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ANZ SUBMISSION TO THE AUSTRALIAN AGRICULTURAL COMPETITIVENESS REVIEW

TRENDS IN THE AUSTRALIAN AGRICULTURAL INDUSTRY

Over the past thirty years, Australian agriculture has undergone significant change. Agricultural productivity grew strongly in response to the economic reforms of the 1990s. The structure of the industry also changed markedly to achieve these productivity gains.

However productivity growth has slowed in recent years, and the changing industry is placing pressure on farmers and the agribusiness supply chain. There are significant opportunities for Australian agriculture in greater Asian export markets. New investment and productivity gains are needed to take advantage of that opportunity.

The economic reforms of the 1980s and 90s saw Australian agricultural markets opened to international trade and a reduction in domestic support for farmers. This increase in competition from international producers led to significant changes in the structure of Australian agriculture, including an increase in on-farm productivity and reduction in inefficient production and farmland.

For example, broadacre farmers improved their productivity (measured by total factor productivity) by an average of 1 per cent per year between 1977 and 2011. Dairy farmers' productivity has grown by an average 1.6 per cent per year over the same period (ABARES, 2014a).

To achieve that productivity growth the structure of the ownership and land use also changed. Since 1970, farm numbers have fallen from 192,550 to 135,692 in 2012. Over the same period, the total area of land farmed in Australia fell from 500 million hectares to 405 million hectares (ABARES, 2014b).

The structure of the Australian farming sector has continued to change in response to global and domestic circumstances and economic drivers. However, it is notable that productivity growth in many agriculture sectors has slowed in the past 10 years.

Productivity in the broadacre, cropping, beef and mixed livestock sectors have all slowed or declined in the past decade (ABARES, 2014a). While productivity has improved in the sheep industry after the removal of the wool reserve in 1991 and remained stable in the dairy sector, productivity growth rates in the agriculture sector more broadly have slowed (Nossal & Sheng, 2013).

Globally, the agriculture sector is consolidating to increase efficiency and meet customer needs more effectively. Some companies are increasing 'vertical supply chain' integration, increasing their ability to control production from farm through to consumer. Other companies are seeking greater efficiency by controlling particular points in the supply chain ('horizontal supply chain integration').

Declining productivity growth and increasing pressure from global competitors mean new ways must be found to increase productivity and improve Australian agriculture's international competitiveness.

Future productivity and competitiveness gains will come both from improvements in on-farm productivity and enhancing the competitiveness and efficiency of the agribusiness supply chain. The competitiveness of the industry is not reliant on on-farm operations alone and the efficiency of the agribusiness supply chain is also very critical.

Productivity gains will continue to involve restructuring, particularly affecting traditional family-based farming. While family-based farming will continue to be important, alternative business structures, still oriented around families, can offer

greater specialisation or economies. It will be important to remove obstacles to restructuring of traditional farm structures and promote generational change to protect the long term interests of farming families and communities.

There is great opportunity for Australian agricultural exports with the right policy framework to support change and increased competitiveness. The ANZ Insight Report, *Greener Pastures: The Global Soft Commodity Opportunity for Australia and New Zealand* found that Australia could more than double the real value of annual agricultural exports by 2050. This would result in up to an additional $1.7 trillion in revenue over the next four decades through to 2050. To achieve this, Australia will require additional capital investment of $1 trillion, including $400 billion to assist older farmers exit the industry and younger farmers enter. Additional sources of capital must be considered to take advantage of this opportunity.

ANZ AGRIBUSINESS LENDING

ANZ has a long history of financing Australian agriculture. ANZ products provide flexible finance for a range of purposes and farm sizes. ANZ approaches all business lending, including farm loans, on a risk basis. ANZ takes debt mediation seriously and we work closely with our customers to find the best way through financial difficulties.

ANZ has been financing Australian agriculture and agribusiness for over 150 years. We are committed to being the leading bank in regional and rural Australia and supporting rural communities now and in the years ahead.

We believe we have a strong understanding of the challenges, rewards and opportunities our agribusiness customers face. We have agribusiness specialists with expertise in a number of industries. ANZ's international network means that we are well positioned to help Australian farmers take advantage of the opportunities in rapidly growing Asian markets.

ANZ provides a range of financial products which are tailored to the diverse needs and demands of the Australian farmer. Our range of products seeks to provide solutions for farmers for everyday access to finance, lines of credit, long-term investment and short-term loans.

All loan applications are assessed on the basis of risk taking account of factors including climate, geography and product demand. This risk-based approach also takes into account standard banking factors such as ability to service debt, security and business history.

