# Fertile ground for agribusiness

**Investment in agribuisness provides welcome opportunities to enhance clients' portfolios. Jim Blackburn examines the changing landscape of this diverse sector**

The landscape for investment in the Australian farming and forestry sector continues to change significantly. Drought, climate change and a global financial crisis have proved to be significant factors in moulding the way we now view investment risk, time horizons and the comparative performance of these sectors against the different asset classes such as equities, property and fixed interest.

Through both the listed and unlisted markets, and at the retail, wholesale and institutional level of investment, there is a renewed focus on core investment themes in food and fibre production, food security and the scarcity of natural resources such as land and water. In addition, there is broader discussion around the specific technical aspects of the risk-return, diversification and correlation characteristics that agribusiness and forestry investment may provide to an investment portfolio at both the fund and individual level.

## SUB-SECTORS

In 2008, the combined gross value of production across the agribusiness and forestry sector equated to $47.5 billion. These industries provide a broad range of investment opportunities through listed equities, managed investment schemes, and managed fund products for retail, wholesale and institutional investors. At the industry level, the broader sector is divided into a number of specific sub-sectors:

### Agriculture

This is perhaps the largest sector of farm production in Australia and is dominated by the meat and livestock industry, grains and oilseed production, cotton, dairy, and a vast array of broad-acre mixed farming interests. The sector is characterised by a continued divergence between individual family-run operations and larger scale corporate or consolidated holdings. At all levels, production efficiency and cost management (including access to water) are determining factors in economic sustainability. The global market for agricultural commodities such as wheat and beef is deep, with increasing competition, and has evolved with new technologies such as biofuels that significantly alter supply and demand dynamics.

### Forestry

Forestry in Australia is structured around native and plantation based estates which supply the domestic and international pulpwood and construction timber industries. Native forest resources continue to be a major contributor (8.5 million cubic metres per annum compared to 4 million cubic metres from plantations) but this is expected to decline with increased limitation on native forest exploitation. Whilst the sector is dominated in production volume by the Eucalyptus (hardwood) and Radiata Pine (softwood) species (1.9 million hectares under plantations), there is a significant high value sub-sector that has been developing in Australia around species such as mahogany, teak and sandalwood. The Managed Investment Scheme (MIS) industry has been a key player in new investment and plantation development in the forestry industry.

### Viticulture

The challenges facing the Australian wine and wine grape industry are well known to most Australians. The oversupply of some varieties from specific regions has given rise to great debate within the industry, particularly around the topic of new investment and new vineyard developments. Furthermore, the impact of the continuing drought, which comes with mixed blessings at a time of over-production, and the more recent impacts of the global financial crisis on wine consumption, are cause for significant uncertainty in the short to medium term.

### Horticulture

The Australian horticultural industry covers a very wide range of products including stone fruit (apricots, nectarines, and the like), apples, pears, citrus, nuts, berries, olives and olive oil to name a few. Access to key high-value export markets has provided significant stimulus for growth together with increasing intensity and scale of production. The availability of water, development of new genetics, and the potential impact of climate change are key drivers being discussed in recent industry forums.

### Fisheries and aquaculture

The production of seafood from wild capture fisheries and aquaculture has had a mixed year under challenging conditions. Key domestic sub-sectors include the northern prawn fishery, southern rock lobsters, southern bluefin tuna, oysters, pearls and salmon farming based in Tasmania. Australia participates in key global markets, which are currently being affected by significant changes in exchange rates, company debt structures and availability of new capital, and reductions in discretionary incomes (affecting demand and price). Whilst there will continue to be some changes (ones we can see in our relatively small market here include the switch to lower value seafood imports) there is an expectation of durability for the domestic industry in some of the mature markets for well established Australian seafood products.

