Agricultural Competitiveness White Paper Submission - IP578
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Agricultural competitiveness
Issues paper

PPB Advisory

PPB Advisory submission

Enhancing access to finance:

1. How do we better attract private capital into farm investment?

Agriculture can provide strong long-term dividend and capital returns which are backed by real assets. For speculators, agriculture only provides occasional short term opportunities.

Role for government

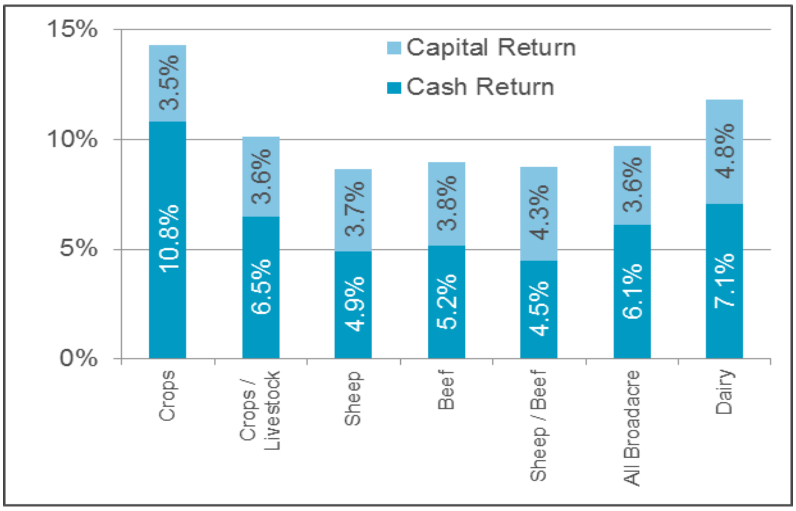
The government could assist to promote Australia as an investment destination by:

- undertaking efforts to promote and foster Australia's competitive advantage, which broadly rests with the production of differentiated and value added products (and not competing in the commoditised goods market)
- greater market access through improved terms in Free Trade Agreements
- creating and facilitating infrastructure investment opportunities for large scale offshore sovereign and pension funds utilising domestic professional advisors
- promoting programs that attract investor capital to agriculture such as the significant investor visa initiative
- obtaining quality, current data, on a wide range of operations which can be used to promote agriculture in Australia to potential investor groups
- Funding fact-based research into the 'investment thesis' behind investing in Australian agricultural sub-sectors and regions which promote investment and provide additional information to assist investor decision making.

The above strategies to promote investment in Australian agriculture are part of a broader picture. The investment fundamentals for agriculture are sound, and Australia is well positioned to capitalise on the compelling macro-economic factors that categorise the sector, these include:

- minimal sovereign risk and strong rule of law
- best practice production efficiencies developed in response to low producer subsidies and global exposure to developed markets
- current capacity to feed an additional 40 million people globally and be a surplus food producer beyond the 2050 peak population forecasts
- being positioned to deliver superior risk-adjusted returns (through a combination of cash and capital) in the context of volatile, low returning equity markets (see Figure 1)
- a limited correlation to, and a lower volatility than, mainstream assets
- a proven store of asset value during inflationary periods with low asset value volatility
- providing diversification to an investor's portfolio
- stable returns as part of a diversified portfolio (see cash and capital returns for various agricultural sub-sectors as displayed in Figure 1).

Figure 1: cash and capital returns from various agricultural sub-sectors in Australia



Source: ABARES 2013, rate of return for top 25% of producers, 1978 – 2012.

Returns can be further enhanced by:

- selecting appropriate assets
- implementing appropriate management to optimise farm returns.

In creating an environment that fosters foreign investment, Australia cannot lose sight of the fact that it competes on a world stage. Investors have a global outlook and weigh opportunities in Australia against other agricultural opportunities.

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

Financing models that attract new sources of capital can:

- revolutionise traditional family farming business models
- de-lever agriculture – providing solutions for operators and their current financiers
- improve succession planning by encouraging entry by younger participants
- promote growth in productivity and earnings.

Figure 2 details four financing models which potentially hold the key to long term investment and growth across the industry.

Figure 2: potential financing models for agriculture

Example	Key characteristics
Sale / lease back	▪ Involves the sale of group's assets to provide a capital injection which can be used to retire debt ▪ The vendor then enters into an agreement to lease back the sold assets and continue operating
Joint venture	▪ A mutual agreement by parties to purchase land and machinery ie assets with a productive use ▪ A valuable way to get a foothold, but also requires sharing information, genetics or technology as part of the partnership ▪ Opportunity for domestic and international partnerships which aid distribution (this method has been adopted in the wine sector to promote international partnerships) ▪ Generally incorporates a termination agreement to provide a clear exit path
Equity partnerships	▪ Very prominent in New Zealand, however not widely use in Australia ▪ Involves a number of passive investors, possibly with a farmer operator, to fund property purchase with debt, agreed management compensation, machinery etc ▪ Generally standalone operations ie not part of an aggregated group ▪ Exit strategies and termination agreements a must
Farmer equity fund	▪ Managed on a portfolio basis with knowledge of risks and mitigation ▪ Possibility of value adding at the corporate level with operations run by existing family farmers ▪ May be linked with preference shares or shares associated with a minimum coupon (which Australian agriculture needs to explore further).

3. What would encourage up take of new financing models?

Farmers must be investment ready

In our experience, farmers are highly receptive to the new financing models due to both the necessity for an alternate financing source and the desire to grow their business. The bigger challenge lies in developing and promoting investment structures which attract capital to the sector from institutional sources.

In order to access the opportunities to drive investment in the sector, local operators need to be "investment ready", with:

- governance structures appropriate to attract third party equity
- regular and formal productivity reporting
- monthly financial reporting processes which align with the reporting requirements of potential third party equity providers (and lenders).

The nearer farm business models come to satisfying investor requirements, the easier it will be for institutional investors to transition their portfolios toward the sector.

Asset values must be recalibrated

In our view, central to the goal of attracting capital is a recalibration in agribusiness valuations.

Institutional investors typically undertake a more formal analysis of returns and require a higher hurdle rate return which effectively drives down asset prices by comparison to the way a traditional farmer approaches farm acquisitions. Investors will also discount multiple based valuation methods to factor in seasonal variability.

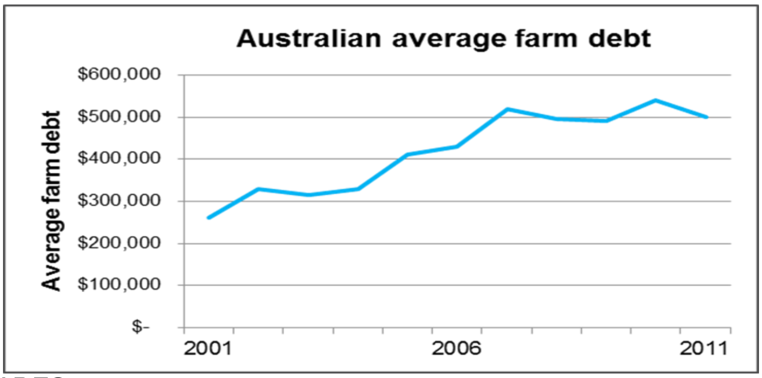
The agriculture sector needs to embrace enhanced governance (as stated above) in order to facilitate a move to valuation methodologies which reflect the productive capacity of agricultural properties, rather than simply comparable sales.

Farming sector strongly reliant on traditional financing

The Australian agriculture sector remains heavily reliant on bank debt funding as a capital solution. Whilst this method is appropriate for some entities, a strong dependence on debt financing across the sector has several limitations, including:

- its use, in combination with the extensive fluctuations of farm returns, can lead to unavoidable phases in which aggregate farm debt grows rapidly (see Figure 3 below) which outlines average farmer debt and debt servicing becomes challenging
- the limited domestic savings from which capital for debt financing can be drawn: an annual Current Account Deficit has been a feature of the Australian economy since white settlement, but particularly over the last fifty years
- post Global Financial Crisis banking reforms that have led to a reduction in the growth of farm debt financing, placing further pressure on the sector in accessing finance
- the sector's requirement for additional capital in order improve productivity and to capture the advantages from the commodity boom (ANZ and Port Jackson Partners estimated in 2012 that the industry will need an extra $600 billion in funds between then and 2050).

Figure 3: Increase in average farm debt during the period decade to 2011



Source: ABARES

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

The family farm is arguably the most robust small business in Australia. It is for this reason that those in the corporate space are increasingly attempting to emulate the family farming structure.

Attempts to corporatise and scale agricultural production have been mired by disappointment. Corporate ownership has performed poorly in investment markets as corporates have struggled to convert the implied economies of scale and associated gains into reliable and consistent returns.

