I. Project Context

Country Context

More than twenty years after the end of apartheid, unemployment, poverty and inequality remain important development challenges in South Africa, despite substantial progress in overcoming the legacy of the past. While total employment increased from 9 million in 1996 to 16 million in 2015, the unemployment rate has stayed stubbornly high in the range of 20-26 percent. In 2015 approximately 5.4 million South Africans were unemployed, of which about 40 percent were new entrants. A 30 percent increase in per capita GDP since the late 1990s and a sharp expansion of the social grant coverage enabled a significant decline in the poverty rate—from 43.5 percent of the population living below ZAR219 (inflation-adjusted) a month in 2000 to 36.7 percent (or 18.3 million people) living below R501 in 2015. Nevertheless, pockets of poverty remain deeply entrenched, mostly among the historically disadvantaged population. With a relatively stagnant income Gini coefficient of around 0.69 in 2011 (versus 0.72 in 2006) and expenditure Gini of 0.634 in 2015 (versus 0.67 in 2006), South Africa has one of the highest inequality rates in the world. Land distribution, in particular, is one of the most unequal in the world. Threatening progress in poverty alleviation is the impact of the drought on agriculture and the widening gap between those with and without jobs.

Recent developments in economic activity are not indicative of major improvements in growth or employment. South Africa’s annual GDP is estimated to have increased by 1.3 percent in 2015,
compared to 1.5 percent in 2014 and 2.2 percent in 2013, a result of depressed global conditions, as well as labor unrest and electricity shortages which compounded structural constraints. This weak growth is well-below the projected 5 percent growth needed to drive down unemployment. Inflation was relatively subdued in 2015 amid lower food and fuel prices (5.2 percent as of December 2015, up from 4.8 percent in November). However the Reserve Bank increased the repurchase rate by a total of 125 basis points from start 2015 to end March 2016 due to a deterioration in the inflation outlook as a result of the effects from rising food prices due to the drought, the risk of a higher pass-through from the sharp depreciation of the rand (depreciated by more than 30 percent against the dollar in 2015 and continued to weaken in January 2016, before showing a subsequent moderate recovery) and subdued global growth.

A weaker growth environment will pose a challenge in the management of the fiscal deficit, which in turn increases the sovereign credit risk. In an effort to mitigate sovereign credit risk, the National Budget Speech of February 2016 announced a strong fiscal adjustment effort, bringing the fiscal deficit from 3.9 percent of GDP for 2015/16 to 2.8 percent by 2017/18. The original target of the 2015 budget had been 2.5 percent, however deterioration in the growth outlook rendered the target unrealistic. In December 2015, Fitch and Standard and Poor’s (S&P) downgraded South Africa’s creditworthiness rating to BBB-, one notch above speculative grade, and S&P placed its rating on negative watch. The turmoil in markets experienced in December 2015 when a weakening in the government’s commitment to fiscal discipline was perceived, hints at the potential fallout from a further ratings downgrade.

A substantial reduction in poverty and inequality will be hard to achieve without a major success in rural development. As stated by South Africa’s National Development Plan (NDP), the main challenge for rural development in South Africa is to “combat the marginalization of the poor”. While the rural share of poverty fell from 70 percent in 1993 to 58.3 percent in 2011, partly due to migration of the poor to townships and informal settlements around urban centers, rural areas remain characterized by greater poverty and inequality than urban areas. The contraction in agricultural production at double-digit rates in the first three quarters of 2015, as extreme weather conditions related to El Nino led to the most severe drought in almost 20 years, pushed an estimated 50,000 South Africans into poverty.

Agriculture development and successful land reform are key pillars of the strategy laid out by the NDP for integrated and inclusive rural development. South Africa’s agriculture sector is characterized by dualism: a modern, market-oriented capital intensive farming sector consisting of a small number of large commercial farms (around 40,000 farming units) and a large number of subsistence and small-scale or emerging farms, many in the former homeland areas. In addition, there is growing consolidation in the industry with a number of mergers taking place and the acquisition of smaller players. While improving economies of scale, this consolidation may also lead to lower competition in the market. Around 2006, over 80 percent of South African farmers worked on a piece of land of one hectare or smaller, and another 11 percent on one to five hectares. Only 3 percent had access to land of larger than 20 hectares. It is estimated that there are 2.5 – 3.5 million households engaged in subsistence farming, about 350,000 – 700,000 who can be classified as emerging farmers, producing part of their output for the market, and between 11,000 – 15,000 small to medium scale farmers who are commercially oriented.