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## TYPES OF INVESTMENT VEHICLES

### Listed equities

The Australian Securities Exchange includes approximately 50 listed agricultural stocks, which cover seven global industry classification standards (GICS) sub-sector classifications. The description of agricultural stocks is inherently broad and covers few very large stocks - the largest by market capitalisation being Incitec Pivot ($3.4 billion) - and many more small to micro cap companies such as AWB ($523 million) and PrimeAg ($142 million). As a consequence, the agricultural indexes that are based on the ASX listed companies are heavily weighted toward a small number of stocks, which makes them inherently more volatile than global indexes across similar sectors. Interestingly, the appearance in Australia of global equities funds that include in their portfolio a number of ASX listed stocks underlines the fact that these companies participate in their respective markets at a global level.

### Managed investment schemes

Tax-effective MIS investment products have had a long and interesting history in the retail investment landscape for Australian accountants and financial advisers. Early problems with poorly planned and managed schemes have thankfully given way to more sophisticated products that employ skilled and well resourced operational management teams. Regulatory uncertainty, particularly regarding to taxation provisions, has hampered the industry. However, recent resolutions by the Australian Taxation Office (ATO) have hopefully brought some greater certainty. The industry is largely focused on the plantation forestry and horticulture sectors with some involvement of the livestock, grains and aquaculture sectors. Investment in the 2007-08 financial year totalled more than $1.1 billion and included approximately 60 projects from managers such as FEA, Great Southern, Gunns, ITC, and Timbercorp.

### Unitised trust structures

These products can be considered to fall between the tax-effective MIS and mainstream managed fund products, and offer a simplified unitised trust structure that is used to invest directly in farmland, forestry land and operations. Investors participate as unit-holders, with limited liquidity available. In addition, the vehicles are generally not considered to be tax-effective. The funds are generally managed by boutique fund managers with specialised skills in their particular sub-sector exposure for which the fund is designed, such as Warakirri, Macro Funds, and Challenger.

> ‘The opportunity is to reshape a portfolio using a strategic rather than tactical view’

### Managed fund products

As mentioned above, a number of agriculture and related global thematic equity and commodity funds have appeared within the retail investment space over the last few years. Deutsche (DWS), Colonial First State (CFS) and Barclays Capital are amongst the fund managers that are currently or prospectively in this space. The Global Equity funds are built around the core discipline of equities analysis or bottom-up stock picking. The pool of securities (or universe) may be defined by a set of rules (or filters) that match the theme that the fund is trying to target. By comparison, the commodities funds, which include agricultural (soft) commodities exposure, may invest directly in commodities future contracts. These contracts will vary according to a long- or short-term view, based on the fund's outlook on price.

It is within the context of these diversified sectors and vehicles for investment that the Australian agribusiness and forestry sector continues to build its investment case. For retail investors, the opportunity is to reshape a portfolio using a strategic rather than tactical view of agribusiness and forestry. The proliferation of managed funds and continuation of the MIS industry will provide the products, and further research on portfolio diversification and correlation benefits will re-define the strategy.

For institutional investors, the barriers to growth of new investment in agribusiness and forestry are less clear. International investors, including large pension fund and sovereign funds from the US and Middle East, have made significant investments in Australian agribusiness and forestry. Meanwhile, the domestic institutions remain largely on the sidelines. Some speculate that our domestic institutions are constrained by the historic comparison to high double-digit returns from equities and property investments. By comparison, the consistent but less spectacular returns from agriculture just don't look all that attractive.

What pervades these considerations is a number of important global trends. Firstly, there is the significant shortage of new arable land to feed an increasing world population, and to provide key resources such as paper and timber products.

In addition, the consumption patterns of this increasing population are changing towards a Westernised diet of high-quality protein and carbohydrates, and increasing consumption of high quality fibre.

It is these underlying trends, combined with the analysis of agricultural and forestry performance in a volatile financial market environment, which should provide the strategic pathway for new investment. ■

Jim Blackburn is head of agribusiness research for Lonsec.

No matter what the market does...

# Forget tax, how does it stack up?

**Once spruiked almost exclusively for their tax benefits, agribusiness investments are moving towards mainstream investment credibility. Simon Hoyle reports**

In years gone by, hundreds of millions of dollars of clients' funds were channelled into agricultural investment schemes, just about on the strength of the available tax deduction alone.

