

Farmland investing: A bright future

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Abstract

The boom in food prices over the past 15 years and associated volatility in food prices has prompted relatively wealthy countries dependent on imports to renew their focus on policies to enhance food security. This has in turn prompted many of them to search for opportunities to secure food supply internationally. Coupled with a depressed yields in other assets such as equities and bonds, the food the boom has led to investors 'rediscovering' the agricultural sector, particularly in farmland acquisition in developing countries. While this could be seen as a unique opportunity to reverse long-standing underinvestment in agriculture in many regions, it could also lead to a general failure to provide broad social, environmental and economic benefits when governance is relatively weak and property rights are ill-defined and unenforced.

Nevertheless, investment in farmland has acquired renewed interest from many quarters, particularly institutional investors and pension funds saddled with the management of liabilities over very long durations. But investors demand reliable access to performance metrics so that rates of return and downside risk on holdings in farmland and agricultural operations can be compared with alternative investments. Metrics that form a comparable basis necessarily include: return on farm gate commodities (price and volume) including cost savings from operational efficiencies and productivity improvements through farm management; and capital appreciation of farmland.

Key Words: Food security, Agriculture, Farmland investing

DATA IS KING

Returns need to be measured for different types of farming activity on a comparable basis with farm assets located overseas as well as against other asset classes. This requires data sources to be transparent, auditable and derived in accordance with generally accepted accounting principles. But many sources of performance data on agricultural returns are not sufficiently robust and those that are usually tend to be based on voluntary farmer surveys engaged only in the production of certain commodities.

A relative lack of an independent official data series providing risk and return profiles across commodity producers in the global agricultural sector on a comparable basis represents a substantial problem for institutional investors. It not only limits the availability of a reliable investment benchmark for operating conditions over the business cycle, it also prevents understanding of the top tier performers in each agricultural segment through time. Benefits to agricultural investors obtained through irrigation, clever crop management, precision agriculture and automation will be difficult to detect and compare so long as data availability remains low.

Data scarcity is therefore the major limiting factor for large institutional investors to commit funds to the agricultural sector. The desire for data availability motivates investors to stick with well-known asset classes

primarily because it is so much easier to benchmark risk-return profiles of conventional investments. Investors who remain interested in farmland assets are thus operating at a disadvantage and as a result may consistently demand a discount to the 'fair' price of such assets to compensate for inherent information asymmetry. Deficiencies in data may be artificially depressing farmland from reaching its true potential.

INVESTMENT PROSPECTS

While a lack of reliable data may limit interest from institutional investors, the actual lack of investment alternatives could actually override this concern entirely. There is a significant risk in assuming that real interest rates will continue to fall or remain close to zero in the medium term. Future asset prices and portfolio composition will be greatly affected if real interest rates normalise to pre-financial crisis levels. This will favour some asset classes, especially agriculture, while adversely affecting others such as bonds and certain bond-like assets.

Tightening interest rates in investment-hungry countries in response to a surge in global inflation will directly devalue global bond prices. It will also depress the prices of bond-like assets including residential and commercial property, infrastructure and equity investments in utilities and heavy industries.

Table 1 illustrates the modelled sensitivity of asset prices to a 100 basis point (1 per cent) permanent increase in interest rates. Equities represent the most sensitive asset class to an increase in interest rates. Other highly sensitive assets include commercial real estate and bonds. For a balanced portfolio that holds yield shares, bonds, real-estate assets and other long duration investments, a permanent 2 per cent increase in long-term rates would reduce the value of those assets by around 10 to 20 per cent. Given that balanced portfolios are by far the most dominant portfolio combination supporting the management of retirement assets, this potential outcome offers heightened challenges for institutional investors to meet the retirement needs of their members. In contrast, it is expected that returns to agriculture assets and associated operations would benefit from a 100 basis point interest rate increase far more significantly due to a once-and-for-all reduction in the duration premium.

Global Value	Asset Type	Effect on price when interest rates are expected to rise	Change in asset value for a 1% change in interest rates
\$201 trillion	Bonds	↓ Variable	0% to -11%
\$162 trillion	Residential property	↓ Less inelastic	0% to -5.9%
\$21 trillion	Infrastructure	↓ Less inelastic	0% to -6.8%
\$67 trillion	Equities	↑ If rate rise is small	0% to -14%
		↓ If rate rise is large	

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\$27 trillion	Commercial real estate	↓ Most impacted	0% to 11.9%
\$31 trillion	Agriculture property	↑ Most likely	0% to 15%
Source: Duxton Asset Management, GMO LLC, IFM Investors.			

Table 1: Duration risks associated with global asset allocations.

EXPECTATIONS

For institutional investors to consider commodities in strategic asset allocation decisions, historically their investment process has been motivated by three main benefits:

Diversification: Agricultural commodities exhibit low average correlation with major asset classes (equities, bonds, property) and the addition of agricultural assets during certain epochs has resulted in a significant increase in portfolio risk-adjusted returns.

Inflation Protection: Among all asset classes agricultural commodities generally exhibit the highest degree of sensitivity to price pressures of material goods.

Return and beta: The cyclical nature and lack of cash flow yield from agricultural commodities invites questions concerning the legitimacy of a commodity class ‘risk premium.’ Historical analysis reveals that a suitable investment strategy which accounts for commodity cyclical nature and is broadly diversified will achieve equity-like risk-adjusted returns over the long term.

Agriculture is an investment theme that does make sense in many portfolios from both a diversification perspective and because the long term fundamentals in a range of areas are attractive. Unlike other ‘real’ commodities assets – such as mining assets – income cash flows are renewable and capital gains are sustainable in the sense that they are not depleted from operation, so they are long-lived assets. There are also social, and governance benefits associated with these assets, due to the increased use of precision farming which reduces wastage and environmental impacts.

Agricultural production is unusual compared with other business activity due to its strong dependence on biological processes, so there are some factors that potential investors need to understand prior to committing funds

to long term investments. Farmers have minimal ability to alter the rate of development of a crop or animal. For most commodities, the production cycle is measured in months or years. Other features impose a relatively dynamic structure, especially on prices. The seasonal impacts on production, the high cost of adjustment once production is underway and the need to carry inventory also pose interesting challenges.

DANGERS

With the growth of investment, there has also been heightened interest in countries with weak land governance. This permits a higher propensity for foreign investors to acquire land well below its fair value which can also result in neglecting local community rights and the exploitation of local labour. There is a danger that recently contracted agricultural projects in some developing areas will yield above average returns for investors while failing to deliver social benefits to the communities themselves.

It has also been argued that institutional investors do not need the same returns as owner farmers because of the diversification benefits that agriculture brings to their portfolios. As such they can justify even lower operating returns which undermines future investment in agricultural technology and training. There is some evidence to suggest that this change in valuation has driven up land values, however this is not universally so.

A limited resource in many agricultural areas has been access to water. Institutional investors with geographically diversified exposures however can avoid this risk, as well as investing directly in water infrastructure to support their operations. But the potential also exists for such access to be exploited for other means.

OPPORTUNITIES

The fundamentals of globally scarce arable land in response to increasing food demand will be a major driver of agricultural asset prices in the future. Agricultural assets represent a viable investment alternative for those willing to devote time and resources to understanding the opportunities in the sector. It is up to the agricultural research community to address the shortfall in data quality and availability to open the sector up to further investment. This will not only unlock substantial value inherent in many agricultural regions, it has the potential to change the livelihoods of many farmers in developing regions. Yield-seeking capital offers sustainable benefits for those willing to bridge the large knowledge gap between investors and farmers.