The progress of land reform has been slow and a large number of land reform beneficiaries are not using the land productively. The government committed itself to transfer 30 percent of the 82 million hectares of agricultural land owned by whites in 1994 to historically disadvantaged farmers by 2014, a total of 24.5 million hectares, through both land restitution and land redistribution. According to the Twenty Year Review published by the Presidency, only 9.4 million hectares have been redistributed since 1994 through both land restitution and redistribution. Achieving the objective of “productive use” of redistributed and restituted land requires even greater efforts and innovation. Land reform in South Africa to date has involved the transfer of relatively large commercial farms in their entirety to groups of
beneficiaries. Land reform beneficiaries are typically resource-poor, risk-averse, and inexperienced historically disadvantaged farmers. Support provided to them after their takeover of the land, that is post-settlement support, has been inadequate. Land reform beneficiaries have experienced numerous problems accessing services, such as credit, training, technology extension, transport, plowing services, veterinary services, and marketing services. The well-developed agribusiness sector that services large-scale commercial agriculture has not been seen extending its operations to emerging farmers who, in most cases, would be cash-strapped and incapable of paying for such services anyway. As a consequence, there is limited integration of small farmers into the value chain.

Support for small-scale farmers is equally crucial to job creation. Employment in the formal agriculture sector declined from 1.1 million in 1992 to 739,000 in 2014 despite output growth. Nevertheless, the NDP believes that with successful rural development and land reform the agriculture sector has the potential to create 1 million new jobs by 2030. The NDP counts on small-scale/ emerging farmers for over 35 percent of the job creation target, in addition to a 10 percent share from subsistence farmers, a 10 percent share expected from better use of the land that has already been redistributed or restituted to land reform beneficiaries, and a 30 percent share from expansion of labor intensive commercial farming.

**Sectoral and institutional Context**

South Africa’s financial sector is the most developed in Sub-Saharan Africa and is significantly larger and more diversified compared to regional and income-group peers. It is supported by an elaborate legal and financial infrastructure and a generally effective regulatory framework. South Africa’s financial system totaled approximately ZAR 10 trillion in assets as of year-end 2014 (US$ equivalent of 1,026 billion). As of end 2014, the banking sector constitutes almost 40 percent of the financial system assets, with pension funds and long-term insurers each contributing roughly 35 and 18 percent, respectively.

The banking sector is highly concentrated, but at the same time commercially driven and professional. The ‘big four’ banks in South Africa, two of which are foreign owned, account for over 83 percent of total banking assets. This concentrated ownership structure has led to limited competition and distorted incentives for these banks to serve the lower end of the market, especially micro, small, and medium-sized enterprises and the low-income population. Nevertheless, the banking system generally is highly professional and commercially driven, and does not suffer from distortionary policies.

**Provision of agricultural finance and support**

One of the main challenges for rural and agriculture development is affordable access to working capital for emerging farmers and medium to long-term finance for small and medium-sized agricultural enterprises. While the financial services needs of the large commercial farms are generally well catered for by the private sector, farmers in rural areas experience many of the challenges faced by their peers in other African countries, ranging from difficulties in accessing markets, poor infrastructure, and little or no physical assets that could be used as collateral for accessing financing. With few exceptions, emerging and small-scale farmers are unable to use the land that they farm on as collateral given that the state owns most of the land in the former homelands. FinScope’s 2010 Small Business Survey estimates that of the roughly 700,000 emerging and small commercial farmers, only 5.6 percent used formal credit services and only 2.5 percent from a bank. In contrast, nearly half of those farmers used formal savings and/ or payments services and about 30 percent formal insurance.

Without adequate collateral, rural farmers face challenges in accessing credit from traditional commercial banks. While the ‘big four’ commercial banks have made efforts to become more inclusive, their business models and cost structure do not lend themselves to serving the agricultural sector. Some
banks are funding value chain off-take agreements with large processors and retailers for on-lending to smaller farmers, but such lending is small compared to the overall loan book of commercial banks. According to the Department of Agriculture, Forestry and Fisheries (DAFF), total farming debt amounted to ZAR 116,576 million (US$10,137 million) in 2014, out of which ZAR 66,345 million (US$5,769 million) was from commercial banks and ZAR 30,580 million (US$2,659 million) from the Land Bank. Compared to total commercial bank loans and advances of ZAR 2,967 billion (US$258 billion), agricultural lending amounts to about 1 percent of their total loan book.