Today, it's possible to discuss investment in agribusiness and have tax make up a very small part of the conversation. Increasingly, though by no means always, agribusiness schemes are being assessed on their investment merits.

Some planning firms continue to pump money into agribusiness as part of aggressive end-of-financial-year tax "planning". But Dug Higgins, senior investment analyst for Zenith partners, says this is a myopic view of the sector.

"Planners generally would be savvy enough [to know] that if you're just investing in these things on the basis of tax, you're not really seeing the big picture," Higgins says.

"Historically, a lot of people who have been burnt in these things invested in them purely on the merits of tax, and when they didn't deliver at the back-end, despite the fact they had really ignored that when they invested, they got a bit shirty. I think that's a fairly shortsighted view to take.

"We would hope that planners are saying, you do it on its merits and you have the added advantage of tax, rather than the other way around. As to whether or not that actually happens, it would be very difficult to tell."

Higgins says the investment case for agribusiness is relatively straightforward: done properly, it can reduce portfolio volatility, generate attractive investment returns, and provide a tax benefit along the way.

"Agriculture generally - and in talking about agriculture on a general basis I'm lumping in anything from agribusiness stocks to managed investment schemes to actually owning farms [directly] – it's to a greater or lesser extent going to have a reasonable level of negative correlation to the broader markets," Higgins says.

"Certainly a bit of work has been done in looking at how farms fit in a portfolio. Granted, most people don't have the wherewithal to buy a whole farm, but theoretically arguing that if you did, and you chose those farms that sit in the top quartile performance-wise, they do have a very positive impact on ironing out volatility in a portfolio."

Kim Cowie, technical services manager for agribusiness group ITC, says a correctly-structured agribusiness investment can reduce portfolio volatility and provide a hedge against inflation.

Cowie says agribusiness assets are not positively correlated to investment markets. She says that rising commodity prices tend to fuel inflation, so when inflation rises it's because commodity prices are rising – good news for agribusiness investors.

However, rising inflation tends to have a dampening effect on the sharemarket. Rising inflation generally leads to higher interest rates, raising the cost of debt for companies and reducing consumer confidence.

Cowie says all of these factors tend to reduce corporate profitability, leading to lower dividend expectations and, as a consequence, lower share prices.

Some agribusiness holdings may be appropriate for some client portfolios, but Higgins says investors and planners need to remember that an agribusiness investment can be highly illiquid.

"It's rare for an agribusiness scheme to have a timeframe, say, of less than about 10 years. There are one or two that would be under five years, but generally, you'd be in for at least 10 to 12 years, and at the top end you might be in for as long as about 25.

"That said, there are recent rules on secondary trading in forestry schemes which should make it easier for people who evidence a need to get out to do that; but even so, you have to be in for the first four years for that to apply."

When it comes to assessing specific opportunities, Higgins says the research required is intensive.

"The list would run along the lines of what level of experience does the manager have in that area of agriculture or horticulture the project is involved in? Do they have any track record? Have they actually begun harvesting? Are they getting the prices that they're after? Can they manage the thing on the ground?" he says.

"Some of these guys have been around long enough that they are starting to work up a fairly credible track record. Others have not been around so long and perhaps there's still, if not a question mark, then a level of unknown about their ability to go through a full cycle.

"Some of these projects run on very long timeframes before you get a harvest, particularly the long-rotation forestry projects. So while you can run along for, say, perhaps the first 10 or 15 years where things broadly are looking OK, it can get a little bit difficult to tell just how good is the ultimate harvest going to be?

"It's really to a certain extent a bit of an unknown until the day it happens. That adds to the complexity of it."

Higgins says it's also critical that planners are satisfied that statements or claims that managers

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are making about specific projects are true.

"But that really goes for all asset classes, because you do see a lot of people who go blindly into things, and let other people go blindly into them on their behalf," Higgins says. "Invariably it ends up nastily. So that sort of aspect, while it's a bit of a drag, it is certainly worthwhile."

Higgins says risks that affect agribusiness schemes can be quite different from "mainstream" investments and asset classes.

