THE ROAD TO RICHES: driving investment in Western Australian agriculture

Department of Agriculture and Food Western Australia

kpmg.com.au
Identify & categorise contributors

Contributors were selected to ensure insights were captured from a range of perspectives in the sector here in Australia as well understanding what has worked well in other countries.

KPMG leveraged our global network of agribusiness subject matter experts in South Africa, Israel, China, New Zealand, Poland, France, the United Kingdom, Poland, Brazil and the USA were approached to provide their insights and understanding of their local agriculture sectors.

Step 1: IDENTIFY & CATEGORISE CONTRIBUTORS

Step 2: DEVELOP CONVERSATION FRAMEWORKS

Our conversations with contributors focussed on different perspectives and aspects of the sector along with its challenges and opportunities.

We developed a set of targeted questions to frame our discussions with each category of contributor.

Step 3: ENGAGE WITH CONTRIBUTORS

Global Network

Engage with contributors

Conversation frameworks were circulated by email and followed up with either face-to-face discussions or telephone calls with contributors.

Step 4: COLLABATE & ANALYSE FINDINGS

Collate & analyse findings

Using global datasets and indicators, KPMG developed an overview of the Australian Agriculture sector’s performance in key areas in relation to its global competitors. The analysis of time series data looked to identify changes in the sector over time.

Our market analysis was supplemented with thematic analysis of our conversations with our contributors to draw key trends from a range of perspectives.

Step 5: SUMMARISE & REPORT CONCLUSIONS

Summarise & report conclusions

The results of our analysis and our recommendations have been summarised in this report.
**Inherent Limitations**

This report has been prepared as outlined in the Scope of Work (please refer to Appendix A1 (“Scope”)). The services provided in connection with this engagement comprise an advisory engagement, which is not subject to assurance or other standards issued by the Australian Auditing and Assurance Standards Board and, consequently no opinions or conclusions intended to convey assurance have been expressed.

The findings in this report are based on a qualitative study and the reported results reflect a perception of DAFWA but only to the extent of the sample surveyed. Being DAFWA’s approved representative sample of management and personnel/stakeholders. Any projection to the wider management and personnel/stakeholders is subject to the level of bias in the method of sample selection.

No warranty of completeness, accuracy or reliability is given in relation to the statements and representations made by, and the information and documentation provided by, DAFWA’s management and personnel/stakeholders consulted as part of the process.

KPMG have indicated within this report the sources of the information provided. We have not sought to independently verify those sources unless otherwise noted within the report.

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The findings in this report have been formed on the above basis.

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February 2015

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THE ROAD TO RICHES
driving investment in Western Australian agriculture
1 KEY FINDINGS

From one of the most geographically remote places in the world to one in the middle of the action, Western Australia has recently been the focus of the Australian economy due to its mineral resources and their utilisation in building, powering and benefitting the homes and businesses of Asia.

Attention is now shifting to the next phase, expanding agricultural production to feed these developing economies in Asia. However, access to capital looms as a major limiter of growth for Western Australian agriculture. Growth will require continued investment for succession, productivity and consolidation to improve efficiency and maximise the value of production. This will require significant investment with the necessary financing estimated at $600 billion by 2050 to increase exports by $1.7 trillion.

Agriculture in Western Australia has a significant opportunity to follow in the footprints of the mining industry and become a strong pillar of the economy for subsequent generations. The opportunity exists to capitalise on growing demand from Asia’s emerging middle class who are demanding high quality safe food. Recent securing of “Free Trade Agreements” with our major Asian trading partners will further broaden and deepen the trading opportunities for many of our agricultural products.

Managers of farm businesses will need to approach financing differently to access capital from different sources using different structures, in particular to better leverage equity in land and other assets. Only if farm managers embrace these new concepts will Western Australian agriculture gain access to sufficient capital to undergo transformation and realise its full potential.

The opportunity for Australian agriculture is real and some would argue it is already passing us by. Agriculture needs investment to ensure it is competitive and to increase production and improve export capabilities to meet the needs of growing higher value markets. The focus for industry and government must be on actions to facilitate investment so that Australian agriculture can realise this opportunity.

The purpose of this report is to review the financing position of Western Australian farm businesses and explore options to obtain financing for this investment. Critical to this is action by government and industry to overcome challenges and facilitate the provision of investment financing.

Government has a facilitation role to play in assisting the sector to reach its growth potential, however industry must take the lead to achieve that goal.

Agriculture in Western Australia has a significant opportunity to follow in the footprints of the mining industry and become a strong pillar of the economy for subsequent generations. The opportunity exists to capitalise on growing demand from Asia’s emerging middle class who are demanding high quality safe food. Recent securing of “Free Trade Agreements” with our major Asian trading partners will further broaden and deepen the trading opportunities for many of our agricultural products.

Australian farm businesses must accelerate investment for succession, consolidation, productivity, conversion and marketing. This investment will support successful outcomes by optimising farm management and asset allocations, maximising farm efficiency and the value of production while ensuring Australian farm businesses realise prices that justify new investment.

What does success look like?

An Australian agricultural sector with revenue double current levels having invested to grow production and develop a leading market share in Asia’s premium food markets by 2025.

So how does Australian fund this future?

Australian farm businesses have historically been financed by a combination of internal equity (i.e. from within the traditional family structure) and bank and trade finance. However, changes within the traditional farm structure present significant challenges to financing new investment including:

- Additional demands from within family structures on equity, limiting availability for re-investment in agriculture;
- Historically high bank debt that combined with land value based lending practices limit additional bank financing; and
- Trade finance that is unable to meet the total working capital needs of Australian agriculture.

Agriculture in Western Australia has a significant opportunity to follow in the footprints of the mining industry and become a strong pillar of the economy for subsequent generations. The opportunity exists to capitalise on growing demand from Asia’s emerging middle class who are demanding high quality safe food. Recent securing of “Free Trade Agreements” with our major Asian trading partners will further broaden and deepen the trading opportunities for many of our agricultural products.

There are options to improve the effectiveness of this financing to support new investment such as pooling capital between farm businesses to generate economies of scale or crystallising value held within grower co-operatives. Critical to optimising the use of existing funding is protecting what is already in use by farm businesses. This is particularly relevant for working capital that is put at risk every season. This investment is more difficult to fund and consequently debilitating when lost due to poor seasonal conditions to the extent the loss of funds restricts farm businesses from capitalising on favourable seasonal conditions in subsequent years. Australian farm businesses need access to enhanced risk management tools that protect the annual investment in working capital. However it is important these products do not simply encourage greater risk taking within the industry.

While the majority of industry participants are supportive of insurance for this purpose, there remains scepticism in respect of the cost and risk mitigation effectiveness of new products currently available in the market. By reducing volatility of profits there is potential to increase the overall debt capacity of any given business, or to reduce debt costs that could potentially offset the cost of insurance. Further, this new earnings profile would be of greater appeal to investors from outside agriculture who are uncomfortable with the degree of seasonal volatility it is exposed to.

While optimising the use of existing financing will support additional investment, it is unlikely to fulfil the total investment need of Australian agriculture. Thus a new approach to financing investment in Australian agriculture is needed.
Become investment ready

Australian agriculture must tap into the relatively infinite source of capital categorised as external equity. At present, most Australian farm businesses are not ‘investment ready’ and face challenges in attracting external equity due to financial performance or management skills and expertise to operate under more professional management structures required by external equity investors.

Professional management structures, such as advisory boards, impose governance, planning and reporting on business that drives transparency and decision making discipline, better forward planning and risk mitigation and independent assessment of farm and manager performance. These practices can assist to transform farm management and improve performance of all farm businesses, not just those who are considering external equity. Further, it allows the development of the necessary skills and expertise to work with external investors.

Australian farm businesses need access to new tools and expertise to implement these structures to improve business performance and to become investment ready.

While external equity includes a range of different sources, those with the greatest potential to provide funding to Australian farm businesses are:

- Retail: high net worth individuals and self-managed super funds; and
- Institutions: superannuation and pension funds.

In Australia alone, the funds held by the superannuation system totals $1.8 trillion.

CONSIDERATION

A ‘best practice’ business management framework and associated policies and training materials should be developed to enable better governance, planning and reporting with an aim to improve financial performance and support adoption of professional business management structures. This could include a workshop training program that combines management education with practical tools for farm managers.

CONSIDERATION

Industry should further develop specialised agribusiness advisory and legal services to support farm businesses implementing professional management structures and improve financial outcomes to encourage change within the sector.
Direct measures to support competitiveness and investment

While agriculture is of interest to retail and institutional investors, there are concerns regarding:

- Volatility of earnings due to seasonal factors and commodity prices;
- Historical returns and reliable data to inform decision making and measure investment performance; and
- How to invest in a sector where many investors have limited understanding of business operations.

Based on ABARES Farm Surveys, returns over the last 20 years indicate an investment in the top performing farms would have outperformed the ASX All Ordinaries in all production segments. Further, returns display low levels of correlation to equity markets and provide a means to reduce portfolio risk through diversification. However, many investments to date have not met expectations, leading to poor perceptions of investment in agriculture. Australian agriculture needs robust and timely investment performance data to allow comparison with other investment classes and provide transparency for investors to assess manager performance.

CONSIDERATION

Industry requires a national agricultural performance index in Australia comparable to the successful NCREIF operating in the USA. Government could consider grant funding to assist the establishment of the index.

