REPORT AUSTRALIAN AGRICULTURE & SUPERANNUATION

As both a farmer and a financial planner, I sometimes wonder why international pension funds find our neighbourhood an attractive asset and yet our local superannuation funds hesitate. The 2018 inquiry into Superannuation Investment in Agriculture explores the differences, issues and deficiencies that have prevented superannuation funds investing in agriculture. It is, however, worth balancing this type of analysis with a discussion on alignment. In what ways is agriculture a valuable fit for Australian superannuation investors?

This report aims to provide a perspective that inspires, I hope, a more productive discussion between the agricultural and financial sectors. The 2018 inquiry has uncovered some opportunities for those working in agriculture and looking to innovate, especially while there is a gap between the skills the industry needs and those that are available. The inquiry also offers farmers the opportunity to push for more diversity in farm funding models which, in turn, would inspire a more diverse industry overall. The stagnation of farming capital tends to be a handbrake for diversity and can result in the next generation putting their ambitions on ice in an environment that feels out of their control. While the financial sector is listening, farmers need to set their sights on taking action towards the possible improvements.

It is useful to begin by discussing a few of the hurdles noted by the inquiry and to balance them out by listing some complimentary characteristics. Also, some of the barriers to investing in agriculture are not unique to that industry. The difference between a 'barrier' and an 'excuse' is subjective and there are opportunities for the next generation hidden here. Volatility is a popular reason given for avoiding investment in agriculture, so that is a sensible place to start.

> If financial markets are driven by fear and greed, why is super so fearful of agriculture?

Volatility of returns

John McKillop, CEO of Hassad Australia, notes that "Ag investment needs to be a minimum of 10 years as it takes time to invest, bed down and then go through the usual cycles of seasons and commodity prices. My rule for investors is that 80% of your profit over a 10-year period will come in 3 of those years, therefore you need to be ready for them and don't chase trends." (McKillop, 2018).

How does this investment timeframe and objective compare with the default investment option of the largest superannuation fund in Australia? According to their website, 90% of Australian Super members are invested in the Balanced Option (Australian Super, 2019). A flick through the Australian Super Investment Guide shows that a Balanced Investor needs to have an investment time horizon of "at least 10 years", which is a curious alignment of objectives.

Figure 1 below is a summary of the Australian Super Balanced Option as per the Investment Guide (Australian Super, 2019).

Understanding your investment options

On the next few pages you'll find more detail about each investment option. To help you understand what makes up each investment option, we've put together the example below.

Balanced

Invests in a wide range of assets. Designed to have medium to long-term growth with possible short-term fluctuations.

A short summary about what the option's invested in and what it was designed to achieve.

Investment aims

- To beat CPI by more than 4% pa over the medium to longer term.
- To beat the median balanced fund over the medium to longer term.

The goals set up for each option, often comparing their performance to the CPI (Consumer Price index), which is the official measure of inflation.

Minimum investment timeframe:
At least 10 years.

If you can't keep your money invested for at least this long, this option probably isn't for you.

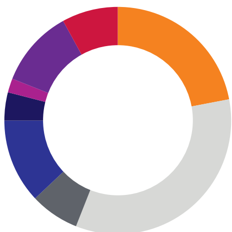
Risk level for the time invested

Short-term	Medium-term	Long-term
High	Medium	Low to medium

The risk profile of each option will vary depending on how long your money will stay in it. See page 14 for more.

Risk of negative return:
About 5 in every 20 years.

How often this option is likely to go backwards in a 20-year period.



The chart shows the combination of asset classes that typically make up each option.

- Australian shares 22% (10–45%)
- International shares 34% (10–45%)
- Direct property 7% (0–30%)
- Infrastructure 12% (0–30%)
- Private equity 4% (0–10%)
- Credit 2% (0–20%)
- Fixed interest 11% (0–25%)
- Cash 8% (0–20%)
- Other assets 0% (0–5%)

The percentages for each asset class are the strategic asset allocations with the range shown in brackets.