"You've got fire, flood, disease and all those sorts of things,' he says. "They affect most investment types. But there will be others, where there might be commodity-specific risks affecting that project. It might be in relation to the markets and prices that those projects operate in. It might be specific agricultural risks that they operate in."

Higgins says it's also very important to understand what's going to happen to the commodity if and when it's harvested.

"Firstly, you'd have to be asking yourself what certainty is there that there is a market for the produce when it's harvested," he says.

"But given that you tend to be quite often on long timeframes, the second thing is, well, is the market still going to be there when the product is harvested? And thirdly, what arrangements are there in place to allow some sort of certainty for sale of the product when that happens?

"Some companies will have sales contracts in place – some will be fixed-price and some will not be, just depending on ongoing timeframes and everything else – and quite often some of these projects won't have sales contracts in place.

"The presence of at least some sort of marketing plan and strategy for the product is a positive to look for; I am always a little bit hesitant – and you don't get this very much any more – about managers that say, look, we'll worry about that when the time comes. That's something you want to be very wary of.

Whatever strides towards mainstream credibility agribusiness schemes may have made, not all major players are convinced of their investment merits.

Anthony Serhan, head of adviser and research for Morningstar, says he has "never used them, and I do not advocate the use of them".

"When I have spent time looking at them…I have seen very few that stack up on an investment-case basis," he says.

"And for that fact alone we've never covered them. They also tend to be high-commission-structure vehicles. Saying there's a very strong investment case for them has been very difficult.

"For that reason, we haven't done it. But most [planning firms] do have an agrischeme or two on their [approved] lists, from a tax planning perspective – and to be fair, I think the industry has cleaned itself up a bit from where it may have been previously."

Serhan says issues that financial planners need to consider include "to what extent do you think the investment case has improved, and to what extent can you point to schemes that have run their 10-year course and have returned a lot of capital based on their investment merits?"

"These things have been sold for a long time – show me some schemes that have matured," Serhan says. "It's always about the next [selling] opportunity. But show me what they have done."

Higgins agrees that it can be difficult to compare fees and charges and even commissions from one scheme to the next.

"It's notoriously difficult for an investor to work out whether or not those fees and charges are reasonable because, unlike perhaps broader managed funds, where fee benchmarks, et cetera, are a lot more transparent and widely known, things like this are very difficult and vary related to the various commodity subsectors that they're operating in," Higgins says.

"We know that adviser commissions in this area tend to be higher than most other investment sectors. It averages 8 per cent across the industry – that's on a preliminary set of numbers I've worked up based on 200 projects over the last couple of years. It'll go perhaps as low as 5 [per cent] to as high as 15 [per cent].

"Mostly the levels of commission will be disclosed in product disclosure statements (PDSs); sometimes, however, they won't, and I usually take a fairly dim view of that, if you really do not know how much the product is being pushed. We just know for a fact that products with higher levels of commission tend to be riskier than stuff that's mainstream. Certainly in the property industry, on the unlisted side, there's a very strong correlation between high commissions and product failures.

"It's an accepted part of the world, in that the riskier a product is, the higher the level of commission you need to get a sale. To a certain extent, that's a fact of life. It's a wise thing to go and check what commissions a project offers generally."

Higgins says it's also necessary to understand how tax benefits will accrue, and how investors can expect to receive returns over the life of a project.

"The projects on offer tend to have a broad range of how the income streams will act," he says.

"Some projects will have a lump sum at the end, like forestry; other projects might be looking to pay a return each year, once they're set up and established, so that's things like horticultural projects, or viticultural projects.

"Other projects might have a shorter start-up time - there's a couple of grains projects out there that really only take a season to get going. So if you were looking perhaps to have a regular income, you might buy some units in a forestry scheme that gives you a lump sum at the end, and mix that with some units in a scheme that also pays you ongoing income.

"And that aspect flows through to the tax implications as well. Some projects will pay all their fees upfront, so you get all the tax deduction upfront; others might have a lump sum upfront but they might have ongoing annual payments as well, so you also get a continuing knock-on effect from the tax-effective point of view as you go.

"So there's the ability to mix-and-match not only on the diversification or risk side, but also the income side as well." ■

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