer on what a company should do to survive to see the dawn of the next decade.

Capital Access

Surviving involves understanding international trends and also your own finances in the context of those trends. Capital is returning to agriculture and agribusiness, and I expect this trend to continue for the foreseeable future, but with a few caveats. Agricultural credit is much more plentiful today, in contrast to the mid-80's, when banks, including the Farm Credit System, pulled back radically, causing the severe recession I mentioned earlier. AgriCapital witnessed this first-hand, and much of our business at that time involved workouts. Believe me, there is nothing scarier than a panicked banker. The winds now have shifted though not quite back to the 70's. A two-tiered lending environment has developed. Credit is flowing to stronger, more profitable farmers but not to weaker, more leveraged ones.

Credit also is flowing to agribusinesses. Those that are creditworthy are finding a borrower's market, as banks become more competitive. In a way, I am concerned banks may be repeating the mistakes of the 70's.

Capital, like water, seeks its own level. In other words, shortages are self-correcting. A good example of that was the entry of one institution into the market when everyone else was bailing out.

This company is Ag Services of America, one of the most exciting start-ups in agri-finance. Starting in the depths of the recession, 1986, with a contributed capital base of \$300, the founders were three Iowa farm boys straight out of "central casting." They saw a need for someone to help finance farmers who had filed for bankruptcy. They devised a package of inputs, multi-peril crop insurance, and finance arrangements, that found great acceptance. Fifteen years later, Ag Services has annual revenues approaching \$400 million! A chart of their earnings looks like the traditional hockey stick Canadians are so familiar with. We are very proud that we played a role in the company's growth, arranging \$4 million in equity financing for them in 1990.

Equity capital also is beginning to flow back into agribusiness. A lot of money has gone into buyout groups, and they are competing aggressively for deals. Unfortunately equity investors tend to move in herds, “when it’s hot, it’s hot; when it’s not, it’s not!” At various times, financial investors types jumped in and out of the feed, hog, seed (AgriBiotech being a prime example) and dot COM markets. They tend to go in on good news and out on bad news, which means they pay too much and receive little.

Speaking of equity, a client once asked me to define equity and being adequately capitalized. My definition, if David Letterman will excuse me, is found in RB’s List of the Top Five Signs of Being Adequately Capitalized:

5. Equity is always being able to pay your bills on time.
4. Equity is being able to exploit opportunities as they arise.
3. Equity is being able to comfortably absorb losses while your competition is squirming.
2. Equity is not having to spend days on end away from your business negotiating with your banker.
1. And most importantly, equity is your banker calling up to buy you lunch.

Re-entrepreneurial vs. Consolidation

Despite continued consolidation and greater capital requirements of modern food production, I see an emerging phenomenon that I refer to as the re-entrepreneurial of agribusiness. In this scenario, certain agribusinesses that are best managed at a local level, will find themselves going back into the hands of mid-sized management or entrepreneurs. The “gospel” has been that economies of scale dictate consolidation. This is true in many areas, but not in all areas. Many major agribusinesses grew aggressively through acquisitions in the 70’s and 80’s, driven largely by access to capital and by the savings that can accrue by rationalizing overhead, etc. However, possible drawbacks to size include losing touch with your customer and the demotivation of employees.

I am beginning to see several major companies that are taking stock of what they have and thinking through what should be spun off to employees, outside investors, or a combination of both. It already happened with Purina. We have also seen this in several areas of the seed business, where companies have or are being spun off to management. Sometimes, and this is especially true in the case of seed, which is commodity oriented, the economics just can’t afford the overhead requirements of a large-scale owner. I will always remember a lesson taught to me by a successful seedsman who said that: running a seed company like a poor man makes you rich, running it like a rich man makes you poor!

There will also continue to be opportunities for entrepreneurs in new and niche markets where decisions have to be made quickly and where the more deliberate decision-making process of a larger company will be to its disadvantage.

Change in the industry will become increasingly complicated, resembling a bubbling caldron, and we at AgriCapital are working hard to see how we can bring the pot to a manageable simmer for our clients.

Feeding an exploding population

Now for what could be the bad news. How will the world cope with a spiraling population? In the U.S. alone, population will double to 520 million in the next 60 years. Even faster growth is expected in developing nations. According to David Pimental, a Cornell University agronomist, the U.S. will cease to be a food exporter by 2025 A.D. if population pressure, urbanization and water depletion continue at the current pace. At a recent annual meeting of the American Association for the Advancement of Science, Pimental said the U.S. will need all of its resources just to feed its own population, in the absence of expanded improvement in productivity.

I am no Malthusian and am basically confident that, one way or another, we can serve the needs of a growing world population for the foreseeable future. Where I think the globe will hit the wall is the environmental and the social problems that arise from squeezing tens of millions of people with a relatively low average age in areas with limited space and economic potential. One does not have to search hard for examples.

Closing Comments

In closing I would like to make two comments.

First, to be able to cope with change, one cannot just know about it but must prepare for it. Life has a funny way of throwing you a curve ball when you least expect it.

Predicting what will actually happen is awfully difficult, as I am sure you often remind your stockbroker. Who, ten years ago, for example, would have predicted that Microsoft would have a market value in excess of IBM's? To me, what is important is how one is structured to cope with change. That is the key.

My other thought concerns the many excellent presentations that you sat through in the past few days. A question many of you may have is, "how do I use all of this information?" Well, one option you may consider was proposed by Lord Nelson, England's greatest naval war hero, and arguably the world's greatest. Prior to engaging the enemy at Trafalgar, he ended a meeting aboard the HMS Victory with his admirals and captains with these immortal words: "Never mind maneuvers, just go at 'em."

Thank you.