Volatility of returns (cont.)

Referring to the Australian Super Investment Guide, what is the risk of a negative return for this investment? To quote "…the risk of a negative return is 5 in every 20 years." (Australian Super, 2019). This figure can easily be converted to one in every four years. This, by comparison, makes a balanced portfolio superficially seem like a riskier investment than a pure investment in an Australian farm.

With news of flood and drought disasters in Australia, why would investors want to put their hard-earned retirement dollars into an investment that attracts such hardship? I spoke with Oscar Pearse who is a sixth-generation farmer from Moree in NSW. Oscar found 2018 to be exceptional, in the unfortunate sense. We spoke about the investment returns for his region. "In our region, most farms generate a 5% Return on Asset every year, plus a property value increase of between 5-6%. Just put those two 2 numbers together. You can run at a loss of 5% (income) and still have a net positive position because of the capital appreciation. We expect that 1 year in every 7 is going to be a shocker. 2018 is going to be that shocker for us." (Pearse, 2018).

Shirley Harlock, Chair of AgCap, has managed investments in Australian farmland. "Before commencing with AgCap, I was anticipating the possibilities associated with having debt free farms to manage having always been commercially involved with a mortgage. This proved not to be the case as in lieu of mortgage payments corporate investment (particularly the superannuation funds) require on behalf of their investors, gold bar governance and management which comes at a huge cost. Alternatively, in commercial and private family agricultural enterprises there is often not the level of governance overlaid nor is family labour truly accounted for. Over a 5-year period AgCap would anticipate 4% income and 4% growth, comfortably. In varying circumstances , dependant on seasonal, commodity and management conditions, you can achieve higher returns." (Harlock, 2018).

An overall comfortable average return of 8% fits within Australian Super's balanced fund objective of a return of 4% over inflation of between 2% - 3%, which is the target set by the Reserve Bank of Australia (RBA, 2019).

Murray Cod Australia is a success story that has outperformed superannuation fund return expectations and this is investigated further in the attached case study.

It would therefore seem reasonable to conclude that ag returns and volatility are generally in line with the needs of super investors.

Why do farmers moan so much if they can make a paper profit in a bad year?

I believe the current farm funding model is holding the best and most progressive farmers back from flourishing. The well-trodden financial options for farm expansion and improvement are to either spend your profits or borrow from the bank. From discussion with our lender and farm adviser, I am informed that a stable farming enterprise needs to have at least 60% equity and be able to prove the loan can be paid off over a 15-year period. Farmers who are progressively updating their technology and equipment to better suit environmental needs and farmers who are borrowing to expand, need to have a couple of good years after they borrow big from the bank. If you borrow big and the weather and markets are unkind, you are in trouble. The problem is, you are also most likely to be the kind of farmer Australia needs to see flourish. This funding strategy is limited to those with existing capital to draw upon, and can prevent the brightest and best from starting innovative ag enterprises.

You can't just buy some dirt and expect a profit

There are big differences in farm profitability. Returns in comparison to asset value can be influenced by the more obvious things such as weather events and your grain marketing strategy. Other endemic asset value influences include the number of corporates in your area; whether you have access to a water scheme; how you have developed your farm (is it efficient?); how you manage your soil and biodiversity; infrastructure (on farm and local area); the progressive character of your neighbourhood; and more. A farm looking towards being more environmentally aware will have a period of reduced profitability in the medium term, but this improves the value of the asset and will increase long-term profitability. At the same time, in order to have a productive discussion, it is prudent to examine some data reflecting farm returns over a 10-year period below.

Looking at the profit generating benchmarks provided by PlanFarm in Western Australia (Figure 2) and the GRDC Opportunity for profit management guidelines in Tasmania (Figure 3) as simple examples, it is amazing to see the differences in profits generated by the top, bottom and average farming operations. Over a 10-year period there is about a 9% difference in returns in Western Australia between the top and bottom performers. The information in the Tasmania-focused report is arranged slightly differently, but the difference between top and average performers is around 6%. With a lack of agricultural investment knowledge in the superannuation sector, the variance (or volatility) in returns is significant. You need to know what you are doing to make money. For superannuation funds to get the right people, with the right experience, ethics and drive, it costs money. Top-level management plus top-level corporate governance come at a top-level cost, reducing profitability.