A wide range of programs have been implemented by the government to provide financial support to land reform beneficiaries and small-scale farmers. In 1994 the government introduced the Settlement/Land Acquisition Grant (SLAG) to enable individuals and groups to finance the purchase of land from a willing seller. Until 2000, redistribution policy centered on the provision of a grant of ZAR 16,000 (~US$1,034) to qualifying households with an income of less than ZAR 1,500 (~US$97) a month. In 2001 the Land Redistribution for Agricultural Development (LRAD) Grant was introduced to establish and promote emerging farmers. LRAD offered higher grants, paid to individuals rather than to households, and made greater use of loan financing through institutions such as Land Bank to supplement the grant. A few years later, the slow pace of land reform led to the introduction of the Proactive Land Acquisition Strategy (PLAS) in 2005-06. The use of grants for land acquisition was discontinued and the focus was shifted to the acquisition of strategically located land through PLAS by the state. Since its inception, PLAS has become the biggest single program area within redistribution, in terms of both budget and land area.

There are also initiatives designed to provide post-settlement support to land reform beneficiaries. The LRAD policy for example sets out to close the post-settlement support gap that prevailed under SLAG. In addition, the Comprehensive Farmer Support Program (CFSP) provides two grants, one for capacity building and one for on-farm infrastructure. In order to access on-farm infrastructure grants ranging from a minimum of ZAR 5,000 to a maximum of ZAR 100,000 (~US$323 to 6,462), beneficiaries must make an ‘own contribution’ along a sliding scale similar to that of the LRAD grant program. It is a once-off support package designed for LRAD beneficiaries. The Comprehensive Agricultural Support Program (CASP) supported by DAFF offers grants to support short-term operating expenses and small operating needs such as machinery. These grants are managed at the provincial level and come from funds that are transferred from the national to the provincial level. Combined land acquisition grants, both for redistribution and restitution, totaled ZAR 13.6 billion (US$1.61 billion) between 2008 and 2012 while grants for movable equipment and fixed improvements amounted to ZAR 3.4 billion (US$1.58 billion) between 2004 and 2012 (DAFF). Borrowing for working capital needs to operate and expand farms has been one of the most acute challenges for emerging and small farmers as well as land reform beneficiaries due to the reasons mentioned above.

Value chain integration is an opportunity to address significant skills and financing gaps of emerging farmers. In South Africa, there is a growing recognition in government and the private sector that value chain integration may be an effective way of building up a new class of commercial emerging farmers. Drawing on the successful experiences in the sugar, poultry, cotton, tobacco and forestry sectors, the government and private sector are joining forces to scale up efforts in these and other sectors. A new area opening for value chain integration is in the supply of fresh fruits and vegetables to retail supermarkets. With new BBBEE procurement policies government is encouraging the private sector to get involved. For example, Walmart-Massmart has established a supplier fund to support emerging farmer integration into their supply chain. The South African Poultry Association through the creation of the Developing Poultry Farmers Organization (DPFO) facilitates technical and financial assistance to access contracts with egg and poultry businesses.
Land Bank

In addition to government grants, financing from Land Bank has been expected to play a critical role in land reform and agriculture development. Land Bank was established in 1912 and is governed by the Land and Agricultural Development Bank Act of 2002. Land Bank was given a mandate of 11 aspects, which fall into five broader areas: (i) access of the historically disadvantaged population to land; (ii) agriculture productivity, growth and job creation; (iii) gender equity; (iv) environmental sustainability; and (v) food security. The NDP published in 2011 continues to call for a key role of Land Bank in providing financial support to land reform beneficiaries and to help them overcome difficulties in entry into commercial farming.

As the leading development financial institution in the rural and agriculture sector in South Africa, Land Bank had an approximately 29 percent market share in agricultural financing as of July 2015. The bank has achieved a significant turnaround during the past five years. It is now on a sustainable trajectory with profits of ZAR 420 million in 2014/15 (up 61 percent from 2013/14), and a Return on Average Assets of 1.12 percent and a Return on Average Equity of 6.78 percent. Total assets stood at ZAR 39.4 billion in 2014/15 with a performing loan book of ZAR 36 billion. Non-performing loans (NPLs) under Land Bank methodology were at 3.72 percent in 2014/15 and the cost-to-income ratio was 54.9 percent. Fitch Ratings upgraded Land Bank from AA to AA+ in January 2014. The rating was maintained at AA+ in December 2015. The bank does not take general deposits and funds itself mainly through the debt and capital markets, issuing instruments such as promissory notes.

Land Bank is fully owned by the South African government and supervised by the National Treasury. It follows prudential guidelines as issued by its Board of Directors. It is consequently not prudentially supervised by the South African Reserve Bank (SARB). The bank is audited by the Auditor General. Land Bank is engaged in both wholesale lending through intermediaries as well as direct lending. Intermediaries are mainly credit providers, cooperatives, or agri-businesses.

