

Contract Farming

by

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Overview

- What is contract farming
- Opportunities, limitations and threats
- Contract farming models
- Organization of outgrower schemes
- Farmer organizations
- Facilitating intermediary organizations
- Role of Government

Overview

- Examples of outgrower schemes
- Characterization of outgrower schemes
- Lessons learned
- Outgrower best practices

Contract Farming

- Large-scale (commercial) and/or smallholder farmers
- Agreement between farmer and private agribusiness processing/marketing company
- Range of activities (services) to secure access to produce

Typical Services

- Provision of inputs on credit
- Extension advice
- Packaging materials
- Transport of produce
- Ploughing
- Crop spraying

Cost recouped when produce is sold*

Opportunities

- Market linkages - assured market for smallholder produce
- Commercialization of smallholder farmers*
- Especially for high-value crops, e.g. horticulture

Limitations

- Often restricted to more accessible areas
- Production base among smallholder farmers often weak
- Productivity levels generally low

Threats

- Contract default
- Scale of smallholder farmer operations

Contract Default

- By company:
 - Failure to deliver inputs/services at correct time
 - Refusal to accept produce
 - Arbitrarily raising quality standards

Usually strong incentive to maintain good relationships with farmers to secure future access to produce

- By farmer:
 - Production failure
 - Avoiding repayment credits – strategic default*

Scale of Farmer Operations

- Potentially high transaction costs*
- Production risks smallholder cultivation higher, especially when rain-fed
- Lack of crop management skills
- Exclusion of weaker farmers

Nevertheless

- Cotton industry in Zambia:
260,000 smallholder farmers
- Paprika industry in Zambia, Malawi,
Mozambique:
30,000 smallholder farmers

Types of Contract Farming

- Centralized model
- Nucleus Estate model
- Multipartite model
- Informal model
- Intermediary model

Centralized Model - Outgrower Schemes

- Contracting company provides support to the production of the crop by smallholder farmers, purchases the crop from the farmers, and then processes, packages and markets the product, thereby tightly controlling its quality.
- Crops such as tobacco, cotton, paprika, sugar cane, banana, coffee, tea, cocoa and rubber
- May involve tens of thousands of farmers
- Level of involvement of the contracting company in production may vary

Nucleus Estate Model

- Variation of the centralized model
- Promoter also owns and manages an estate plantation (usually close to a processing plant)
- Estate is often fairly large in order to provide some guarantee of throughput for the plant
- Mainly tree crops, but also e.g. fresh vegetables and fruits for export
- Focus on smaller number of emergent or semi-commercial 'satellite' growers
- Close supervision of production

Multipartite Model

- Usually involves government statutory bodies and private companies jointly participating with farmers
- May have separate organizations responsible for credit provision, production, management, processing and marketing

Informal Model

- Individual entrepreneurs or small companies who make simple, informal production contracts with farmers on a seasonal basis
- Crops usually require only minimal amount of processing or packaging for resale to the retail trade or local markets
- Vegetables, watermelons, fruits
- Financial investment is usually minimal
- Most speculative of all contract-farming models, with a risk of default by both promoter and farmer

Intermediary Model

- Formal subcontracting by companies to intermediaries (collectors, farmer groups, NGOs)
- Intermediaries have their own (informal) arrangements with farmers
- Disconnects link between company and farmer
- Risks:
 - losing control over production base
 - losing control over prices paid to farmers
 - poorer quality standards and irregular production

Organization Outgrower Schemes

- The processor employs its own field staff mobilizing and managing the outgrower smallholder farmers
- The processor uses local agents or other intermediaries, which work on the basis of a commission, and are the link to the outgrowers
- The processor is linked to cooperative societies or associations, which manage the individual member outgrowers

Farmer Organizations

- Formal cooperatives; or informal farmer associations, farmer production, women farmer or youth farmer groups/clubs, people's participation groups, rural group businesses, etc.
- Organizing smallholder farmers means reaching economies of scale and reducing transaction costs – benefiting both company and farmers*
- Could reduce farmer default in contract outgrower schemes through peer pressure*
- Important to foster good company-farmer relationships*

Features of Successful Farmer Organizations

- Generally involved in relatively simple input supply, marketing, and saving/credit operations
- Close match activity/services and capacity
- Begin with a single activity, as more complex operations often fail
- Concentrate on relatively high-value produce
- Built upon pre-existing organizations or social groups
- Small membership, member-driven agenda
- Viable business objectives (not subsidies)