(Figure 2)

WA 10-year total broadacre farm returns

	Gross Income/ha	Operating costs/ha	Operating surplus/ha	Return on capital
Top 25%*	$453.3	$275.0	$178.3	10.6%
Average*	$457.5	$301.6	$155.8	5.5%
Bottom 25%*	$393.8	$288.6	$105.2	1.2%

The average broadacre farm business in Western Australia has returned 5.5% pa over the past decade before land appreciation. This compares very favourably with published gross returns for other asset classes over the same period including Australian shares (4.0%), Australian listed property (1.8%), global listed property (5.4%), growth managed funds (5.3%) and cash (3.6%).[5]

[4]Return on capital figure does not include changes in land values.
*Ranked on 10-year average return on capital.
[5]Source: https://russellinvestments.com/-/media/files/au/insights/2018-russell-investmentsasx-long-term-investing-report.pdf?la=en-au

(PlanFarm BankWest Benchmarks, 2017-2018).

(Figure 3)

How do they compare in performance benchmarks?

Benchmark	Top 20% of businesses as selected by ROE	Average across the dataset
Return on Equity (ROE)	8.18%	1.94%
Return on Assets Managed (ROAM)	7.36%	4.54%
Profit as % Income	30.3%	11.8%

(GRDC Opportunity For Profit Management Guidelines RDP00013, 2015).

You can't just buy some dirt and expect a profit (cont.)

Both the Tasmanian and Western Australian reports comment on how farming operations have outperformed other asset classes, such as shares.

I believe that when superannuation funds use volatility as an excuse not to invest in agriculture, it is an internal skills-based issue, rather than a sector issue. I also believe that this is something both sectors would benefit from addressing.

It is commonplace for farmers to measure their enterprise profitability on the income generated from their business alone, rather than by calculating the capital gain in conjunction with this. Family farms generally aspire to passing the land on to the next generation. This influences how the asset value is viewed and quantified. Only measuring farm income can make farming seem less profitable, at face value. The recent Government inquiry looked at fast-tracking the availability of data for the ag sector. If more transparency was available for value changes in farming land, perhaps farmers would pay more attention to this aspect of their business. It would be easier to financially justify having employees with the primary role of maintaining the capital value of the land if the latter could be easily quantified.

Plant tree, minus tax, minus commission, plus debt and Global Financial Crisis equals disaster

Agricultural Managed Investment Schemes is a Pandora's box that can frighten people off investing in ag. On our farm we have a crop of trees and know from personal experience that the time horizon for harvest here is around 15 - 20 years. Waiting 15 years for a harvestable crop creates a cashflow issue for a business with ongoing financial commitments. Many trees were planted in the 1980s and 1990s. They were promoted to investors based on anticipated returns and an immediate tax deduction. The advisers who promoted this investment benefited from an immediate commission.

The financial model was problematic and this highlights the importance of having a well functioning financial structure.

With regard to failing Managed Investment Schemes, agricultural investments require scale for efficiencies and to absorb the financial burden associated with a corporate structure. The scale necessary to obtain these efficiencies requires a large investment, which is most attractive when there is limited supply compared with demand. A large-scale investment has the potential to create change in the commodities supply/demand dynamic (Hall, 2018).

Unintended consequences of domestic and foreign-owned ag investment

Superannuation funds generally prefer investments that have a track record of three years. This can make it frustrating for new agricultural investment funds to get started, thus making it necessary to look for overseas investment to source capital for kicking things off.