Where farm debt issues arise, ANZ seeks to work with customers to secure the best possible outcome for the customer and the bank. Where appropriate we use farm debt mediation to resolve issues. ANZ considers factors such as farm product prices and outlook, business financial structures, land quality, succession and business management capability, business track record and impact on community and neighbouring properties.

ANZ also supports local communities through our Seeds of Renewal Grant Program which aims to contribute to building thriving communities in regional Australia by providing grants of up to $10,000 to community organisations for projects focused on creating regional education and employment opportunities. Since it started in 2003, Seeds of Renewal has provided more than $3 million in grants to over 635 community projects.

ACCESS TO FARM FINANCE

Debts levels have increased across Australia since the 1990s and farms have a relatively high level of debt in a low interest rate environment. Pressure on farm profits has substantially come from rising on and off-farm costs. Despite this, ANZ believes that farm debt levels remain manageable.

The increase in the level of farm debt across Australia since the 1990s has caused concerns about the sustainability and ongoing viability of Australian farming. Farm business debt more than doubled in real terms in the decade to 2009 (ABARES, 2014b). However the increases in debt have not been uniform across Australia and certain industries, regions and farm sizes have been more impacted. For instance, in 2013, 70 per cent of broadacre sector debt was held by 12 per cent of farms. High debt levels are generally associated with large new investments and farm acquisitions.

The dry period from 2002 to 2010 coincided with an increase in farm debt from $26 billion to $59 billion. Total farm turnover at its low point was $19 billion in 1991-92 but in forecast to reach $49 billion in 2013-14. Asset values that underpin most farm balance sheets also doubled in this period. This led to a perceived increase in wealth which fuelled debt led investment in land and farm consolidation. Land values have subsequently fallen and today farming is on average more highly leveraged than the beginning of the 2000's. However on a financial cost basis this higher debt is supported by a historically low interest rate environment.

Performance among farming businesses varies significantly. Farmers at the lower performing end are feeling stress, while the higher end of the market is making good returns. Public policy to consider how to help those businesses in the middle of the market lift their performance is critical. This may include improving skills in financial governance, balance sheet and asset management, and business performance. Policy should aim to assist farmers make better informed decisions to facilitate succession, sell or attract additional capital.

On and off-farm costs have substantially increased over the last two decades, and while farm yields have generally improved due to effective research and development, commodity prices have not kept pace with this increase in costs. Australian State and Federal Governments control a portion of this cost burden through red tape and the regulatory burden imposed on farming enterprises and should consider how to ease this impost as a cost reduction measure.

While considering how to reduce farmers' costs, Government could also consider, possibly as a part of the upcoming Taxation Review, what impediments exist on the transfer of farm land to highest productivity use or business structures. For example, stamp duty and capital gains tax may impede restructuring of family farms into more efficient business structures.

On the whole, ANZ remains of the view that debt levels in the agricultural industry are higher than in the past, but remain manageable. In order to ensure adequate research and development, improved productivity and efficiencies in businesses, improvements in infrastructure and succession resolutions, sources of new equity capital are required.

SUPPLY CHAIN EFFICIENCIES

Improving domestic and global agribusiness supply chain is as important to boosting Australia's agricultural competitiveness as improvements in on-farm productivity.

The productivity and success of Australian farming does not rely solely on on-farm productivity. The efficiency of the supply chain, both domestically and

internationally, is integral to ensuring Australian produce gains and maintains global market share and costs are kept low.

The growth of preferential trade agreements and the increasing globalisation of agriculture continue to increase the efficiency of international agricultural supply chains. Australia will be vulnerable to losing market share to global competitors competing on price, quality, reliability and operational efficiency.

Greater attention will need to be paid in the future to the efficiency of Australia's end-to-end agricultural supply chain, from defining customer requirements and demand, to on-farm production, logistics and final marketing distribution.

We believe there is an important role for Government to play in identifying the future structure, capital and infrastructure requirements of Australian agricultural supply chains. By identifying where they can either undertake or facilitate infrastructure and other investment along the supply chain, Australian State and Federal Governments can help create efficiencies which benefit both domestic producers and the Australian agricultural export market.

ANZ would welcome further discussion on identifying the current and future supply chain inefficiencies in Australian agriculture and how Government can assist in mitigating these.

AGRICULTURAL COMPETITIVENESS ISSUES PAPER

How do we better attract private capital into farm investment?

The need to attract additional capital into farm investment is well established. ANZ will continue to provide bank finance and have a strong role in supporting farming businesses and communities. However there are limits to the ability of traditional bank finance to provide additional capital and meet all the investment needs of the sector.