Types of Successful Farmer Organizations

- Farmer organizations are found to be most successful with small, cohesive groups involved in simple activities in liaison with agribusiness
 - the linkage-independent group*, which can stand alone in the market, and provide smallholders with sufficient market presence to seek out independent relationships with other market intermediaries
 - the linkage-dependent group*, having a long-term commitment to a particular service provider

Facilitating Intermediary Organizations

- Can play an important role in organizing farmers
- Tendency to focus on promoting linkage-independent farmer organizations
- Formation/strengthening of farmer groups often objective in itself, without taken into account concerns and needs of the private sector
- Experiences in working with NGOs from perspective of private sector not always positive
- Masquerading as agribusiness enterprises or creating market distortions – lack of appropriate exit strategies*

But

Despite these criticisms it is believed that donors and/or NGO's still have a role to play in:

- facilitating group formation,
- assisting in reducing transaction costs,
- adding value at producers' level through promoting quality control and/or processing,
- promoting savings by farmers, and
- understanding of the role and use of credit to make such farmer groups stronger

Critical Requirements

- NGOs to operate complementary to the functions undertaken by the private sector
- Role of each partner (companies, farmers, and facilitating organizations) is to be clearly defined and understood*

Role of Governments

- Regulatory and enabling role
 - Appropriate laws and efficient legal system*
 - Arbitration or dispute resolution role*
 - Provision of training in technological and managerial skills
 - Initiation and facilitation of research activities into the products under contract
 - Provision of agricultural extension services
 - Specialized services (phytosanitary controls, plant pathology clinics, research stations)

Role of Governments

- Development role
 - Reallocation of development resources towards promotion of contract farming by bringing together agribusiness and interested farmers or farmer groups
 - Dissemination of market information on products for which there is a demand
 - Strengthening managerial skills of farmer organizations
 - Checking that outgrower companies are *bona fide*

Examples of outgrower models*

- Paprika – Cheetah Zambia/Malawi
- Cotton – Dunavant Zambia
- Export vegetables – York Farm
- Tobacco – Tombwe Processing

Characterization Outgrower Schemes

- The paprika sector uses a centralized outgrower model in a linkage-dependent relationship with smallholder farmers, employing its own extension staff
- The cotton sector uses a centralized outgrower model in a linkage-dependent relationship with smallholder farmers, using local agents called Distributors as the link to the outgrowers

Paprika vs. Cotton

Model 1 (Paprika)

Extension Staff, responsible for recruitment of farmers, provision of inputs and extension, credit recovery and crop collection

Group leaders as intermediary link with farmers, receiving small commission on crop volumes

Individually contracted farmers with no collateral

Characterized by low credit recoveries (<50%), with little or no judicial recourse

High incidence of side-selling

High transaction costs

Stagnant or reduced number of farmers reached

Model 2 ('Dunavant model' - Cotton)

Area Managers, having a supervisory and monitoring role; and Shed/Credit Managers

Distributors as intermediary link with farmers, receiving substantial commission based on credit recovery, crop volumes, and correct grading

Distributors provide collateral, and are fully responsible for selection of farmers, provision of inputs and extension, credit recovery and crop collection

Characterized by high credit recovery rates (>85%) – peer pressure plays role

Much reduced incidence of side-selling

Much reduced transaction costs

Increasing numbers of farmers mobilized

Characterization Outgrower Schemes

- The export vegetable sector uses a nucleus estate model. From a linkage-dependent relationship under Agriflora the relationship has changed to one that is linkage-independent under York Farm, but the smallholder farmers remain heavily dependent on donor support
- The production of Virginia flue-cured tobacco by smallholders is another example of a nucleus estate model, but with a Scheme Operator in charge who himself is not the processor but a commercial grower

Lessons Learned*

- There is not a single outgrower model that is 'the best' and would suit all crops, as different crops have different requirements - outgrower models relate to specific crop quality requirements
- Outgrower models are not static - changes are being made all the time to address certain constraints (especially defaulting)
- Elements of various outgrower models are not mutually exclusive
- One element that the various models have in common is linkage-dependent relationships

Lessons Learned*

- There is a need for development of selection criteria to ensure that potential participants in outgrower schemes meet minimum standards
- There is a need to develop transparent pricing systems to allow farmers to make informed decisions on which crops to grow
- The role and responsibilities of donor-funded NGOs in supporting of smallholder-private sector linkages need to be reviewed.