In 2015, Land Bank adopted a new strategy following the completion of its organizational review. The review was undertaken following conditions set by NT pursuant to the issue of a Government guarantee, aimed at enabling the Land Bank to raise longer term funding. The review was completed in August 2015 and subsequently an implementation plan was approved by the Land Bank Board. Land Bank has started implementing the new strategy and key changes are planned to be put in place over a two-year period in line with the priorities of Land Bank. The changes focus on: (i) a strategy to optimize the retail commercial banking segment of Land Bank, the long term viability of which was a concern owing to loan losses and significant operational costs; (ii) new initiatives to potentially expand the development portfolio of Land Bank for emerging farmers in a sustainable and commercially viable manner by adopting a project finance approach in partnership with large corporates and intermediaries to integrate the emerging farmers into established value chains; and (iii) steps to align Land Bank financial soundness indicators, credit appraisal processes and risk management practices with international banking standards.

Following the adoption of this new strategy, Land Bank has two main business lines: Corporate Banking (CB) and Commercial Development Banking (CDB). The new CDB business line is a combination of previous Retail Emerging Markets (REM) and Retail Commercial Banking (RCB) business lines. In 2014/15, CB accounted for 83.6 percent of the bank’s loan book and CDB accounted for 16.4 percent, of which 1.3 percent was composed of loans provided under REM.

Under CDB, the REM sub-business line continues to focus exclusively on lending to emerging farmers for development purposes. Farmers supported under REM typically have no or limited access to commercial funding and little or no collateral, but can be commercially sustainable and viable with
financing and technical support. Subsistence farmers are not supported under REM. Lending is based on cash-flows and non-financial support (end to end on-farm support) is provided by Land Bank intermediaries and agricultural specialists based in Land Bank branches. REM uses wholesale as well as direct lending and offers production financing, installment sale finance, and medium-term loans. The total REM portfolio amounted to ZAR 489 million in 2014/15 (increase of ZAR 97 million in that year).

Intensive and high-quality extensions services under the REM program are effectively provided by Land Bank’s intermediaries. These intermediaries have a comparative advantage in providing these services due to their close interaction with the beneficiaries. The non-financial complementary services, especially extension services, are critical for emerging farmers to develop. The costs for the extension services are embedded in the overall cost structure under REM and are borne by the intermediaries. While the provision of extension services is costly, especially for new emerging farmers, intermediaries can generate profits from these clients over time due to the long-run and comprehensive nature of engagement between intermediaries and their clients. The current model of providing extension services is considered to be of high quality according to the assessment carried out during project preparation.

Under CDB, the RCB business line which was exclusively focused on direct retail lending to medium scale farmers, through 27 Agriculture Finance Centers (AFCs), has been significantly restructured to improve its long term sustainability. RCB was loss-making due to high operating costs of the large branch network and had NPLs of 11 percent in 2014/15. RCB was losing clients to commercial banks and agricultural enterprises who started to lend in that space and could offer a wider range of products. The competitiveness and long-term viability of RCB was therefore questionable. The new strategy aims at consolidating the branch network into 9 provincial offices in strategically important geographical locations which will also result in significant staff reduction. Importantly, the consolidated branch network’s role will specifically focus on facilitating effective partnerships in their respective regions with corporate retailers, emerging farmers, government programs, as well as technical and financial intermediaries to leverage on high impact and high value chain finance deals.

Importantly, as part of the new strategy, Land Bank aims to scale up financing support to emerging farmers in a sustainable and commercially viable manner through their integration in established value chains. The approach is anchored in identifying high-potential value chain projects in a given geographic region and securing buy-in from large agriculture corporates or technical partners to assist in supporting emerging farmers’ integration into the chain. The agriculture corporates will provide technical support (directly or indirectly) to the emerging farmers, building up their capacity to be sustainable suppliers to the chain. Land Bank has identified selected potential value chain projects and agriculture corporates to partner with in the grains, winery, horticulture and livestock sectors for this type of financing.

The CB business line is the corporate part of the bank and the most viable business line. The CB business line involves both direct and wholesale lending. Lending takes place primarily through intermediaries (cooperatives and agri-businesses). CB operates through two offices in Pretoria and Cape Town. The total portfolio of CB amounted to ZAR 31 billion in 2014/15. While CB targets commercial farmers, the workers employed on these farm tend to be part of the low-income population.