Identifying new ownership and management structures or alternative financing models is central to attracting more investment from domestic and international sources of capital.

Domestic capital is an important source of investment. However the flow of domestic capital into agricultural production is still in its infancy. Domestically sourced investment is more likely to be attracted to 'traditional' infrastructure investments within the agriculture sector such as ports. One of the primary barriers to attracting investment along the agricultural supply chain is the lack of valuation methods for investors to assess and measure an industry with inherent and well-documented volatilities.

Foreign investment is a key source of additional capital. To attract capital, the agriculture industry must present a stable, viable and long-term investment opportunity. Ensuring Australia's foreign investment policy is open and transparent will avoid the perception of 'sovereign risk' by international investors and is one factor which will facilitate greater a flow of capital into Australian agriculture.

Where additional sources of capital are identified, structures must exist which ensure that investment is made in high-productivity or high-potential farm investments. Schemes which provide incentives for investment in agriculture, such as Managed Investment Schemes have the potential to drive up land prices and undermine the overall productivity of Australian farming.

Government may also help facilitate greater investment in agriculture by improving access to industry-level data and farm performance statistics. The lack of data available in the Australian industry prevents potential investors from valuing the risk involved in an investment. Government may also consider expanding access to farm management deposits schemes (FMDs), to manage the volatility of farm-

based income, to include appropriate and suitable corporations and trusts rather than just individuals.

What examples are there of innovative financing models that could be used across the industry?

What alternative business structures could be developed for farming that also retains ownership with farm families?

International experience provides examples of different models for attracting private investment and increasing productivity in farming.

Share farming and syndicates in New Zealand have assisted in attracting investment to farming, particularly in relation to dairy farming. In the United States, cooperative farming has also been found to increase productivity through the efficient utilisation of farm inputs and the ability to operate at full capacity, rather than due to scale (Ariyarante, C., et al, 2006). Farm worker share equity schemes in South Africa have helped new farmers overcome market entry barriers (Tom, B., 2006).

In Australia, ANZ is aware of innovative financing models and business structures for small and medium size farmers. The models outlined below allow families to retain ownership or part ownership.

Joint venture offtake agreements

Joint venture offtake agreements are increasingly common and likely to expand further. Offshore manufacturers, retailers and packagers are registering interest and looking to secure their supply chains via offtake agreements with experienced Australian primary producers.

Case study

Structure: An Australian supplier has successfully established a joint venture with a privately owned international retailer of approximately 50 supermarkets.

Arrangement: The joint venture is a structured agreement whereby the retailer provides up front capital for the purchase of cattle, and to cover any inputs including veterinary expenses. The cattle are fattened domestically on grazing land leased by the farmer. They are then exported directly to the retailer, where the joint venture partner has direct distribution through their own network of approximately 50 supermarkets and restaurants. On the strength of the joint venture arrangement, ANZ is likely to approve a loan to the farmer, enabling them to acquire the leased grazing property.

Our client established a beef trading company, of which he is a sole director, then drew up a shareholder's agreement to support the joint venture. The joint venture partner then provided half of the operation's capital to seed fund the venture. As a result of terms and conditions of the Shareholder's agreement the farmer has been required to improve professional business practices, in particular, in producing regular financial reports.

Traditional share farming via an operating company and joint trust

Most common to the dairy industry, share farming arrangements are similar to the more formal arrangement of a co-operative, effectively pooling resources, skills, and boosting the volume of production. They remain popular as they effectively create scale, capital, and potentially higher income streams, and at the same time a viable succession solution.

Case study

Structure: A three-way dairy share farming partnership between individuals was established by creating a trust company. The trust company purchased one of the individual's family farms, with a plan in place to convert it from a crop farm to an operational dairy farm. Another of the partners managed the conversion to a dairy farm, and the ongoing day to day farming operations. The third partner manages the business and financial reporting requirements. The partnership has established an independent board and implemented monthly meetings.

Arrangement: Under the agreement, an operating company leases the land from the trust, providing monthly income to the trust which pays the interest on the bank loan. Both the trust and the management company are backed by shareholder's agreements. In order to ensure transparency and accountability, the management company pays an independent accountant to produce monthly financial reports. Key attributes of the model's success were the complementary skills of the partners; a clear structure with independent decision making supported by a board; and a business plan and financial models to achieve stable and transparent profitability.

Share farming via a flexible lease arrangement

A relatively new funding model that is not yet banked by ANZ has been established by several primary producers in South Australia and has been used more widely in the UK.