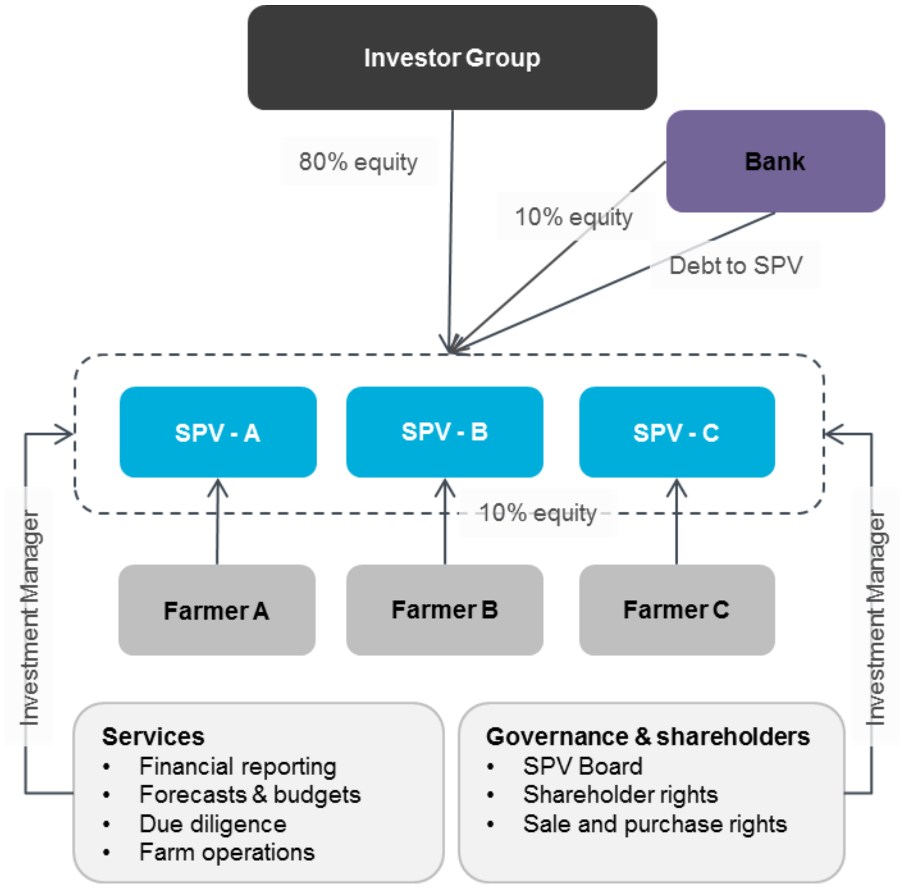
Farmer equity partnerships: delivering governance and productivity improvements

Investors are increasingly seeing value in harnessing the management strengths of the family on the family farm, which can be achieved through farmer partnership models. These are flexible mechanisms that provide the governance needed to motivate farmers to operate profitably, helping to deliver top and bottom-line performance improvements.

The key to success is to not only recapitalise the farm, but improve operations and productivity by retaining and utilising the skills and expertise of Australian farmers, and where appropriate, harnessing technological developments.

This does not mean 'selling the farm' but rather a mechanism to channel capital into the sector; a new form of equity/risk capital. Figure 4 below outlines a potential farmer equity model, whereby an investor group, farmer and / or current commercial lender co-invest and take equity in newly formed SPV entity. This frequently involves retaining existing management or recruiting local resources to control the production process. The key to a successful structure is to effectively align stakeholder interests so that all parties have 'skin in the game'.

Figure 4: potential farmer equity model



Some of the important features of new investment structures which may be more successful in attracting capital to the sector include:

- retention of the family farmer through equity and a management agreement
- implementation of appropriate governance structures to provide investors with adequate reporting
- adoption of appropriate performance incentives and KPIs.

Separating land and business

Separating farmland from the operating business can also attract different forms of capital into agriculture. This concept could attract capital to the sector as institutional investors are more familiar with land as an investment class, allowing these investors to be once removed from agricultural trading.

The reason this method has potential to attract capital is in the way it separates the investible assets of a farming business. Where commonly:

- land is purchased by larger institutional investors who are seeking real estate like returns, with land assets being purchased as part of a diversified long term fund with returns coming from different structures which can include profit sharing and capital gain
- farm businesses are purchased by owner-operators or experienced farm management groups.

There are a number of ways to structure a successful partnership or joint venture, however some of the options and key considerations include:

- profit sharing arrangements which adequately incentivise the operator to maintain the core value of the asset
- output sharing arrangements which compensate both parties for their inputs
- straight forward leasing arrangements.

Splitting the focus of both parties can also drive efficiency gains by having each party focus on their relative strengths.

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

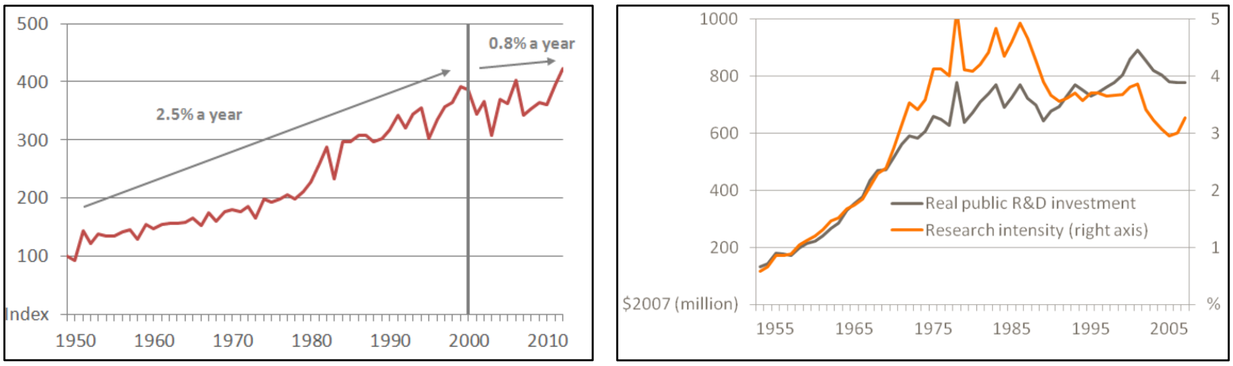
It is widely acknowledged that Australian producers are generally price-takers and the terms of trade are out of the control of an individual farmer. This means that improvements in productivity are central to improving returns and profitability of farming as a sector.

Australia's ability to deliver on future productivity growth is a key determinant of long term sector growth and a catalyst for foreign investment. The productivity issue is two sided, in that:

- investors will purchase assets if they believe the sector can achieve productivity improvements that have a positive impact on their investment
- the agricultural sector needs access to funding which can drive productivity growth.

Figure 5 illustrates the deterioration in productivity growth experienced by Australian agriculture, within the context of government funded research. This represents both a challenge and opportunity for the industry to attract financial partners.

Figure 5: Australian agricultural productivity gains and research and development investment trends



Source: ABARES 2014

Role for government

Investors who view Australian agriculture as a longer term investment play a positive role in promoting sustainability and are likely to place value on 'ahead of the curve' research projects. These players are eager to see their investments generate targeted returns and hence will provide the necessary carry-on finance to achieve production goals.

Government plays an important role in driving productivity growth as many gains will come through supporting industry-wide research and development. Some examples of ways which government could support productivity investment include:

- via the FIRB process, utilising conditional approvals which obligate foreign investors to make commitments to specific projects
- establishment of greenfield projects such as the Ord River Stage 2, development of irrigation area in Northern Australia such as by promotion of the proposed development by Integrated Food and Energy Development (IFED), support of investment by multinational companies in Australia's infrastructure such as Bunge's investment in the Bunbury Grain Port in WA.
- supporting the agricultural sector by commissioning detailed research into the 'investment thesis' which underpins various agricultural pursuits within Australia
- supporting initiatives to assist local operators to become 'investment ready' and to up-skill the sector to ease the transition for investors
- undertaking or assisting with research and development which promotes Australia's competitive advantage.

Background to PPB Advisory & our interest in the White Paper

PPB Advisory

PPB Advisory is one of Australasia's leading independent business advisory firms providing specialist expertise in financial and risk management, business structuring and industry adjustment.

PPB Advisory has extensive experience managing and resolving complex issues in the rural sector, including the agricultural industry. PPB Advisory provides independent advisory services to agribusinesses in Australasia, including farm gate and food processors. Sensitive to the economic and personal impact unique to rural enterprises and communities, the engagements we deal with require us to employ breakthrough thinking to achieve the best results with the least impact on key stakeholders.

With over 300 people employed across Australia and New Zealand, PPB Advisory has a dedicated rural and agribusiness team of 25 agri specialists with backgrounds and direct experience in rural and agribusiness operations across a cross section of the industry.

PPB Advisory's clients include private and public sector businesses and investors, banks, second tier banks and other financial institutions as well as government at various levels.

Our interest in the Agricultural Competitiveness White Paper

The Agricultural Competitiveness White Paper ('ACWP') proposes to establish an integrated approach to enhancing profitability of the sector, boosting agriculture's contribution to economic growth, trade, innovation, productivity and regional communities. The ACWP will shape a manner in which policies are formulated and objectives identified. The content of these policies will underpin Australia's competitiveness in the global marketplace and any change will ultimately impact the profitability of the agricultural sector. A healthy and competitive agricultural sector offers numerous benefits across all divisions of the industry.

PPB Advisory is committed to contributing to a paper that has the potential to significantly impact businesses and the operating environment within its client communities.

PPB Advisory therefore has both a macro and micro interest in the ACWP regarding whether:

- it contributes to increasing the competitiveness of Australian Agriculture
- individual businesses have the necessary information to respond to the ACWP and make fundamental decisions regarding the future of their businesses.