Land Bank aims at increasing its developmental focus in both CB and CDB business lines by strengthening its wholesale business as well as its direct lending to emerging farmers. Both business lines contain a development portfolio with “development” referring to a focus on supporting the historically disadvantaged population in line with Broad-Based Black Economic Empowerment (BBBEE). International experience with development banks suggests that wholesale lending is more likely to be successful than retail lending. The key reason is that wholesale lending does not require a large branch network which is costly to build and maintain but rather leverages the networks already
built by other financial service providers. Wholesale lending is also more market enabling and does not aim at competing with the private sector. Direct lending via value chain financing leverages the corporate partner’s ability to provide technical support to the borrower, building up their capacity to be sustainable suppliers to the chain. As such, emerging farmers in this scheme have the potential to increase their revenues and thus a greater likelihood of fulfilling debt obligations to the bank. The project will therefore focus on supporting Land Bank in scaling up its wholesale portfolio as well as expanding direct lending through LB’s new approach of integrating emerging farmers into established value chains. Using long-term financing to fill existing funding gaps will additionally help Land Bank meet its investment needs as well as improve its asset liability management.

Land Bank is making an important contribution to job creation. Land Bank estimates that the impact of its loan disbursements on employment opportunities in South Africa was close to 400,000 in 2013-2014. This estimate is comprised of over 23,000 new employment opportunities generated and over 370,000 jobs maintained during the year. One employment opportunity constitutes 240 days worked per year. The estimated new jobs created are arising out of the medium and long-term loans Land Bank is providing.

II. Project Development Objective(s)

The project’s development objective is to sustainably scale up Land Bank’s financing, specifically to benefit emerging farmers.

III. Project Description

Component Name

Line of Credit for Agricultural Financing

Comments (optional)

Land Bank will provide both wholesale finance to participating PFIs for on-lending to commercial and emerging farmers and direct financing, in partnership with large agriculture corporates, to emerging farmers to support their integration in established value chains. It will do so through two main financing windows

Window 1: Wholesale finance to commercial and emerging farmers. This window will provide a wholesale line of credit to Land Bank. Land Bank will on-lend the funds to participating financial intermediaries (PFIs) which comply with eligibility criteria agreed with the World Bank. The PFIs will on-lend funds to eligible agriculture enterprises, commercial and emerging farmers, communal property associations and other eligible borrowers supported under the Land Bank’s CB and CDB business lines. Currently, the wholesale line under CDB primarily includes the REM portfolio, however, over the life of the project this may change to include other wholesale loans under CDB.

Window 2: Financing to integrate emerging farmers into established value chains. This window will provide a line of credit to Land Bank to finance direct lending to emerging farmers for integrated value chain finance. For direct lending to value chain finance/development projects, Land Bank will finance eligible emerging farmers and agriculture enterprises in collaboration with large agriculture corporates and/or technical partners in a targeted value chain.

IV. Financing (in USD Million)
V. Implementation

The project is a financial intermediary loan (FIL) of US$95 million to Land Bank as the borrower and implementing agency with a guarantee of the Republic of South Africa. The project has one component: a Line of Credit for Agricultural Financing in the amount of US$95 million.

The loan will be extended to Land Bank as the borrower and implementing agency with a guarantee of the Republic of South Africa. Land Bank will use the funds under the LOC component for on-lending to PFIs. Land Bank will be responsible for project implementation and monitoring. Dedicated staff in Land Bank has been identified for managing all aspects of the project, including reporting on implementation progress and monitoring and evaluation, ensuring compliance with environmental and social safeguards as well as with financial management and procurement arrangements.

Land Bank will report on the PDO and intermediate indicators on a semi-annual basis. The data will come from Land Bank’s internal reports and from information provided by the PFIs. Land Bank will prepare quarterly Interim Financial Reports for the project. The specific reporting templates will be defined in the Project’s Operational Manual. Land Bank’s financial performance will be audited annually by the Auditor General.

VI. Safeguard Policies

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<td>PS 8: Cultural Heritage</td>
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Comments (optional)
VII. Contact point

World Bank
Contact: Gunhild Berg
Title: Senior Financial Sector Specialist
Tel: 473-1150
Email: gberg@worldbank.org

Contact: Uzma Khalil
Title: Senior Financial Sector Specialist
Tel: 458-5515
Email: ukhalil@worldbank.org

Borrower/Client/Recipient
Name: Land and Agricultural Development Bank of South Africa
Contact: Bennie van Rooy
Title: Chief Financial Officer
Tel: 27-83380-0672
Email: bvanrooy@landbank.co.za

Implementing Agencies
Name: Land and Agricultural Development Bank of South Africa
Contact: Bennie van Rooy
Title: Chief Financial Officer
Tel: 27-83380-0672
Email: bvanrooy@landbank.co.za

VIII. For more information contact:
The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop