Cultivating Returns

CAN FARMLAND HELP INVESTORS' PORTFOLIOS INCREASE THEIR HARVEST?

By Sherree DeCovny

In the aftermath of the financial crisis, investors began to migrate toward safe havens and focus on capital preservation and real assets. They sought investments that had a negative correlation with other traded markets, especially public ones, and served as a hedge against inflation. For some, farmland fit the bill.

Strong fundamentals support investing in farmland. The world population and net income per capita are growing, and this trend is increasing the demand for higher-quality food, such as vegetable and animal protein. China used to be a net exporter of meat, but growth rates have leveled off and the country could soon be a net importer. It also is importing large quantities of corn. Other pressures on the demand side include worldwide mandates for using ethanol, biodiesel, and other renewable fuels based on row crops.

KEY POINTS

Growth in world population and net income per capita is increasing the demand for higher-quality food and boosting the value of farmland.

An agriculture portfolio can consist of land in developed and undeveloped countries, permanent or row crops, and productive or undeveloped land.

Returns vary depending on the geography, but in the U.S., long-term returns have been comparable to the S&P 500.

According to HighQuest Partners, a firm that advises investors on opportunities within the agricultural sector, at least 75 million hectares of land will need to be brought into cultivation by 2015. However, only about 1.4 billion hectares are available for production worldwide, and fewer than 24 million hectares were brought into cultivation during the decade ending in 2005. New lands are coming into production in Eastern Europe, Russia, the former Soviet Republic, and Africa, although large-scale investment has been put on hold in Brazil.

"There is land that can be brought back into production, but that's offset by taking existing cropland out of production in various parts of the world due to increasing urbanization," says Philippe de Lapérouse, managing director at HighQuest Partners. "We see the pressure continuing to exist going forward."

Most U.S. farms that go up for sale are still purchased by farmers, and land is handed down from generation to generation. But trends in technology and demographics are changing the dynamics. Equipment has advanced to the point where three or four people can farm 4,000–5,000 acres. The machinery of 40 years ago could plant 100 acres of corn per day. Today, 1,000 acres can be planted in eight hours. There are mechanical pickers for an array of crops. As a result, more children are leaving agriculture for other professions, and they are not coming back.

"We've bought small 600-acre farms that had 17 owners," says Shonda Warner, managing director at Chess Ag Full Harvest Partners. "They become disassociated from the land and think, 'I don't want to mess with this; let's just sell.' Sometimes somebody needs money, and they force a sale."

To this end, traditional farm buyers are facing competition from institutional investors, family offices, high-net-worth individuals, and foreign buyers, especially from Argentina and Brazil. They are buying farms, hiring an experienced manager to oversee the land, and negotiating either fixed-bushel or cash leases with tenants.

DESIGNING A FARMLAND PORTFOLIO

Three issues must be considered when designing a farmland portfolio. One is whether to invest in a developed or developing country. The operating, weather, and political risk varies between countries, and these exposures must be factored into the decision-making process.

Another decision is whether to invest in permanent or row crops. It takes years to develop productive orchards, and the investment is recouped over a long time period. In contrast, row crops, such as corn and soybeans, are planted and harvested during a 12-month cycle.

A third choice is whether to invest in productive or undeveloped land. Depending on the location, investors may have access to years of data on land productivity. They know whether it is rain fed or irrigated, and they understand the implications of a drought. With undeveloped land, it is necessary to invest in the infrastructure to get the land back into production. Land that has been lying fallow for nearly 15 years could take three to five years to bring up to peak productivity.

Additionally, a significant amount of due diligence goes along with investing in undeveloped land in developing markets. Assuming the investor has free title or can negotiate a land concession, spending the money on the infrastructure may be worthwhile.

"The value of that land should be appreciating at a much faster rate than it would if you had acquired land in a developed market where it's been farmed consistently for decades," says Lapérouse.

THE RETURNS

The two components of return on an agricultural property are the current yield from leasing the land and capital appreciation. According to Warner, in the U.S. during the 1951–2010 period, capital appreciation was 6.13% and current cash yields ranged from 2% to 5% in most agricultural states. (The cash yield is a function of interest rates, the state, the crops grown, and whether the land is irrigated or nonirrigated.) Overall, the S&P 500 returned 11.8% with a standard deviation of 16.8, whereas farmland returned 11.52% with a standard deviation of 7.3.

The average current cash yield for U.S. cropland over the past 20–40 years has been around 5%, and the return has increased when interest rates have been high. Nowadays, interest rates are low, so the average return has decreased to about 3%. She also notes that the agricultural sector is not heavily levered. In the 1970s, leverage went up to about 60%, and then the market crashed in the early 1980s. Today, leverage of 25–30% is the norm.

INSTITUTIONAL INVESTMENT IN FARMLAND CAN BE A HUGE ADVANTAGE FOR SMALL STAKEHOLDERS. LARGE INVESTORS HAVE THE RESOURCES TO TRANSFER KNOWLEDGE AND INTRODUCE BEST PRACTICES IN AGRICULTURE.

Ultimately, the expected return varies depending on the geography. HighQuest Partners estimates it can be 15–20% in Russia, 20–25% in Africa, 10–15% in South America, and 8–14% in Australia.

THE RISKS

Owning farmland is a long-term proposition. The marketplace is not consolidated; it is illiquid and pricing is opaque. Weather and natural disasters come as part of the package, but even in worst-case scenarios, prices normalize eventually.

"It's horrible to be in the middle of the worst drought in Texas, but it will rain again," Warner says. "You just have to strap on your seatbelt and make sure that you don't have too much risk on and ride through the unusual weather situations."

A near-term potential risk is an extreme run up in commodity prices accompanied by massive index fund buying and increased volatility. Farmers struggle when input costs rise faster than grain prices. U.S. agriculture consumes roughly 20,000 gallons of diesel per acre, and a big upswing in oil prices can be painful. Conversely, if the oil price collapsed to below US$50 per barrel, the ethanol pipeline would shut off and prices would fall dramatically.

Speculation by new types of owners could cause land prices to rise faster than normal, and a jump in real estate prices or inflation could be destabilizing. Since 2010, the price variance on land values and rents has been wider than ever. In May 2011, a farm in Iowa with a corn suitability rating (CSR) of about 75—a measurement of row-crop productivity given a certain type of soil—sold for about US$8,400 per acre. A month later, a farm 30 miles away with the same CSR sold at about US$16,000 per acre.

There are operational risks, such as finding qualified people to manage farms and downstream activities (elevators, processing, transportation). Not being able to purchase large continuous parcels of land complicates business administration, although geographic diversification reduces exposure to volatile climatic conditions.

Some investors shy away from developing regions that are going through transition because they lack control over an array of issues. For example, in opaque or evolving governmental or regulatory systems, it is often difficult to manage land and navigate land registries.

"Yet, green economy and socially responsible investors are making the proactive choice to invest in those markets," notes Lapérouse. "Their motivation is to help small stakeholders in those markets develop best practices, improve productivity, and stimulate economic activity in those regions while earning a return. They also tend to be hands on in terms of managing their investments."

IMPACT OF INSTITUTIONAL INVESTMENT

There is much debate over whether institutional investment in farmland is good or bad. Concerns over "land grab" have centered on East Africa and, to a lesser extent, Brazil. In Africa, investors supposedly are negotiating large-scale concessions for buying land, essentially obtaining free title to it to the detriment of small local stakeholders. In Brazil, the issue is related to destruction of the Amazon.

"As in any industry, there always are going to be situations where operators do not apply best practices and are bad actors. We would like to think of them as outliers," says Lapérouse. "You can't control everything."

On balance, institutional investment in farmland can be a huge advantage for small stakeholders, who often are living hand to mouth and not farming land in an environmentally sustainable way. Large investors have the resources to transfer knowledge and introduce best practices in agriculture. They can create new employment opportunities, upgrade the level of services, and improve access to the markets by building ports, roads, and railroads.

The demand for safer alternative investments is driving interest in agriculture. Ultimately, farmland could be a solid investment for those who have a long-term horizon and a lot of patience. Given the fundamentals, there are also opportunities to invest in companies that produce seeds, fertilizers, chemicals, and software through listed equities, ETFs, index funds, and private equity.

Sherree DeCovny is a freelance journalist specializing in finance and technology.

KEEP GOING

"The Case for Investing in Farmland," CFA Institute webcast (www.cfawebcasts.org)

"Investing in Farmland," CFA Institute Take 15 Series (www.cfawebcasts.org)

"The Long-Horizon Benefits of Traditional and New Real Assets in the Institutional Portfolio," summarized in *CFA Digest* (Nov. 2010) (www.cfapubs.org)