One of the recommendations of the Government's 2018 inquiry into Superannuation Investment in Agriculture is that managed investment trust tax rates be reviewed. It seems that local investors, once combined with foreign investment funds, miss out on tax benefits they would otherwise receive. The inquiry has recommended a review of the tax rules.

This 3-year investment horizon is not unique to investment in ag.

Other points the inquiry listed for not investing in ag

The inquiry listed liquidity, environmental risk, climatic risk, international markets and regulatory risk as barriers to investment in ag. It is not difficult to reel off other investments that would share some of these risks including Stockland, Rio Tinto, Commonwealth Bank and QBE Insurance.

These issues are not unique to investment in ag.

Invest in what you understand. Who understands ag?

Damian Graham grew up in rural Victoria and is now the Chief Investment Officer for First State Super and responsible for the investment of approximately $100 billion in superannuation funds. First State Super has funds invested in ag. When I asked Damian if there is a general lack of agricultural investment knowledge in the investment world, his response was, "Definitely." First State Super's investment in ag is economically structured to complement their skill set and is driven by a diversification strategy as it has a low correlation to other investments such as bonds and shares. First State Super has tended to purchase farmland and then lease the land back.

"We prefer to reduce our exposure to the ag price cycle. Instead we seek to get a more stable return," explained Damian. Damian believes that ag can suffer from the burden of corporatised structures, leading to less positive returns (Graham, 2018).

Superannuation funds tend to have their agricultural investment analysed by the same department that manages property and infrastructure investments. Agricultural investment requires a different skill set. In comparison, property and infrastructure have a more reliable income that does not rely on the weather and commodity markets. Therefore, like First State Super, it is a cost-effective way to analyse and invest in ag by reconfiguring the terms of the investment to fit with the pre-existing hurdles.

I spoke with Scott Tully, Chief Investment Officer from Colonial First State, who suggested, "You first need to convince investors that agriculture is a worthwhile asset class for investment before you even begin to discuss your own strategy. By comparison, if you are an Australian share investment manager, you just need to prove that you have a great investment capability, the asset class decision has already been made." (Tully, 2018).

Because ag tends to be a small part of a broader portfolio, it is understandable that super funds are reluctant to establish departments dedicated to the sector. If we compare ourselves to one of our North American counterparts, it seems the Ontario Teacher's Pension Plan, agriculture is held in the Infrastructure and Natural Resources Portfolio. This includes energy, mining, food and timberland. This structure has not held the fund back from investing in Australian ag (Ontario Teachers' Pension Plan, 2019).

North America likes Australian agriculture, but Australia… not so much

As mentioned, I have wondered why international pension funds have found our neighbourhood an attractive asset, while our local superannuation funds hesitate. So how do the two systems generally compare?

North American Pension versus Australian Superannuation Funds

When North Americans invest for their retirement, they have a structure that was once commonplace in Australia. They have defined benefit pension funds, where, based on a calculation of their income (and contributions), members are informed of the income they will receive in retirement.

In Australia, members commonly pay into accumulation accounts. The contributions, fees and investment performance influence how this investment increases. Upon retirement the investor draws an income from this account, which continues until the balance reaches zero.

In Australia, super funds pride themselves on having good returns and low fees, but the individual investor bears the ultimate risk of their funds failing to last their lifetime. In North America, it is the employer who does so. To clarify, if the defined benefit is unable to meet its commitment of annual income for their investor, the employer needs to dip into their own pocket to make up the difference. It is worth noting that in Australia some defined benefits do not offer the same protection as in North America.

Due to this structure, North American pension funds are as equally motivated by high returns as they are to protect their investment. In Australia, superannuation funds are fundamentally motivated by outperformance (commonly rewarded by the investor paying additional performance fees).

Security of retirement investment is where ag has an important part to play. Returns from the sector are varied, however, it does provide additional portfolio diversification (by not putting all your eggs in one basket). Also, the growth of both world population and China's affluence (increasing the market's need for protein), make a partial portfolio investment in agricultural land a sensible, long-term play.

Are we measuring success appropriately for the market?

