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PE's Green Thumb: Paine & Partners has proved there's money to be made in agriculture, though the firm advocates a cautious approach

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Few segments exist in the market today where private equity firms won't tread. Semiconductors, for example, used to be one of those areas, as the cyclical, capital-intensive nature of the sector tended to scare off PE investors. Today, though, some of the larger semi names, such as Freescale and NXP, are owned by financial sponsors.

Another area PE firms have traditionally avoided is the agriculture sector. There's a list of reasons sponsors have shied away from the space, but the most often cited explanation is that it's unpredictable. As, Kevin Schwartz, a partner at Paine & Partners, plainly describes: "Sometimes it rains, sometimes it doesn't."

A number of factors have conspired to add some intrigue to the ag sector. This past April, for instance, when Sam's Club and Costco started imposing limits on the amount of rice customers could buy, it might have been an "aha" moment for some. Globalization has also awakened investors to the possibilities. As investors embrace "the world is flat" doctrine, it can be difficult to avoid the opportunity in the ag segment as part of that vision.

Indeed, Goldman Sachs, in August, acquired 10 poultry farms in China for a reported $300 million, while Dutch bank Rabobank Group, near the end of July, launched a new $100 million private equity fund focused exclusively on agribusiness in India.

Cynics might accuse investors of getting into the space just as it hits a peak. Commodity prices, as everyone knows, have skyrocketed. The Food and Agriculture Organization's food-price index grew by roughly 24% last year and jumped an astonishing 33% in the first quarter.

Many investors, logically, are reticent to buy in on the wrong side of what might be a cresting trend line. At the same time, evidence is piling up that suggests there are longer-term drivers behind the increase in prices.

Paine & Partners is one of the few private equity firms that has regularly invested in the space and lived to talk about it. The firm, which considers ag businesses a core focus, among other industry specializations, issued research earlier this year making a case that commodity prices are not simply riding a cyclical high. Instead, Dr. David Buckeridge, an operating partner at the firm, describes: "There have been some fundamental, structural changes occurring" - changes, he says, that underpin and support the prices that continue to confound pundits.

Population growth is one of the more obvious factors behind the sector's strength. A less obvious corollary is that as emerging markets develop, diets tend to shift toward more animal proteins. And that, Buckeridge adds, drives the demand for more crops.

Another driver is that as demand surges, resources are largely "static." Arable land and water for irrigation can't simply be manufactured. And efforts in the US and abroad to adopt bio-energy platforms mean less land is being dedicated to food production. It can create the kind of dislocation that had German beer drinkers abuzz when they noticed the price for a pint had climbed considerably. They were paying for the spike in barley prices - passed on by the brewers - that emerged when farmers transitioned to the more lucrative biofuel crops.

The German government helped create the problem by enticing farmers with biofuel-targeted subsidies. Imbibers may cry foul, but this points to another factor Paine & Partners believes will help sustain pricing. "Public policy is going to drive agriculture activity," Buckeridge adds. "China, for example, is very concerned about food shortages... and there has been a strong demand for renewable fuel, which will continue to drive the production of bio crops in developed countries."

Considering all of this, investing in the sector might sound easy. However, it's not the case in agriculture that a rising tide will lift all boats. Paine & Partners is bullish about the space, but the firm is just as adamant that it's not for everyone. It requires deep industry knowledge. Seeds, for instance, can require just as much technology and research as the semiconductors described earlier on. Then there is the weather. Schwartz made it sound like a simple problem, but it is an issue that requires investors to brace for the worst.

When Paine & Partners' predecessor firm, Fox Paine & Co., previously invested in the space, it structured what might be described as un-leveraged buyouts. To acquire vegetable- and fruit-seed producer Seminis - a 2003, $606 million deal - the investors started with a 40/60 equity-to-debt ratio. And then, in Schwartz's words, the firm "very quickly put cash on the balance sheet to focus on growth," with roughly 13% of the revenues being redirected back into research and development. This was at a time, too, when most PE firms were taking the opposite approach with their investments in the name of dividend recaps.

Seminis, as it turned out, was sold just 16 months later through a $1.5 billion sale to Monsanto. The deal generated a 3.5x return on the firm's equity.

The firm's Advanta investment performed even better. The Paine & Partners principals, again through Fox Paine, invested $75 million, acquiring the agronomic seed company alongside ag-chemical concern Syngenta. After 18 months, the investors completed the last of four divestitures, realizing a 4.5x return and a 600% IRR for its work making sense of and reorganizing the company's disparate units. Advanta, a company Buckeridge oversaw as CEO, was even less levered than the Seminis deal.

In both transactions, the investors were able to avoid any major outside hiccups. That doesn't mean they weren't prepared. In this sector, a month of sun can overshadow even the most compelling macroeconomic trends. Georgia's Pike Family Nurseries, a private equity-backed nursery operator, went bankrupt last year, wilting amid one of the driest summers in recent history. This past June's Salmonella scare highlights another threat, one experienced by Topps Meat Co., formerly controlled by Strategic Investments and Holdings. The ground beef producer was done in last year by an e. coli outbreak. Lawyers looking to sue the defunct company are reportedly claiming that lax testing was the result of an effort to cut costs. Whatever the cause, both cases underscore why capital structure is important.

"It can't be about financial leverage," Schwartz says. "In this sector it has to be about growing the business and making it better."

And there are no shortcuts. "You wouldn't think in this area that you'd be dealing with the most sophisticated customers in the world, but in the seed industry, farmers know exactly what your product will produce if given a set of conditions," Schwartz says. And if the products fail, there's no discount that can win those customers back.

Despite the considerations required, Paine & Partners is indeed bullish on industry's prospects. In fact, the firm has broadened the sector mandate to include agriculture and protein, so poultry, seafood, pork and beef are also on the radar.

This bullishness doesn't mean the firm is going to stop playing it safe. Dexter Paine III, the founder and a partner at the firm, has seen what can happen. "A lot of people have lost money in this sector," he says. "Unless investors are prepared to take a long-term view and deal with the ups and downs, this may not be the right sector for them."