Case study

Structure: Two family farmers established an operating company and leased their farms to the company under a flexible lease arrangement. They later leased a third farm to further increase their scale.

Arrangement: Under the share farm arrangement, the two farmers sold their existing machinery, using the capital to lease an additional farm. One partner manages the farm operations and the other runs the business, administration, marketing and payrolls.

The structure utilises a flexible lease arrangement, whereby depending on the season, the two partners can re-negotiate the price for which they lease the three farms. Each parcel of land has a different arrangement, with a different risk profile. By selling their existing machinery, the partners effectively funded the new structure, and could pay external wages for operations, an administration officer, and put in place a board with an independent chairman.

The model provided both farmers with a viable succession option and enabled them to achieve considerable scale. To operate as a company required a greater level of professionalism and increased financial reporting, driving greater accountability and long term business planning. This has in turn helped secure longer term offtake agreements.

The model also effectively separated the financial reporting and revenues of the real estate and farming operations sides of the business, revealing greater accountability and transparency. Key attributes of success in this kind of arrangement lie with the individuals involved, sharing a clear and singular vision for their business and the provision of an independent board to make decisions and mitigate possible disputes.

Greenfield construction of a processing facility, owned by the farmer suppliers

A funding model was built around a commitment to deliver supply, supported by the best interest of the farmer owners. This is common to co-operatives in the dairy industry.

Case study

Structure: A grower-owned greenfield construction of an agricultural processing facility was established by a group of farmers with an offtake agreement in place with a multinational commodity group.

Arrangement: As the facility generates profits, it will repay the loan, leaving farmers with equity in the partnership and the offtake partner with guaranteed supply.

The partnership was created as one of the farmers provided the land, while the other partners established a company to purchase it. All partners are equity holders. The partnership has employed a third party CEO with significant industry and corporate experience and will seek to raise further equity from other producers. Bringing in additional producers will help guarantee throughput.

An important feature of this structure's success is the grower's equity in the company, ensuring a vested interest in providing the supply. In addition, the processing facility is close to the producers which will reduce freight costs. However, the key in attracting funding is the strength of the offtake agreement and the joint venture partner, a well established commodity supply chain specialist with significant size and global expertise.

Agricultural fund managers

There are several fund managers who own and operate agricultural assets on behalf of institutional or retail investors. The vast majority of this investment is currently provided from offshore investors. As the superannuation pool of funds continues to grow, this funding model is also likely to grow. The agriculture sector must look to superannuation funds in future.

Case study

Structure: ANZ has provided funding to a rural fund manager with a number of close-ended funds that are illiquid and therefore irredeemable for investors. Each fund owns rural assets and has in place long-term offtake agreements with large, corporate retailers and processors.

Arrangement: ANZ provided funding based partly on the strength of the offtake agreements already in place, the professionalism and track record of the management and the long term investors (who provide long dated tenor). Fund managers can be attractive structures as they typically have better access to equity markets than traditional family-owned farms. They also have the following attributes: board oversight; professional marketing and occupational health and safety practices; capability to achieve scale due to access to a wider pool of funds; professional practices and procedures; and they provide regular and transparent financial reporting.

What would encourage uptake of new financing models?

The primary barrier to the uptake of new models of financing is that many small and medium sized enterprises are not aware of the potential alternative models. Family ownership is often seen as the only viable option for establishing or expanding a family enterprise.

ANZ believes that providing information to farmers on the possibilities and successes achieved by other farmers in alternative models would be a significant step towards encouraging uptake of alternative models.

How can foreign investment best contribute to the financing and productivity growth of Australian agriculture?

Foreign investment is central to ensuring adequate capital is invested in the Australian agriculture industry. As indicated above, the ANZ *Greener Pastures Report* found additional capital investment of $1 trillion, including $400 billion to assist older farmers exit the industry and younger farmers to enter. Additional sources of equity, including foreign investment, must be considered to take advantage of this opportunity.

There has been much discussion of foreign investment in Australian agriculture in recent years. It is important to recognise that Australia may not fulfil its growth potential unless significant foreign investment can be attracted. While the focus has been on the purchase of large agricultural assets and agribusinesses, foreign investment can also help finance the smaller end of the market. A necessary, but not sufficient, condition to attract foreign investment is ensuring an open and transparent system for foreign investment review and removing any perception of 'sovereign risk'.

Investment in the productivity of the agribusiness supply chain is also critical to improving competitiveness. Foreign capital may have a significant role to play by investing in the supply chain, rather than focussing on farm land alone.

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