My experience in financial planning gives me personal insight into what every day Australians are looking for in their superannuation and what their concerns are. Everyone wants their superannuation to make money. Low fees are very important too. It is, however, the fear of their investment disappearing that keeps them up at night. I have never heard a client say, "I was up all night worried that my super would only return 8% this year instead of 10%". Clearly, returns and low fees provide Australians with a better-quality retirement. The missing link here is that this focus on high returns and low fees is not meeting the market demand, where peace of mind is also of great importance. If ag comes with higher management fees than property and infrastructure and if the returns are also slightly lower, isn't it just easier for super funds to invest in other low hanging fruit and avoid the unknowns of ag?

Some possibilities for the next generation in ag

Currently, there is a space for cost reduction enterprises for corporate governance and ag. This would most likely require a combination of legal, accounting, IT and ag expertise. There is money to be made in this space with the right people and the right product.

There are investors who want to diversify their investments into ag, but without the short-term risk, as discussed earlier. There is a space for a financial vehicle that purchases land and leases it back to local farmers wanting to expand. Alternatively, such a product could lease to farmers who may have impressive experience and qualifications but no capital. This would be an exciting way to diversify the workforce and hopefully accelerate ideas in ag for how to take on the climate and sustainability challenges of the future.

For farmers looking to leave ag there are several ways farms could be leased and sold gradually over time to younger farmers. I would like to see an increase in this sort of knowledge being shared and standard contracts being made available to farmers who want to stay on their land as they age and reduce their workload. Clearly there would be many nuances to be sorted through, but it would provide older farmers with more confidence if they could put in place a type of agreement that was standard practice.

Development and sharing of standard agreements so that farmers can take a year off and lease out their property, would also be amazing. No harm in putting that one out there!

In the attached case study, Roger Commins speaks about how Murray Cod Australia was able to realise their vision, without a typical debt to equity funding mechanism.

You are cordially invited to rethink farming finance

With a royal commission on farm finance and another on banking, the scene is set for change within the financial sector. Now is a great time for farmers to be discussing more appropriate finance options to fund their ag ambitions in Australia.

Industry Super Australia notes in a report that, "[I]t may be better for superannuation funds to partner with experienced family or corporate operators with established track records running successful operations". This is an invitation for family farms to think about how they want to design their financial future. Why should farmers resign themselves to the current debt to equity treadmill?

The government inquiry into Superannuation Investment in Agriculture makes four recommendations. The one that excites me the most suggests improving agricultural statistics. This measure could lead to more transparency, confidence, liquidity and financial product innovation.

Conclusion

The difference between a 'barrier' and an 'excuse' is subjective. The courtship between Australian ag and superannuation has been rather lack luster and as discussed;

- North American defined benefit funds are invested to provide for members retirement income needs, but if the money runs out, the employer must pay. Australian super funds focus on high performance and low fees. As sensible as this is, the member wears the risk if the funds run out.
- Australian ag can generate a profit comparable to other asset classes, but with volatility that has a low correlation to other asset classes. This is a win for diversification and investors.
- Australian farmers have an opportunity to seek out and cultivate innovation in farm finance options. Now is a good time to talk about it.

The groundwork has been done. We need to get talking to our banks, to each other and to industry super funds before Anzac Day arrives and our financial yields are impacted.

CASE STUDY: AUSTRALIAN AG AND SUPERANNUATION INVESTMENT:

Roger Commins loves a challenge. After 13 years of working for “someone else”, he and his brother Tim teamed up and started farming together on their own terms. “We did that for about six or seven years, but eventually your learning gets capped and you get a bit stale”. So, in the pursuit of challenge, both brothers and their families ventured into the stainless-steel fabrication business. Which led to a wine storage fabrication business. In turn this led to an onsite wine storage business, then to a liquid fertiliser storage business, and eventually to the building of a cotton processing facility.

The cotton gin was a joint venture between four local farming families and was established without any backing from the big banks. But wait, there’s more: In 2015, Roger teamed up with Mathew Ryan and the two tried their hand at aquaculture. In 2017 the floating of Murray Cod Australia on the Australian Stock Exchange sparked investor interest, including that of Australian Super. Winning the attention and support of a company such as Australian Super is a momentous step, as the company currently only invests around 0.19% of funds under management (or $250 million) in agriculture and ‘agriculture-like’ investments.

So, what makes MCA a sensible choice for Australian Super? MCA has a fantastic growth story. It produces a unique and top-quality local product; has state of the art stainless steel facilities to care for the fish; a solid environmental sustainability story; and vertical integration with ownership of the fish for their full life cycle. All these attributes have allowed Australian Super’s investment at $0.06 per share in April 2018 to be worth $0.18 per share as of 23rd of August, 2019 (Australian Securities Exchange, 2019).

However, we go back to the start. Mathew, Roger and their respective families put in both serious courage and capital to kick things off. They developed a vision, bore the risk of the first few years and felt the financial reality. Roger was careful to point out, “When you start you aren’t going to be at the top of your game. You make a few mistakes. Nothing like a hit to the hip pocket to sharpen you”.

Roger explained the importance of being diligent and setting up a framework when investing with others. “You need ground rules. A good shareholder agreement that is binding and covers off on all the things that might eventuate. If we run out of money, things go bad, or we want to dissolve, or one investor wants their money and to go – it’s all covered off before you even start. Then there can be no arguments. Framework is very important.”

Roger described the first capital raising for MCA. “We wanted to raise $10 million so we issued 200 million shares at $0.05 per share. The support blew us away. A large percentage of the shares were taken up by people in our local community. Friends and people who know us also supported us. They had been watching what we had been doing over the years [cotton gin, etc] and they probably thought ‘Ah well, probably worth a bloody punt here’. They backed the people and we couldn’t have done it without them.” Not long after that, Australian Super became investors too.

It is difficult to find a superannuation fund in Australia with a dedicated agricultural investment department and, as a result, most are not equipped with the knowledge and capabilities to support an entity like MCA, or at least not until its founders had already done the hard yards. How would MCA's growth have been accelerated if it had been able to take on the 'roll up your sleeves and get the job done' attitude and team them up with a super fund that could provide capital and corporate governance support?

Roger is able to create and impart a vision for agricultural businesses, work effectively in a team and walk the talk. He is keen to emphasise the importance of doing what you say you are going to do because, "[T]hat gives people confidence to back you financially".

There are other important lessons ag can learn from Roger Commins:

- Partnerships, Joint Ventures and ASX listing can open opportunities. Banks are just one option. Roger's successes have all been as a member of a team.
- If you can, have two banks. Roger says it keeps them honest.
- If you have a vision, the numbers add up and you have the right people, it can be done.
- Investors are willing to back agricultural businesses that are environmentally progressive, have a growth story and a level of control.

There is further evidence of Roger's persistence and capacity for further learning. He was flying his helicopter in 2005 when the engine failed. The helicopter landed in a paddock, rolling several times. When asked by ABC News if he would fly again, he said "Yes, I expect this will make me a better pilot."

The important lessons superannuation funds in Australia can learn from Murray Cod Australia and Roger Commins:

- Agriculture is a diverse sector with many opportunities and there have been numerous possibilities where Roger has declined to get involved. Roger goes looking, asks the questions and does the numbers. It is easier for superannuation funds to replicate this if they have a department for agricultural investment analysis, rather than making ag the departmental 'plus one' of other asset classes, such as infrastructure.
- There are worthy investments available in the market and teaming up with the right people can pay dividends.
- Waiting for the agricultural bandwagon to get moving before jumping on might limit your ability to gain adequate exposure to quality assets in the sector at a good price. Australian Super being limited to a $2.3 million investment in MCA is one example.

Ultimately, Australian superannuation funds need to partner with the right people, roll up their sleeves and become better pilots for their members' superannuation balances.

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