Outgrower Best Practices

- Various outgrower schemes have different modalities in terms of the type and number farmers, their spatial distribution, contract arrangements, delivery of technical support (extension services), marketing mechanisms, and quality requirements
- To recommend a single best practice outgrower model that suits all of these diverse scenarios will be difficult, if not impossible.

Outgrower Best Practices

- Any model should promote the move away from donor-dependency and distortion towards self-sufficient, economically viable supply chains, with each party knowing and recognizing its role and responsibilities and undertaking them in a responsible, profitable and sustainable fashion
- Outgrower schemes are not an end-goal in itself but should be seen as a transition phase from linkage-dependent relationships between producers and processors towards linkage-independent, self-sustainable farmers and/or farmer groups.

Important Elements of Outgrower Best Practices*

- Criteria for grower selection
- Registration of growers and maintenance of records
- Contracts
- Input supply and loan recovery
- Extension services
- Marketing arrangements
- Pricing mechanisms
- Payment modalities
- Group development facilitation

Criteria for Grower Selection

- There often appear to be no strict criteria for the selection of farmers
- Focus has to be placed on ensuring that the right caliber producers are contracted
- Selection criteria could include land availability, location and conditions, agricultural knowledge and experience, basic business-awareness, willingness to learn, and minimum acceptable production standards

Registration of growers and maintenance of records

- Detailed information regarding personal details, registration number, location, credit provision, and previous crop history of individual farmers is to be recorded
- Computer programmes should be designed to facilitate monitoring the performance of individual smallholder farmers
 - e.g. for assessing the eligibility of farmers for higher input packages

Contracts

- To be transparent and comprehensive, incorporating as a minimum personal details of the individual farmer, identification/registration number, area contracted, period of agreement, quality requirements, grades and descriptions, input costs and repayment modalities, extension provision, and obligations/responsibilities of the involved parties
- Must be understood by farmers
- Company should keep a record of all contracts, if only for monitoring purposes

Input Supply and Loan Recovery

- Conditions that apply to the provision of inputs, range of inputs made available, cost, farmer contributions towards value of inputs, interest charged and repayment modalities must be clearly stipulated
- Timely delivery of inputs and other services needs to be properly planned

Extension Services

- There may be a need for companies to perform a full training and extension needs analysis
- Costs of extension services are usually reflected in the prices paid but perceived by farmers as being for 'free' – needs to be made transparent
- Provision of extension services is ideally linked closely to production cycle

Marketing Arrangements

- Establishment of a network of depots and buying centres
- Staff positioned at these depots should be well trained in grading procedures, and closely monitored
- Grading standards should be clear and transparent (visual aids)
- Farmers need to be well trained in grading of the produce

Pricing Mechanisms

- Expectations for minimum pre-planting price often unrealistic
- Relationship to international market prices often not understood
- Uncertainty about price levels leads to mistrust and feeling of exploitation
- Development of transparent pricing systems important to alleviate constraints

Payment Modalities

- Should be as prompt as possible, preferably when produce changes hands
- Any transaction should be properly recorded, indicating grades, corresponding weights and prices, total value of the delivery, and any deductions for inputs or, if applicable, other services provided

Group Development Facilitation

- Not economical for outgrower companies to service each and every farmer individually
- Group approaches to farmer organization means reaching economies of scale
- Farmer groups are usually mere 'interest' groups, and should be the cornerstone for group development
- Good communication and close monitoring remain particularly critical issues

Code of Conduct

- Objective would be to promote ethical and transparent trading
 - Agricultural inputs are both adequate and appropriate
 - Open and transparent marketing services
 - Increasing capacity of smallholder farmers to become efficient and competent commercial producers
 - Developing self-reliance and sustainability
 - Fostering safe and responsible agricultural practices

Donors/NGOs

- Have a role to play in:
 - facilitating group formation
 - assisting in reducing transaction costs
 - adding value at producers' level through promoting quality control and/or processing
 - promoting savings by farmers
 - promote understanding of role and use of credit
- Operating complementary to private sector