2. The correlation between agricultural returns with the ASX All Ordinaries over the period 1993 to 2013 was 0.25, ABARES Farm Surveys and ASX.
Develop the market for external equity

External equity is deployed through a range of structures to meet the individual needs of each investor and may involve separating the ownership of the farm business between land and operations. While this has the advantage of aligning the relative competencies of each party, capital for investors and operational competency for farm business managers, it can introduce conflicts of interest between the land owner and operator where one can be advantaged over the other through land management practices. These structures require protective terms that balance the interests of each party, in particular investors that may have less agricultural knowledge and expertise, to support sustainable investment success.

While the concept of a farm business that doesn’t own any land is generally viewed unfavourably by Australian farm managers, it is not necessary to own land, certainly not all of it, and farm businesses can realise significant operational and financial advantages by leveraging the capital of investors while focussing on what they are good at, farming operations.

External equity structures such as leasing are common, relatively standardised and understood by industry stakeholders, however most structures are not.

Evidence from other markets, such as the New Zealand dairy industry, demonstrate that standardised structures support broader use and provide an important stepping stone for new farm managers to build equity and become business owners. Australian agriculture requires standardised structures that are embraced by all stakeholders to support uptake and the development of a more efficient market that minimises costs, encourages investment and attracts new entrants to the industry.

A critical element of external equity is connecting compatible farm businesses and investors. Given external equity is a relatively new source of funding, this connectivity requires the development of new relationships between parties with significantly different backgrounds. When compared with the success of Australia’s mining sector that raised significant funding through large corporations and hundreds of listed mining companies, Australian agriculture has few parties promoting investment in a similar way. While investment will still occur, there is a critical role for professional advisors to act as intermediaries identifying and connecting suitable parties and assisting with the development of relationships and opportunities to attract and accelerate investment that otherwise may not occur.

Consideration

Where land is leased or share farmed, measures are required to establish consistent conditions for the maintenance or improvement of the natural resource and infrastructure while the property is used by the land operator. Such documentation would assist parties to external equity contracts manage conflicts of interest. State Governments have measures for resource management which should be considered for inclusion in these contracts.

Industry and Government should work together to develop innovative or contemporary frameworks for leasing, share farming and equity partnerships in collaboration with all stakeholders, including traditional finance and farm advisory providers, to provide a best practice template for use by farm businesses and investors to foster successful outcomes.
Direct measures to support competitiveness and investment

When it comes to global agricultural investment capital, Australia faces strong competition for capital from other nations. Australia must offer investors returns that compare favourably. While there are a range of challenges faced by Australian agriculture that impact on competitiveness, many issues such as labour costs and inflexibility are economy-wide and difficult to change. However, there are changes within the control of the State Government that could materially enhance the competitiveness of Australian agriculture.

Harmonising regulation that is important to agriculture would allow investors to view Australia as a single investment jurisdiction rather than having to deal with varying rules as investors move from one state to another. Further, stamp duty is uncompetitive with our closest competitor for agricultural investment capital, New Zealand, where there is no duty on farm land transactions. This places Australian farm businesses at a distinct disadvantage to attract investment.

CONSIDERATION

Australia should enhance its appeal to international investors by harmonising state and federal regulations that impact farm ownership to simplify investment. Land tenure reform (along the lines undertaken in Queensland) and concessional Stamp Duty on agricultural land are key priorities and require a firmer resolve by Government to amend in order to facilitate investment.
CONCLUSION

Western Australia has experienced what some commentators believe to have been a once in a generation boom linked to mining investment. It would be easy for Western Australian’s to rest comfortably in the knowledge that our future prosperity is linked to the production phases of these enormous investments. However there is another view, one that proposes to use the skills sets, infrastructure and supply chains to our Asian customers established during the mining investment boom and to connect them more effectively to our smaller, yet no less determined agricultural producers. In order to take advantage of this potential opportunity Western Australian agribusinesses needs to overcome numerous challenges that cumulatively conspire to frighten investor capital away. In this report, we have outlined critical factors that need resolution to enhance investment prospects in WA agriculture, namely:

- **Farming enterprises to become investment ready to attract financing from all available sources;**
- **Optimising the use of financing already deployed in the sector;**
- **Development of the market for external equity structures to facilitate financing from alternative sources; and**
- **Direct measures to enhance Australia’s competitiveness for agricultural investment capital, particularly for retail and institutional investors.**

Agriculture often requires investors with patient capital and a long term vision. If we are to secure investment in agriculture we need to act with resolve and in haste in order to capitalise on an opportunity that will otherwise be embraced by our competitors. This also depends on a stable policy environment to give investors confidence that their investment will not be placed at risk by arbitrary policy changes. If we are successful, we may set the scene for the “second - once in a generation boom” for Western Australia, but this time in our agricultural sector with benefits spread more evenly to all of the regions across the State.
INTRODUCTION
Access to adequate capital for investment will be critical if Western Australian agriculture is to remain internationally competitive and in a position to take advantage of opportunities arising from population and economic growth within Asia and the Middle East.

A number of examples of innovative ownership arrangements can be found in agriculture, including:

- those driven by incentives previously available to management investment schemes; and
- those arising from the provision of enhanced genetic material to farm businesses which are then responsible for growing the animals or crops to a marketable stage.

In general, however, non-bank capital flows into agriculture have been limited and highly selective. Investment practices in other sectors of the economy have not readily found a place in agriculture.

Investment has occurred beyond the farm gate and has included investors focussed on enhancing business performance for the purpose of subsequent sale. In addition, foreign investors, in particular from China, the Middle East and Japan, have sought to improve food security by investing across the supply chain.

Prior to the commissioning of this consultancy, broad consultation was conducted with agribusiness service providers which highlighted the need to examine and promote alternative farm business ownership structures, management and financing models.

Bank debt financing has been the predominant funding source for the purchase of land, equipment and sourcing working capital. Banks have traditionally based their assessment of loan applications on equity and land values. A series of poor seasons in Western Australia had eroded equity to levels where the viability of some farm businesses may be questioned by financiers. The Australian agricultural industry must look at options to improve the effectiveness of this funding.

It has been estimated Australian agriculture requires $1 trillion for investment over the period to 2050\(^3\). While the family farm is the primary management and ownership structure in Australia, meeting this target will require industry to look at options to introduce new sources of equity. This may require the refinement of existing management and ownership structures or the development of new ones. While concerns have been raised in respect of foreign investment activity, it presents a source of funds actively seeking to invest in agriculture while domestic institutions are generally inactive having undertaken limited investment to date.

Australian agriculture must consider what can be done to facilitate new investment and address the impediments that limit or slow investment in the sector.

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Australia’s opportunity

Agriculture has been heralded as one of the next big opportunities for Australia. Compared with other major international producers, Australia has a small agricultural sector ranking 17th in terms of the value of annual production. However, Australia has a large agricultural resource relative to its population with the highest levels of arable land per capita in the world, albeit this resource can be constrained by low sustainable water supply (refer figure 2.1). This translates into Australia holding a highly strategic position with a relatively large share of global trade in key soft commodities such as red meat, wheat and dairy where Australia is ranked 2nd, 4th and 4th respectively.

While Australia was historically a low cost producer, it has now been surpassed by South American and Eastern European countries in this regard. Consequently, Australia must invest to remain competitive or it may be limited in servicing general commodity markets that feed the world due to its cost base. Otherwise Australian must leverage its clean, safe and internationally regarded productive environment to supply niche markets where premium prices can be achieved.

Asia has the fastest growing middle class in the world driven by urbanisation and industrialisation, particularly in China and ASEAN countries (refer Figure 2.2). Asia-Pacific’s middle class population is expected to increase over the period 2009 to 2030 from 0.5 billion to 3.2 billion, representing a 514% increase. This middle class is undergoing a dramatic change in culinary preferences with increasing meat protein, dairy and sugar consumption. While ‘clean’ and ‘green’ are important these have been superseded by ‘safe’ and ‘trusted’ following a number of food safety related events, such as those in China relating to melamine and meat contamination. Importantly, the more wealthy among these high growth populations are prepared to pay a premium for safe food from trusted sources.

The opportunity for Australian agriculture is in supplying high growth premium markets, particularly in Asia where Australia generally has freight advantages due to proximity to market and counter-seasonal advantage over Northern hemisphere competitors. With the highest level of arable land per capita in the world Australia has the natural resources to capitalise on this opportunity.

Figure 2.1: Land and water resources


Figure 2.2: World middle class population

Source: Brookings Institute, World Bank Data.

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4. Based on average annual production value 2008 to 2012 (EU-27 single producer), FAOSTAT, FAO.
5. Based on average annual production volumes 2008 to 2012 (EU-27 single producer), OECD-FAO.
Australian farm businesses will only prosper if they are cost competitive or can realise price premiums in high value markets.

The current opportunity for agriculture will be transient. Agriculture needs investment to ensure it is competitive and to increase production and improve export capabilities to meet the needs of growing high value markets. The focus for government and industry must be on actions to facilitate investment so that Australian agriculture can realise this opportunity.

For Australian agriculture to realise its full potential it must invest, an estimated $1 trillion by 2050, to service the growing needs of these premium markets. The focus for government and industry must be on actions to facilitate investment so that Australian agriculture can realise this opportunity. However, the window of opportunity to fund this investment will not last for ever and some would argue it is already passing us by.

While mining may not be directly comparable to agriculture, the Australian mining industry demonstrates what can be achieved by capitalising on high commodity prices and favourable investment settings with Australia’s mineral exports increasing from $46 billion in 2002-03 to $146 billion in 2012-13. (Refer Figure 2.3)

What does success look like?

An Australian agricultural sector with revenue double current levels having invested to grow production and develop a leading market share in Asia’s premium food markets by 2025.

Critical to this is attracting an increased proportion of global agricultural investment capital. Global markets will react to increased demand for food, initially through higher prices. This trend appears to be playing out in certain soft commodity markets such as beef where international prices are significantly above long term trends. However, commodity booms in the past have shown supply will respond leading to a moderation of prices, albeit to levels potentially above long run averages. Iron ore markets appear to be in the latter stages of this cycle with the majority of the investment having already been undertaken demonstrating the importance of capitalising early in the economic cycle when returns and capital availability are greatest.

As with previous commodity cycles, those countries that attract investment and capitalise on this market dynamic early in the cycle are poised to benefit in the long term from the associated increase in productive capacity. Australia faces competition for this investment from a range of developed and developing countries and must not be complacent in providing the most conducive investment environment to attract capital into the sector.

Through our benchmarking and knowledge of our client base, the difference between the top 25% and the average over the longer term comes down to small differences in production, cost control and pricing but adds up to double the profit. They achieve this through being very focussed, good planning, being able to adapt to change (and seasons), knowing their strengths and above all they enjoy farming.

*Planfarm*
Agricultural investment broadly fits into five categories:

1. Succession to ensure Australian agriculture retains and attracts talent that can manage and develop Australia’s farm businesses;

2. Consolidation of Australia’s less efficient farm businesses by better performing businesses;

3. Productivity growth through investment in new infrastructure, technology and operating practices;

4. Conversion from sub-optimal production to the highest possible value production which may include new types of production; and

5. Marketing and logistics to ensure production is delivered to market specification at the lowest cost and for the highest price.

Goals for Australian agriculture

Financing of investment is a critical ingredient for all business and agriculture is no different; albeit exposure to global commodity prices and seasonal variability introduces risk unfamiliar to most others.

With an aging farmer population, succession is increasingly a challenge in terms of retaining and attracting skills and expertise within the sector. Investment and management structures that provide a pathway to generate equity for the next generation is critical to replenishing this supply. This is further complicated by changes in equity distributions within family structures, such as increased off-farm expenditure by retiring farmers and equal distribution of equity between family beneficiaries. This is impacting the next generation’s succession funding requirements which have been estimated at $400 billion to 2050.

Consolidation can increase Australia’s productive capacity by leveraging scale advantages available to farm businesses such as maximising utilisation of equipment and management expertise. The bottom performing 25% of broadacre and dairy farms in Australia comprise approximately 57 million hectares with an estimated market value of $23 billion (Refer Figure 2.4). The consolidation of these farms by the top performing farms could dramatically increase profits within the sector. Applying the rates of the return achieved by the top performing 25% of farms to this land would increase total farm profits by $2.6 billion per annum, which reflects an increase in farm profits of over 80% for the broadacre and dairy sectors in Australia.

Farm performance is not attributable solely to land price or quality, with top performing farms in lower

Figure 2.4: Australian farm performance

Rate of return excluding capital appreciation
Rate of return including capital appreciation
Total cash receipts

Source: Combined broadacre and dairy farms, ABARES Farm Surveys.
value regions, poor performing farms in higher value regions and vice versa (Refer Figure 2.5). What distinguishes top performing farms from the rest is they have the management capability and financial resources to innovate and implement productivity enhancing measures while fully capitalising on favourable seasonal conditions when they arise.

New technology and farming practices are the primary drivers of productivity. In addition to management’s preparedness and capacity to adopt and successfully implement change, it requires significant investment including machinery, equipment and training.

While Australia has the highest level of arable land per capita in the world, it is constrained by sustainable water supply. Investment in new infrastructure, technology and farming practices that improves the efficiency of water storage, distribution and utilisation can increase the value realised from this water supply and is essential for Australia to realise the full potential of its agricultural resource. This is particularly relevant for dairy, horticulture and agricultural development in Northern Australia.

As production techniques, technology and markets change so too does the most optimal use of land. Changing production types from a lower value to higher value use lifts Australia’s productive capacity while increasing farm profitability. This can involve changing from one form of agriculture to another, such as livestock to dairy, or changing within a particular form of agriculture such as rice to cotton. The investment required to undertake this change, typically in the form of additional working capital and new infrastructure and equipment, is critical to maximise Australia’s production value from its finite resource.

For investment in Australian agriculture to be justified farm businesses must be able to market our food to export markets and realise premium prices cost effectively. This requires investment in:

- Logistics infrastructure, such as on farm storage or transportation infrastructure, that can efficiently deliver our food on time, in good condition and to the requirements of markets; and
- Marketing, such as identifying opportunities and developing in-country sales and distribution capabilities, to maximise prices and ensure Australian farm businesses can justify investment further back along the value chain.

The combination of this investment will support successful outcomes by optimising farm management and asset allocation, maximising farm efficiency and the value of production while ensuring Australian farm businesses realise prices that justify new investment.

Facilitating this investment will allow Australian agriculture to realise its full potential and maximise the value of production from Australia’s finite agricultural resource.

So how do we fund this investment, what is impeding investment, and what can be done to facilitate investment?
AGRICULTURAL FUNDING OVERVIEW
The sources of finance for investment are diverse and each has its own characteristics which vary significantly from one source to another. Australian agriculture has historically been financed through a combination of debt and internal equity passed from generation to generation.

Internal equity, comprising owner and family equity, is generated through a combination of asset appreciation and retained earnings. Internal equity is an effective source of funding given the strong alignment between equity providers, management and the long-term creation of value. However, it is finite and changes in distributions within family structures are impacting its supply.

Australian’s are living longer and expectations from retirement are increasing. Overseas holidays are no longer considered a luxury, and a home in the city is increasingly common. Adding to this is changes in cultural practices in such a way that farms are passed between generations as they were and there is a broader distribution of equity to family beneficiaries that is bringing forward the need to plan and implement succession.

These changes are utilising funds that would otherwise exit the sector. In cases where these conflicts have not been managed, equity has been withdrawn from the sector and is typically replaced by bank debt. Debt is an important source of finance for Australian agriculture and is relatively cost effective. Over the last two decades the level of debt held by the sector has risen dramatically and is broadly distributed proportional to operational profitability, with higher performing operations carrying a higher debt level. This increase in debt is highly correlated with the increase in land prices experienced over the last 20 years (Refer Figure 3.1). Farm numbers have reduced by a third over this period with bank debt being the primary source of financing to support this consolidation.

Trade finance, which is a more specific form of debt, is sourced from a combination of supplier and buyer trade counterparties and is unique in that these counterparties generally have an equivalent understanding of the agricultural sector and global market conditions. Trade finance provides financing highly aligned to working capital requirements and business seasonality. To date, trade finance is primarily provided by suppliers, such as those providing farm inputs and machinery, with limited involvement from buyers of production. While trade finance presents an opportunity to better structure and provide more effective debt

13. As of 2012-13, broadacre and dairy farms only, Agsurf farm surveys, ABARES.
financing, given total debt levels are already high, in isolation there is limited scope for it to play a role increasing overall funding levels.

Since the 1990’s the ratio of debt to income has increased rapidly to 200%. This change in debt ratio was closely correlated with appreciation in land prices. Following the global financial crisis this relationship was no longer evident with land prices falling while debt levels were increasing. Given the reliance on asset values and gearing ratios by Australia’s banking institutions, this presents a significant challenge for Australian agriculture and will limit scope to obtain additional debt financing without changes to either asset values, profitability, or the variability of profits.

While internal equity and debt financing sources will play an important role in the future funding mix, there is an urgent need to develop alternative sources to meet the sector’s investment requirements.

External equity involves the provision of capital and management expertise by different stakeholders and can involve separating farm business ownership between land and operations. While this has the advantage of aligning the relative competencies of each party, capital for investors and operational competency for farm business managers, it can introduce conflicts of interest between the land owner and operator where one can be advantaged over the other through land management practices.

External equity represents a small share of current funding in Australian agriculture. Farm managers commonly perceive external equity as too costly, complex, impractical and unsuited to agriculture. While some of these concerns may be well placed, much stems from a deficit in the requisite skills and expertise to manage external equity and operate with the associated governance and reporting obligations.

Australian’s are living longer and expectations from retirement are increasing. Overseas holidays are no longer considered a luxury, and a home in the city is increasingly common.
THE BROAD TYPES OF EXTERNAL EQUITY ARE:

**RETAIL**
- Comprises funds held by individuals, self-managed superannuation, and high net wealth individuals (“HNWI”) managed by, or under the oversight of, the beneficiary of these funds. Self-managed superannuation funds alone now total around $560 billion in Australia.\(^\text{14}\)
- Few investors have exposure to agriculture other than a limited number of ASX listed equities or Managed Investment Schemes (“MIS”).
- Key factors in terms of investment in agriculture:
  - Typically have strong understanding of small-to-medium enterprise (“SME”) business and the non-agricultural business issues faced by farming businesses;
  - Flexible source of funding given the diversity of parties and their preferences in terms of risk, return, investment horizon, etc.; and
  - Currently limited agricultural investment options as most investments require significant agricultural knowledge and expertise.

**INSTITUTIONS** (domestic and foreign pension funds)
- Comprises funds managed by third parties on behalf of beneficiaries with domestic funds of around $1.2 trillion and global funds in excess of $29 trillion.\(^\text{15}\)
- Varying degrees of investment in agriculture to date with foreign funds having the greatest levels of activity, particularly in the USA, Canada and Brazil.
- Key factors in terms of investment in agriculture:
  - Domestic fund managers operating on shorter timeframes, typically less than 10 years, whereas foreign fund managers have longer time horizons better aligned with the agricultural business cycle;
  - Australian market has a lack of scaled investment entry points acting as a barrier to initial investment or limiting the effectiveness of investments;
  - Domestic funds typically consider agriculture an ‘alternative investment’ where it competes for funds against other unlisted asset classes, such as private equity and infrastructure, rather than being treated as real estate which is the primary asset; and
  - Domestic funds perceive that agricultural investment cannot deliver returns that meet hurdle rates of return, typically in the low teens, or that returns are not commensurate with the risk associated with the sector.

**PRIVATE EQUITY**
- Comprises business development, turnaround or arbitrage funds managed by third parties on behalf of institutions or high net worth individuals.
- Limited investment in Australian agricultural production with examples limited to:
  - Integrated intensive agriculture, such as horticultural production, with operations extending into processing and marketing; and
  - Agricultural services such as freight, farm inputs, and processing activities.
- Key factors in terms of investment in agriculture:
  - Investment structures unsuited to agricultural seasonality and business cycle typically involving short term investment horizons of around five years; and
  - Investment potential limited to niche high value, high risk opportunities where annualised returns in excess of 20% can be achieved, such as conversion or post farm gate.

\(^\text{14}\) As of June 2013, Australian Taxation Office.
\(^\text{15}\) Global Pension Assets Study 2013, TowersWatson, 2014
Comprises foreign investors and sovereign wealth funds who are typically long term investors seeking to secure long term supply or leverage long term global investment themes.

Moderate activity to date with significant investment from the Middle East and increasingly from Asia.

Key challenges in terms of investment in agriculture include:
- Public perceptions of the potential costs and benefits from foreign ownership in Australian agriculture;
- Cultural and social differences are acting as a barrier to investment and successful outcomes.

Funding source summary

Of these different sources retail and institutional funds have the greatest potential for Australian agriculture due to known current interest, limited regulatory hurdles and close cultural alignment. However, a key challenge with external equity is connecting compatible farm businesses and investors. Given external equity is a relatively new source of funding, this connectivity requires the development of new relationships between parties with significantly different backgrounds. When compared with the success of Australia’s mining sector that raised significant funding through large corporations and hundreds of listed exploration companies, Australian agriculture has few parties promoting investment in a similar way. There is a critical role for professional advisors to act as intermediaries identifying and connecting suitable parties, assisting with the development of relationships and opportunities and driving investment while capital is available.

With traditional funding sources constrained, external equity, with its relatively infinite supply, offers the greatest potential for new funding and investment in agriculture. External equity is not without its challenges, such as potential conflicts between investor and manager, which must be overcome if agriculture is to fully utilise this funding source. Investment structures have the potential to address some of these challenges and facilitate funding for Australian agriculture.
Funding structures

Funding structures utilised to deploy internal equity, bank debt and trade finance are common place and well understood in the agricultural sector. These structures, while less than perfect, have been effective and include:

- Internal equity in the form of ‘vanilla equity’ utilising trusts, companies or direct ownership;
- Bank debt in the form of term loans and overdrafts; and
- Trade finance from suppliers in the form of machinery loans, deferred terms for inputs and livestock.

Given the current debt profile of the sector, there is limited scope to increase funding from debt, however there is potential to provide greater working capital funding through trade finance and improve the effectiveness of these structures to optimise the use of existing funding in the sector.

Working capital financing and production insurance are key issues for farm businesses.

There is potential to pool farm or leverage cooperative equity to optimise the use of existing financing.

External equity has different characteristics that require different structures to align the preferences of each investor group.

There are a diverse range of structures for external equity that offer varying degrees of operational risk, certainty of returns and potential application in the sector.
Working capital facilities

The availability of working capital financing is critical to the success of agricultural enterprise, as with any enterprise. This financing is increasingly important with expenditure relating to annual farm production having increased by 34% over the 10 years to 2013.\(^{16}\)

While bank debt has been a traditional source of overdraft facilities, this typically involves security over the total farm business assets. Further, this rarely involves the provision of new financing specifically for working capital, such as inputs or inventory, where security is limited to these new assets. This effectively limits debt financing to those businesses with surplus equity, even though cash flows derived from new investment may fully support the debt necessary to undertake this investment.

Rural services companies have traditionally provided this financing through trade finance facilities, however in recent times this source has failed to meet the needs of the market, particularly livestock related financing. A concerning example is the recent situation in the Northern Territory cattle sector following poor seasonal conditions and suspension of the live export trade that has restricted the financial capacity of many farming enterprises. The resulting limited borrowing capacity through bank debt (supported by land valuations) has restricted restocking required to capitalise on favourable seasonal conditions and renewed export market demand.

This is a profit opportunity for Australian agriculture that has not been fully realised due to funding constraints.

Constrained seasonal finance from the rural services sector is a result of a number of factors including challenging financial circumstances in respect of service providers and unsuccessful attempts to restructure seasonal lending offerings. While rural services company’s credit policies are now more rigorous, crop related working capital requirements are relatively well funded through deferred terms for farm inputs. However, funding for livestock is challenging which has resulted in a significant funding gap that is impeding investment in assets that would increase production and profitability from Australia’s existing agricultural resources.

Our investigations reveal the provision of financing by banks for short term working capital facilities is not currently economic due to regulatory and service costs rendering these loans unviable from the lender’s perspective. Further, while banks are generally comfortable with security arrangements under the Personal Property Security Act 2009 there are concerns as to how this security is realised when it relates to assets such as crops and livestock.

There are now a number of specialist finance providers operating in the market for livestock financing, although rural services companies remain the best placed to provide financing with low service costs through existing networks that provide deep borrower knowledge in terms of capability and circumstances. Further, they have the necessary expertise and market activity to manage and realise security through livestock agency networks.

\(^{16}\) Farm costs 2002-03 to 2012-13, ABARES
Production risk mitigation

Australia is at a distinct disadvantage compared with other major producers such as Canada, Brazil and the USA due to a lack of crop related insurance products that provide risk mitigation in respect of poor, seasonally driven, production outcomes as current insurance is limited to hail, fire and post-harvest events.

A key priority for insurance is to ensure it does not result in any unintended consequences such as encouraging risk taking. This is particularly relevant where insurance covers profits encouraging planting otherwise not supported by prevailing seasonal conditions. Australian farm businesses need insurance that protects annual investment in working capital to reduce risk, not encourage it.

In respect of cropping this is changing, with a number of products available in the market for the 2013/14 season. These products, such as the multi-peril policy by Latevo and the spring rain policy by Pro Crop allow farm business to mitigate seasonal risk, to varying degrees, and replace working capital that would otherwise be lost in the event of poor seasonal conditions.

While the majority of industry participants are supportive of this insurance, there remains scepticism in respect of the cost and risk mitigation effectiveness of products currently available in the market.

The development of a fully functional and competitive market will minimise the cost of such insurance and encourage uptake while at the same time minimising potential financial demands on government for drought related assistance. The key risk to the development of this market is an adverse event while insurers are in the process of building a diversified portfolio. Reaching a critical mass and diversifying insurers exposure as quickly as possible mitigates the risk of such an event occurring.

Production insurance would allow managers to reduce the variability of earnings and the entire risk profile of their business providing confidence to all sources of funding which would encourage investment in the sector.

In respect of debt, production insurance would support the separation of different financing facilities and the alignment of these structures with the assets they relate to. Historically the security supporting these facilities has been linked, leading to outcomes where low risk assets, such as land, are used to support high risk assets, such as working capital. The consequence of this has been the contamination of the security profile of each respective facility leading to overall higher borrowing margins and sub-optimal security arrangements. Quarantining each structure to the asset it relates would result in significant benefits including:

- Better alignment between lender risk appetite and asset risk profile allowing the optimisation of borrowing margins;
- Enhanced security profile with higher risk funding aligned with higher risk security, and vice versa, reducing the overall risk to borrowers;
- Improved ability to manage adverse events and recover from poor seasons.

While insurance will come at a cost, the development of a competitive and efficient market should ensure policies are cost effective. The industry needs to embrace insurance if the market is to develop and reach a critical mass that attracts competition and reduces costs, however this will only occur if products offer cost effective risk mitigation to farm businesses.
**Pooling farm capital**

While the Australian agricultural sector has undergone significant consolidation, many operations continue to operate at scale inconsistent with optimum efficiency. While the size of the average Australian cropping farm has increased by around 65% over the last 10 years\(^{17}\), many farming enterprises remain sub-optimal in terms of scale. There is potential to improve performance of these farms by combining the capital and assets of multiple operations to increase scale to optimum levels.

One such structure involves the establishment of a new Collaborative Farming Venture (“CFV”) that combines the assets and expertise of multiple farming operations by leasing the land from the existing owners with all operating assets transferred into the new entity. This can include leasing or share farming additional land from third parties.

The advantages of CFV’s include advantages based on the development of scalable operating units that allow the efficient use of labour and machinery, including through upgrading and rationalisation to align with the increased scale of the operation. While these benefits may appear obvious, it is the advantages relating to the establishment of a professional business governance structure that oversees the CFV that is responsible for improved decision making and business outcomes through:

- Transparency and management accountability to a board;
- Independent board representation to provide objective input and advice;
- Strategic planning to support long term business initiatives in terms of productivity, innovation, growth and risk management; and
- Financial reporting that is timely and sufficiently detailed to inform the board. This supports more disciplined business assessment while the board provides complimentary expertise and guidance to management to support improved business outcomes.

While our main focus was to create a higher level of efficiency and profitability through collaboration, the real benefits go beyond this. The professional style management and governance structure has yielded some of the largest positive impacts. So far this has included instilling a business that is professional in its approach, has an effective decision making process, is focused on building business relationships across the whole supply chain and has a high level of accountability and transparency.

John Gladigau, Bulla Burra collaborative farming enterprise.
Co-operative equity

Farmer owned co-operatives contain significant equity that has limited utilisation by farm businesses due to its illiquidity. It cannot be accessed and consequently it is not recognised by financiers and other industry stakeholders. Co-operatives typically evolved through the provision of critical services that were not available in the private market. Over time co-operatives have the potential to create significant value within their ownership structures. Further, changes in the structure of the market and the activities of co-operatives can lead to situations where the current capital structure is no longer necessary or optimal for the co-operative or its members.

One such example, the Bega Cheese farmer owned co-operative (“Bega”), was established to provide dairy processing and marketing services to its members in the Bega Valley. Overtime Bega expanded its operations into activities unrelated to its members including procurement of milk from outside the Bega Valley from suppliers who were not co-operative members. Over this period the market had evolved competitively with prices set by global rather than local factors. The Bega co-operative was privatised in 2011 through an initial public offering (“IPO”).

A key concern of Bega’s shareholders was the potential for market failure under private ownership which could lead to lower prices. However, transparent global prices combined with permanent and temporary structures put in place as part of the IPO, such as farmer Board representation and a shareholder cap respectively, were seen as sufficient safeguard for suppliers under the new ownership structure. In the case of Bega it was no longer necessary for growers to own and control their processing and marketing operations.

Alternatively, co-operatives can optimise their capital structure without changing voting rights through non-voting equity structures, such as Fonterra Co-operative Group Limited’s (“Fonterra”) share unit listing. While this structure minimises the funding demand on Fonterra to meet its obligations, it has the added benefits of creating a liquid market to set prices for transactions between members and provides a liquid market allowing members to buy and sell shares and manage their total business funding requirements.

There are currently multiple co-operatives in the Western Australian market that have potential to release capital to the agricultural sector. This has been considered in the past and co-operatives and their members should evaluate on an ongoing basis whether all, part or none of the operations and services currently undertaken are necessary in light of the current market structure or whether the current capital structure is optimal in the context of grower member priorities.

The Bega Cheese co-operative shareholders were the owners of the company. It was our Board’s responsibility to objectively present the different options to our shareholders and to accept their judgement on the future for Bega. Ultimately our shareholders chose to realise the value that had been created within the company. This was on average $1.6 million per shareholder on listing, which has subsequently increased to $4 million today for those shareholders who have retained their shares. This has supported a range of shareholder funding requirements while improving the flexibility of the company.

Barry Irvin, Executive Chairman, Bega Cheese Limited

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External equity structures

While developments relating to the better use of existing equity and debt within the agricultural sector may support significant new investment, it will not necessarily provide the vast additional funding required to be competitive and capitalise on the global ‘safe’ and ‘trusted’ food opportunity. This requires the encouragement and application of structures that can deploy large amounts of external equity.

External equity is provided under a diverse range of structures arising from the individual characteristics of the source of funds in terms of preference for exposure to operating responsibility and income risk.
• Leasing typically involves terms of 3 to 5 years with a set annual fee (approximately 3% to 5% of the underlying land value) that may increase each year. Leases operate under broadly accepted terms and conditions.
• Leasing, along with share farming, represent the most common structures utilised to deploy external equity in the Australian market. This is particularly the case in Western Australia which has the deepest leasing market.
• Lease costs are typically rigid and do not accommodate for seasonal variability. There is generally a winner and a loser depending on the season.
• Leases appear to provide an operational responsibility and income risk free structure, however this is only in the case of efficient and liquid leasing markets where lessees can efficiently be replaced without material re-leasing costs or pricing risk.
• Leases can result in conflict between the land and operating entities in terms of land care and improvement given the operating entity does not share in any value retained or created in the land.

• Share farming typically involves sharing farm profits between the land owner and farm manager. However, terms vary widely within the industry with no standard industry framework that is accepted by stakeholders.
• Share farming, along with leasing, represents the most common structures utilised to deploy external equity in the Australian market, however this is not so in Western Australia where share farming is less common.
• Share farming costs are linked directly to financial performance in any given year providing flexibility to manage seasonal variability in terms of land costs.
• Share farming structures limit exposure to operating responsibility. While the risk of default may increase this exposure, the flexibility of the structure mitigates default risk significantly.
• Share farming can result in conflict between the land and operating entities in terms of land care and improvement given the operating entity does not share in any value retained or created in the land.

• New Zealand sharemilking involves the provision of land (50/50), or land and a dairy herd (lower order), to a manager who is responsible for the operation of the total farming enterprise. Lower order agreements are governed by a legislated contract with 50/50 agreements a variation of these terms. Sharemilking is in many ways equivalent to share farming in Australia, albeit with the benefit of standardised terms understood and accepted by all key stakeholders.
• Sharemilking is broadly accepted in the New Zealand dairy market being utilised by around 35% of the total number of farms. This includes 24% operating under 50/50 agreements and 12% operating under lower order agreements18.
• Sharemilking costs and milk revenues are shared between the land owner and sharemilker resulting in no fixed land costs. The terms vary between 50/50 and lower order, with the sharemilker responsible for all, or some, of the operational costs while the land owner is responsible for the costs of maintaining the land.
• Sharemilking limits conflict between the land and operating entities as the landowner is responsible for the cost of maintaining the land including building infrastructure, fertiliser and fencing.

18. New Zealand Dairy Statistics 2012-13, DairyNZ
Joint ventures such as equity partnerships and co-investment, involve a combination of external equity, manager equity and debt finance through a partnership, trust or company structure. This structure typically owns and operates the total farming enterprise sharing profits based on performance. Equity partnership agreements may provide for the manager to increase equity ownership over time.

Equity partnerships are commonplace in the New Zealand dairy industry, however there are limited examples in the Australian market.

Equity partnerships involve a flexible cost structure for the manager who is remunerated based on farm performance.

Equity partnerships ensure alignment between external investors and managers with both stakeholders participating in the value created in land.

Asset management involves the provision of external equity that is under the control of a ‘manager’. These managers are remunerated based on investment performance and other factors including assets under management.

Asset management is increasingly common in the Australian market with numerous managers having raised and invested funds in the sector. However the structure is generally perceived unfavourably by institutional and retail investors as a result of a number of poorly performing investments.

Asset management structured appropriately can limit conflict between the external equity investors and the manager through aligned remuneration models, however some structures deployed to date have failed to do so with managers profiting while investors achieve returns materially below expectations.

Public ownership involves external equity sourced through a company listed on a publicly traded share exchange from retail and institutional investors. These funds are typically deployed, in combination with debt, through a farming model that includes direct asset and business ownership.

There are examples of public ownership investments in Australian agricultural production. However, these companies typically trade at significant discount to asset value reflecting a misalignment to investor preferences focussed on short term earnings rather than long term value creation.

Public ownership results in strong alignment between land and operating assets given it typically involves ownership of the total enterprise.
Property trusts involve external equity sourced through either listed or unlisted trusts from retail and institutional investors, with the funds deployed through other external structures, such as leasing, share farming or equity partnerships, seeking to minimise exposure to operating responsibility and/or financial risk.

Property trusts have had limited success in Australian agriculture with a number of trusts established to fund MIS land requirements having experienced poor outcomes arising from poor investment strategies and single tenant exposure.

Property trusts typically have the same characteristics as leasing and require the development of deeper, more liquid external equity markets to provide the characteristics sought by investors.

Listed property trusts have the potential to overcome asset allocation constraints by providing liquidity and allowing agriculture to compete with other asset classes within domestic institutional allocations.

### Figure 3.2: External equity structure summary

<table>
<thead>
<tr>
<th>External equity comparison</th>
<th>Pro's</th>
<th>Con's</th>
<th>Potential for additional funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leasing</td>
<td>• Existing market acceptance&lt;br&gt;• Generally accepted terms and conditions&lt;br&gt;• Allows manager to build equity</td>
<td>• Inflexible cost to manager&lt;br&gt;• Potential conflict between land owner and operator</td>
<td></td>
</tr>
<tr>
<td>Share farming</td>
<td>• Existing market acceptance&lt;br&gt;• Flexible cost to manager&lt;br&gt;• Allows manager to build equity</td>
<td>• Potential conflict between land owner and operator&lt;br&gt;• No generally accepted industry terms and conditions</td>
<td></td>
</tr>
<tr>
<td>Joint ventures</td>
<td>• Flexible cost to manager&lt;br&gt;• Alignment between land owner and manager&lt;br&gt;• Ideally suited to SMSF investor pool</td>
<td>• Limited market acceptance in Australia&lt;br&gt;• No generally accepted industry terms and conditions in Australia</td>
<td></td>
</tr>
<tr>
<td>Property trusts</td>
<td>• Potential to solve institutional liquidity constraints</td>
<td>• Requires further development of leasing market</td>
<td></td>
</tr>
<tr>
<td>Sharemilking</td>
<td>• Proven structure adaptable to Australia&lt;br&gt;• Flexible cost to manager&lt;br&gt;• Alignment between land owner and manager</td>
<td>• Application limited to dairy&lt;br&gt;• No generally accepted industry terms and conditions in Australia</td>
<td></td>
</tr>
<tr>
<td>Asset management</td>
<td>• Access to large capital pools&lt;br&gt;• Flexible cost to manager</td>
<td>• Perceptions based on past performance</td>
<td></td>
</tr>
<tr>
<td>Public ownership</td>
<td>• Liquid investment structure</td>
<td>• Misalignment with investor preferences</td>
<td></td>
</tr>
</tbody>
</table>
There is no ‘magic’ structure that will support the needs of all investors and farmers. It will take a combination of all available options if Australia is to maximise the funds it can obtain for investment.

Of the external equity structures reviewed, leasing and share farming present the greatest opportunity given existing market acceptance and the development of more liquid markets will enhance the effectiveness of these structures.
4 CASE STUDIES
Although a recent softening has occurred, the New Zealand dairy market has experienced significant growth in both dairy farm numbers and production over the last 10 years (Refer Figure 4.1). While the increase in milk prices has supported this growth, it is not the only factor, as milk production in Australia has reduced over the same period.

The New Zealand dairy market has a number of characteristics that have attributed to this success, namely:

• a free trade agreement with China which is a major buyer of dairy production from New Zealand;
• a highly successful marketing co-operative that has invested in market development and infrastructure to support export sales growth;
• a transparent and well organised industry with timely and readily available farm production data, on a region-by-region basis, allowing benchmarking and independent assessment of individual farm performance; and
• a range of external equity structures that have facilitated succession and the effective deployment of significant capital to support this growth.

These structures provide managers at each stage of the internal equity cycle with funding options that facilitate the development of equity over time and the progression from limited equity through to levels where a farmer can own the entire farming enterprise (Refer Figure 4.2).

- Lower order sharemilking structures fund around 12% of dairy farms in New Zealand. This structure provides managers a funding option where minimal internal equity exists, which is typically the case for new managers without family support and equity. For example, a manager would only need sufficient equity to fund labour and supplementary feeding which is generally not necessary.
- 50/50 sharemilking structures fund around 24% of dairy farms in New Zealand. This structure provides managers with a small amount of existing equity to transition to asset ownership through the herd without the need for sufficient capital to own land.

20. New Zealand Dairy Statistics 2012-13, DairyNZ.
Under both sharemilking structures managers operate their own business and share in profits as though they had ownership in the total farm enterprise.

- Equity partnership structures are considered part of the owner-operator class for reporting purposes and as such no specific data is available. Equity partnerships provide a structure to pool capital from multiple investors, including the manager, resulting in scale that otherwise wouldn’t be possible.
- Owner operator structures fund around 64% of dairy farms in New Zealand including equity partnerships. Owner operators require full internal equity to fund the farming enterprise and are considered the final stage of the ownership cycle\textsuperscript{21}.

The advantages of these funding structures include:

1. Sharemilking provides top performing managers with a means to generate equity over time and make the transition to higher equity structures;
2. The presence of a liquid sharemilking market provides certainty for retiring farmers that if they retain investment in farm land there is an efficient market to generate income with low tenancy risk. This encourages the retention of external equity within the dairy sector that would otherwise need to be replaced; and
3. Equity partnerships provide a structure that allows external equity, particularly from sources with limited agricultural experience, to invest alongside management. This has advantages to managers providing the capital they require, while providing advantages to investors with a manager aligned investment that reduces risk while offering agricultural exposure that may not otherwise be viable.

There have been attempts to utilise sharemilking structures in Australia. While unsuccessful to date, these ventures failed to take into consideration the differences in farming practices, management requirements and the associated impact on the economics of the New Zealand sharemilking structures.

Australian dairy operations generally require increased management expertise, particularly in respect of pasture fertilisation and irrigation, due to Australia’s inferior soil quality and rainfall. Further, Australian dairy operations often require additional grain feed supplements as the resulting pasture lacks nutrients compared with New Zealand. These factors distort the financial returns from sharemilking and consequently require the adaptation of these structures to suit the Australian operating environment. However, our investigations suggest that with adaptation New Zealand structures could provide the same benefits to the Australian dairy market. The development of liquid and broadly accepted share farming and equity partnership markets has the potential to replicate the success in attracting external equity as has been the case in the New Zealand dairy sector.

The application of these structures is not limited to dairy farming in Australia. Other types of agriculture are in need of the same benefits realised in New Zealand dairy and there is no reason why similar standardised structures cannot be developed for cropping or livestock.

\textsuperscript{21} New Zealand Dairy Statistics 2012-13, DairyNZ.
Learning from our own success: Professional management structure

Carrawingee Farms is located near Yuna, north-east of Geraldton, and is managed by Brady and Erin Green. The business comprises 8,800 hectares focussed on broadacre cropping.

In 2009 the Green’s were 2 years past the 2006 and 2007 drought years, had purchased neighbouring farm land, were in the early stages of farm business succession and in their second year of implementing a major change within their business, controlled traffic farming, which required significant new investment. Having heard about the advantages of a board in terms of supporting management and improving outcomes, it was at this time the Green’s decided to create an advisory board to help management through this challenging time.

The board comprised Brady and Erin Green, Brady’s parents and three independent directors with complementary expertise to management in respect of financial management, controlled farming system production and agribusiness. The new board, with assistance from a business advisory professional, went about developing the board policy, such as management reporting requirements and the development of a strategic business plan.

Common concerns raised about boards include the loss of control and costs associated with directors and preparation for board meetings. While these costs are real and can be significant, successfully implementing a board can yield benefits that far outweigh the costs.

Control
While private company boards involve additional management oversight, they rarely have veto powers over management. In these circumstances, a board’s primary responsibility is to provide guidance and independent advice to management, however ultimately the decision rests with management and owners. Further, through the reporting and decision making process the board structure requires, it enhances the level of control management has over the business. Management is held accountable in respect of decisions made, how they are implemented and the outcome realised. This re-enforces the need to diligently consider all major decisions, to learn from past experiences and leverage all available expertise in the business.

Costs
The establishment of a board will involve additional cost in terms of director’s fees and internal management costs. The requirements of boards will inherently involve significant work to prepare management and financial reports that ensure directors have sufficient information to understand the business and the issues it is facing. However, it can equally be argued that management should use this same information to properly manage the business. Preparing a budget that is only used at the end of the year to track performance ignores the underlying purpose of the budget, to manage and correct business performance throughout the year. It is a management tool, not a report card.

Likewise, understanding and tracking key performance indicators (“KPIs”) within the business and the effect of management initiatives enhances management’s ability to realise better results. It instils a discipline to make informed decisions as management is measured and held accountable.

The other major advantage of a board is access to a broader range of expertise that is complimentary to management. This expertise helps management with general business skills that may not otherwise be a strength of management, such as procurement of production inputs and machinery, marketing and financing. Further, this expertise supports management and shares the decision making responsibility, reducing the stress of farm management.
It was hearing about another farmer’s success in implementing a board and how the board was able to support them to improve their business that encouraged us to pursue a board for our business. It involved a significant amount of work, and was confronting as we were now revealing all to people from outside the family, but given it was such an important and challenging time for our business we thought it would be worth the effort.

The perceived loss of control has been raised with us on multiple occasions. From our perspective, the changes we have made make us realise that we now have far better control over our business. Our board provides broader business experience to analyse the issues we are confronted with from different perspectives. The board is invaluable in providing objective and independent advice to guide management and help us arrive at better decisions, however ultimately we make the decisions.

We have always had access to KPIs through our farm consultant. However, it wasn’t until we started reporting for board meetings that we began to closely track our KPIs over time. Rather than using KPIs to see how we compared to other farmers, it became a tool to manage ourselves against past performance and decisions that were made within the business. Our KPI’s are now more focused on our progress over time, rather than our performance compared to others.

There are times when preparing for board meetings that we question whether all the hard work is worth it. However, following board meetings we consistently look back and think ‘we have achieved so much and are totally focussed on what we have to do’. There is no question that having a board has improved our business’ performance, we better manage risk and have created significant financial value by leveraging our boards expertise and the disciplines it requires. Above all, being able to work through challenges with a board that is objective and only thinking about what is in the best interest of our business has significantly reduced some of the stress of farming.
Learning from our own success: business separation

The ownership of land and operations within the farm businesses is the traditional farm structure used within the Australian agricultural sector. This structure has served agriculture well in the past and is the foundation of Australia’s current standing in the global market, however in the current environment funding is constrained and is limiting further investment. Farm businesses need to consider whether they could achieve superior returns by reducing their investment in land and increasing their investment in operations, in particular working capital.

Farm land yields relatively stable long term returns comprising an annual capital and cash return. Long term capital returns average 3% per annum while cash returns, which are theoretical for farms where land and operations are combined, are around 4-6% using lease rates as a proxy (Refer Figure 4.3). Returns realised by farming operations above these levels are attributable to the operating business.

The Planfarm Bankwest benchmark data up to and including the 2012/13 season shows the return on capital for the top 25% of broadacre farms in Western Australia was 7.5% per annum averaged over the prior 6 years. This return comprises an operating return on land and a return on operations.

There is significant opportunity for farm managers to leverage external equity to fund land for business expansion. This could include increasing farm scale where managers have excess equity to fund additional working capital, or the sale of land to provide working capital with owned land replaced by land funded through an external equity structure such as leasing or share farming. The benefits of this include:

- Aligning farm manager investment in farming operations where managers have a comparative advantage, rather than land assets that are more capital intensive and better aligned to capital rich investors;
- Leveraging external equity to increase farm scale and improve operating efficiencies;
- Increasing the total returns that can be realised by farm managers from any given level of internal equity amount;
- Optimising the use of equipment across a significant area to avoid over investment in machinery and other infrastructure; and
- Reducing exposure to the agriculture sector where funds realised from a sale are partially invested in other assets.

This analysis demonstrates the potential financial advantages to farm managers by aligning investment in the operating business and utilising external equity to fund capital intensive land requirements. What this analysis doesn’t include is the potential operating efficiencies which could significantly increase the financial returns to farm managers over and above the levels shown.

Leasing is often viewed unfavourably by farm managers due to concerns around losing control of the land. While a sale does involve the loss of exposure to future capital appreciation, it doesn’t necessarily mean a loss of control. This highlights the importance of a well-structured lease that includes terms to protect lessee’s long terms interests, such as rights of renewal and purchase options, and partnering with investors that are seeking complementary investment exposure. This is the case for many institutional and retail investors that are seeking more stable annual returns and long term capital growth. These investors would likely consider operational exposure as a risk that as detracts from the investment case rather than an opportunity.
We decided to sell and lease back our land with an institutional investor. As part of this the institutional investor acquired a nearby property that we also leased. Through this structure we are able to operate an efficient farm business by fully utilising our management capacity and equipment. It has also allowed our family to reduced our exposure to agriculture to assist with other family funding requirements while increasing the return we realise on our equity invested in agriculture.

Chris Henderson, Gregmaun Farms

Figure 4.3 Farmer returns under different land ownership models

Table: Farmer returns under different land ownership models

<table>
<thead>
<tr>
<th>Farm Manager Equity ($M)</th>
<th>Total Farm Assets ($M)</th>
<th>Farmer Manager Return ($K)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owned land only</td>
<td>$0M</td>
<td>$0K</td>
</tr>
<tr>
<td>1/3 owned &amp; 2/3 leased</td>
<td>$10M</td>
<td>$15K</td>
</tr>
<tr>
<td>Leased land only</td>
<td>$20M</td>
<td>$600K</td>
</tr>
</tbody>
</table>


23 Based on a farm manager equity investment of $2.5M, loan to land value borrowing ratio of 50%, land to operating capital ratio of 8:1, average operating returns of 7.5% based on Planfarm Bankwest benchmark data with no additional operating efficiencies included as farm scale is increased.
Learning from others’ success: new external equity investment in agriculture

There are examples of institutional and retail investment taking place in Australian agriculture that demonstrate success is possible through using a range of different investment models that combines different external equity structures. These structures are based on the separation of land and business ownership whereby external investment in land is leveraged by farm businesses to increase scale or free up funding for new investment.

Just as retailers do not need to own the shopping centre, farmers do not need to own the land. Most retailers focus their investment in their area of expertise, operations, and rely on property developers to build and own the locations from which they conduct their business.

Pension fund investment

One of the largest pension fund investors in global agriculture is TIAA-CREF, a US based financial services company. TIAA-CREF is the manager of two global agriculture funds representing an estimated US$3.5 billion managed on behalf of its own pension funds, and other pension fund managers including AP Fonden 2, British Columbia Investment Management Corporation and the Caisse de dépôt et placement du Québec.

TIAA-CREF has undertaken significant investment in farmland in the USA, South America and Australia. It has been speculated that to date Westchester has acquired around $1 billion of farm land in Australia.

The primary external equity structure utilised by TIAA-CREF in Australia involves partnering with farm managers through lease arrangements. This will typically involve a collaborative approach to identify the right property that meets the criteria of the farm manager, and then acquiring the property with a lease to the farm manager at around 5% per annum. This can also include additional capital for investment, such as land improvements and irrigation, to improve land productivity. A key advantage of this investment model is it leverages the operational capabilities of farm managers which allows Westchester to limit its asset management costs resulting in an efficient investment model for investors.

TIAA-CREF, as with other pension funds, is a long term investor to match the profile of their investor retirement demands. This long term focus is well suited to agriculture given its seasonal and asset price cycles. For farm managers, the benefits of this long term perspective are considerable compared with other sources of funds, such as public markets, allowing farm managers to make decisions that drive long term value which is consistent with the approach adopted by the traditional family farm.
Listed property trusts

Public markets are a significant source of capital that offers investors the highest levels of liquidity and the ability to cost effectively invest. While not the rule, listed agricultural companies have a history of trading at material discounts to underlying asset value which diminishes the value of utilising public markets as a source of capital. A key factor contributing to the agricultural discount is the disconnect between the profile of agricultural returns, comparatively low cash yields and long term capital growth, compared with the short term profit focus of equity investors.

For agriculture to effectively utilise public markets it must offer returns sought by equity investors. Real estate investment trust (“REIT”) investors make up a significant portion of public markets and seek stable but lower cash yields and long term capital growth. Agriculture can offer comparable returns where land is leased to operating partners.

Listed property trusts allow agriculture to access public markets with an investment offering that is valued by the market and is supported to provide funding for capital intensive land that can be made available to farm businesses.

While there have been numerous listed agricultural REIT’s in Australia, these were generally associated with MIS promoters and experienced financial hardship along with the rest of the MIS industry.

Rural Funds Group (“RFG”) is now Australia’s largest listed agricultural focussed REIT with total assets of over $240 million comprising a diversified collection of land rich assets including chicken farms, almond orchards and vineyards. RFG successfully listed on the ASX in February 2014 and since this time it has traded strongly with shares currently trading at a 14% discount to net tangible assets after listing at a 26% discount. This highlights the growing support for a structured agricultural investment that meets the requirements of investors.

While this discount may appear high, it is significantly lower than the discount of other listed agricultural businesses that do not have significant processing and value add operations that lift overall cash returns.

The example of RFG demonstrates that a property trust that utilises public markets is an effective funding source for agriculture if combined with other external equity structures, in particular leasing, that provide returns sought by equity investors.
5
KEY CHALLENGES
There are a number of challenges that are impeding investment in Australian agriculture. These challenges are largely within the control of industry and government. Australia must not be complacent and must work to address these challenges if it is to attract the maximum amount of investment in agriculture.

Australia must not take for granted its natural agricultural resource and growing Asian markets because these factors will not guarantee success. There is strong global competition for capital and Australia must ensure it provides a stable and business-friendly environment to encourage the deployment of this capital in Australia to support agriculture and the economy more generally.
Skills

The Australian agricultural sector, with its aging farmer population, faces a number of human resources challenges, in particular education and management expertise (Refer Figure 5.1). Farm performance is reliant on the quality and development of management capabilities to access funding necessary for investment in productivity and working capital. Productivity enhancements increasingly involve complex technology solutions such as precision agriculture and environmental monitoring systems. It is critical that Australian agriculture has access to a resource pool with the necessary education, training and expertise to embrace innovation and new technologies, implement change and manage funding sources that support the necessary investment.

Education

Agriculture has one of the lowest levels of university graduates in Australian industry. Worse still, the rate of graduation in agricultural related degrees has been declining over the last 10 years. This is particularly relevant in Western Australia where the rapid expansion of the mining sector over the last decade has drawn from the regional population base.

The impacts of this decline are not immediate, but accrue over time and will be significant in the medium to long term if not addressed. Australia, as a high labour cost environment, must increasingly be reliant on productivity enhancing technologies and practices to improve sector profitability and specialised education underpins our capability to research, develop and implement these changes.

Figure 5.1: Agricultural University graduate levels

Source: Australian Bureau of Statistics; Graduate Destination Survey, Graduate Careers Council of Australia.
Government training and education needs to expand on its existing production focus to include increased content on business management to provide farm managers with new skills and expertise to improve financial performance and attract equity from new sources.

Management expertise

Australian agriculture has a low level of corporatisation and independent management oversight in contrast to other industry sectors in Australia. While many farmers are not comfortable with the idea of reporting to an advisory board or independent directors, due to the benefits these management structures offer, it is now common practice in many medium to large private enterprises.

Utilisation of professional governance structures introduces new disciplines that support improved decision making and business outcomes. Further, independent board representation can add new expertise, including financial management, strategic planning and marketing, to complement management’s operational capability.

Further, as these disciplines and capabilities are developed within farm management structures, so too are the skills necessary to attract and manage funding from new sources that may otherwise be unattainable.

The approach to decision making, third party accountability, financial and operating reporting, multi-year business plans and risk management planning are all requirements common to independent management oversight and external equity. The development of these skills is essential to broaden agricultural capabilities necessary to access new funding structures.
Investor perceptions

The Australian agricultural sector currently has low levels of corporate investment. Many prior investments, such as MIS and various institutional offerings, have performed poorly and the sector is generally perceived by the Australian superannuation industry as offering an inferior risk-return profile compared with alternative investment options. This is at least in part attributable to prior investment performance which have utilised investment structures lacking commercial foundation, such as MIS, and management structures misaligned with the agricultural business cycle.

While concerns around prior investment performance are real, returns within the sector are skewed with the top 25% (by return on capital) delivering returns broadly consistent with institutional targets (Refer Figure 5.2). Returns over the last 20 years indicate an investment in the top performing farms would have outperformed the ASX All Ordinaries in all production segments.

Further, returns display low levels of correlation to equity markets and provide a means to reduce portfolio risk through diversification.

However, there are concerns within the investment community in respect of the ABARES farm surveys data which forms the basis of this analysis on farm performance and returns.

These concerns primarily relate to:
- the delay between reporting periods and publishing data of up to 18 months;
- Analysis methodology, in particular the inconsistency of population classification; and
- few controls over population data integrity and consistency of financial reporting from farm to farm due to the data being survey based.

This data is critical to support the assessment of agriculture under the methodologies required by Australia’s superannuation industry. The allocation of funds by asset managers involves the comparison of returns from different asset classes. If agriculture does not have data considered reliable it will be challenging for these managers to recommend agriculture compared with other classes where this data exists. The other key challenge for investors is assessing manager performance given the lack of data for comparison. This is particularly relevant given seasonal variability which can make it difficult to attribute performance to market and manager factors.

The development of an agricultural farm performance index would provide the necessary data to support the investment community in its assessment of agriculture as an investment class while providing a benchmark for manager assessment that allows investors to determine whether investment performance is attributable to the market, or the manager.

The NCREIF Agricultural Farm Index provides an example of an effective index that is valued by industry and should be used as a template for the Australian agricultural industry.

Figure 5.2: Farm performance - top performing 25% and middle 50%

Industry leaders, and in particular large asset managers with significant assets under management, need to support the development of a national farm performance index.

Source: All Ordinaries historical data; Agsurf Farm Surveys, ABARES.

24. The correlation between agricultural returns with the ASX All Ordinaries over the period 1993 to 2013 was 0.25, ABARES Farm Surveys and ASX.
Global competition for capital

Our investigations reveal Australia is generally considered a top tier agricultural destination for global agricultural investment capital. There is a well-established and highly regarded legal system with functional financial markets that ensure certainty and support investment. However, Australia has lost some of its appeal following a number of regulatory changes that have impacted on business conditions and introduced elements of sovereign risk into the investment equation (Refer Figure 5.3).

Regulatory

Australia’s reputation in the international investment community has been impacted by regulatory changes introducing elements of sovereign risk given these changes have impacted returns of historical investment. Examples include:

- the proposed Resource Super Profits Tax and the replacement Mineral Resource Rent Tax;
- the Carbon Tax; and
- changes to managed investment trust regulations that have effectively doubled the rate of withholding tax on all investment held as of 1 July 2013 within these structures.

These changes applied retrospectively and impact on the return on investment made under the prior regulatory framework, introducing uncertainty and legitimate concern about the stability of Australian regulations. International investors are highly critical of these changes and it has impacted Australia’s reputation as a destination for foreign investment.

State-based regulations in Australia are another significant issue for business, particularly foreign investors. Most foreign investors do not appreciate the complexity involved in operating large scale business in

![Figure 5.3: Burden of Government Regulation on business rankings](source: World Economic Forum)
Australia which in many aspects, such as workplace health and safety and the environment, present the same challenges as operating in seven different countries adding significant compliance cost.

The World Economic Forum annual business survey demonstrates the worsening impact that government regulation is having on Australian business. Putting aside the national rankings, what is most concerning is the trend where Australian business is clearly saying the impact of regulation has deteriorated significantly since 2010-11.

Investors must be confident that any investment undertaken will not be impacted by subsequent changes in regulation. Government institutions must minimise changes in regulation and ensure that any necessary changes are developed in consultation with business to limit any adverse consequences.

Agricultural policy

Australian agriculture has one of the lowest levels of government financial support in the world. While this is often criticised by segments of the Australian agricultural sector, it has the advantage of providing a relatively stable and low risk environment for investment. While the perception of the media and public is that Australian agriculture is highly subsidised, the industry is less reliant than most other markets on government subsidies and assistance, and consequently has a low risk profile in that changes in policy are unlikely to materially impact investment performance (Refer Figure 5.4). This is viewed favourably by investors, particularly foreigners, with heightened concerns in respect of policy risk. While Australia has historically ranked highly in the world, this position has fallen and from our investigations the most common grievances relate to uncertainty in respect of foreign investment guidelines and competition concerns.

Market access

Agriculture experiences high levels of trade barriers due to a combination of government subsidies, tariffs and other barriers such as quotas and food safety requirements (over and above those applied to domestic suppliers). Examples include:

- Government support payments, such as those in Japan and the Republic of Korea, where in 2010 they represented 50% and 45% of gross farm income, respectively.
- Agricultural trade tariffs average 8% in respect of Australian exports to ASEAN nations.

While this is of concern to global markets due to the distortions it creates, it presents opportunity for individual countries whose governments are able to negotiate preferential market access compared with competitors. This can be achieved through free trade agreements (“FTA”) that enhance sector profitability creating an incentive for investment compared with other markets. Government is the only stakeholder with the capability to implement these changes and favourably position Australia compared with its competitors.
As has been witnessed in other markets, such as New Zealand with the China FTA and European countries who have entered the European Union (“EU”), there are significant trade and investment flows that follow FTAs driven by reduced trading costs and improved access to the relevant market.

With Australia having recently entered into three new FTAs with Korea, Japan and China the Federal Government has made significant progress in this regard. Australian businesses must now invest in these markets to realise the full potential these FTAs offer.

Labour supply

The ability to effectively secure labour is critical to agricultural sectors. This means at a viable cost and through flexible arrangements that align with seasonal demands. Australia is now considered a high cost and inflexible labour environment with international investors in particular focussed on options to reduce the labour intensity of Australian operations or shift functionality and labour intensive activities to more cost competitive countries.

While it is easy to argue that we do not want to compete with low cost developing nations in terms of labour, these comments often relate to an ability to undertake business in other developed countries for significantly lower costs. Comparatively speaking, Australia has a labour cost problem and it is impacting foreign investors’ assessment of opportunities in Australia. Since 2000, Australia’s labour costs have increased at over double the rate of the USA and significantly above Canada and New Zealand (Refer Figure 5.5). Further, our investigations revealed a high level of frustration with industrial relations laws that limit flexibility and add further cost through regulations ancillary to labour rates. Although it is likely that the softening of the economy post-mining investment boom may improve the labour market for agribusinesses, labour market issues threaten to reduce the potential benefits to the broader community in rural and regional Australia which is reliant on employment growth and expenditure from those people working in the agricultural sector.

The cost of labour is particularly relevant to the post-farm gate sector where labour, and energy, are key inputs to add value to production. For Australia to maximise returns from its agricultural output it requires a successful post-farm gate sector and cost effective labour supply is a key ingredient to its success.

Figure 5.5: Labour unit costs for Australia and its peers

Source: FAOSTAT, Food and Agriculture Organization of the United Nations; Statistics New Zealand Tatauranga Aotearoa, New Zealand Government.
Seasonal variability

Australia has high levels of production variability compared with other major agricultural producers, in particular those countries Australia competes with for agricultural capital such as Canada, USA, Brazil and New Zealand. This variability is driven by seasonal conditions due to a combination of the level of rainfall and timing. In the case of cropping this variability is extreme and demonstrates the additional risk faced by Australian producers (Refer Figure 5.6). While New Zealand shows comparable levels of volatility in respect of meat and dairy, this volatility is magnified by the mass conversion from livestock production to dairy which is adding to this volatility.

The consequences of this variability are considerable. For example, the volatility in earnings is a key concern of investors given the implications on the timing of investment and how this can affect returns.

Volatility of earnings adds significant financial risk to operations and the need to plan for greater incidences of poor or negative returns. In particular, successive years of poor returns exponentially increase the overall risk profile given the current reliance on bank debt for additional funding.

Australia, unlike Canada and the USA, has limited access to crop production insurance tools that allow managers to mitigate the impact of seasonal variability, particularly against extreme events that can materially reduce equity. The consequence of such events can exceed the initial loss and impact on production for years to come, including:

- **Reduced flexibility to capitalise on good seasons:** lower future earnings due to constrained funding limiting input expenditure resulting in reduced yields and profits;

- **Increased fees:** additional fees and charges arising from default or renegotiation of debt terms, particularly where term facilities are impacted;

- **Lost opportunity:** the cost of not having the financial resources to capitalise on other investment opportunities; and

- **Increased interest costs:** the compounding effect of interest results in greater costs for years to come.

Insurance products have a cost, however if priced through an efficient market these costs should be offset by avoiding consequential losses and through lower borrower margins that reflect the reduced risk profile of an insured business.
Land tenure models

Australia currently has a range of land tenure models including freehold and various forms of government leases. This is particularly relevant for Western Australia where pastoral stations are the subject of Pastoral Leases that require periodical renewal.

While Australian investors are generally comfortable with non-freehold land ownership, this is not the case with foreign investors. In particular, our investigations revealed investors are concerned leases subject to government review and renewal rights could be impacted by subsequent changes in regulatory policy in response to populist concerns, such as foreign ownership and environmental management. These concerns are not easily addressed while these review and renewal rights exist.

The Queensland State Government is currently reforming state land tenure through the Land and Other Legislation Amendment Bill 2014. This Act, currently before parliament, provides for a number of measures to improve lease holder certainty and remove unnecessary regulations. This includes:

- Rolling pastoral lease renewals where leases will be renewed for a further equivalent period without the need to enter into a land management agreement;
- Allowing the conversion of a pastoral term lease to freehold land without having to first convert to a perpetual lease; and
- Simplifying the valuation for the conversion of term and perpetual leases to freehold to a ‘net present value’ of annual lease costs.

These reforms will simplify land ownership in Queensland and provide greater certainty for investors that an investment in a lease can be quickly and objectively converted to freehold land to encourage investment.

Although there are a myriad of issues such as Native Title and mining or exploration leases that pose problems for improving land tenure for agricultural pursuits, the resolution of these issues are critical for the attraction of patient capital.
Transaction costs

In agriculture, land is the primary business asset. Unlike other real estate markets, the Australian agriculture sector does not have the benefit of a deep and liquid leasing market. This leads to inefficiencies in redeploying land from one tenant to another, or from managers moving from one landlord to another.

As a consequence, a typical business sale will include land which contributes the vast majority of the business’ value. The business is the land and the land is the business.

Stamp duty

This characteristic results in a unique disadvantage in terms of stamp duty acting as a barrier to investment. Given the high value of land in any business’ valuation, stamp duty is disproportionally high in respect of the sale of agricultural businesses.

When it comes to foreign investment Australia is competing internationally with countries such as New Zealand that have no duty on commercial property, including farm land. Australia’s stamp duty rules immediately dilute investment returns in Australia by around 5% compared with investing in New Zealand. To put this into perspective, this equates to approximately a full year of cash profits from farming. Stamp duty further complicates investment due to varying rates and regulations from State to State adding to the disincentive to investors.

While stamp duty represents an important source of income for State governments and is unlikely to be removed, the refinement and harmonisation of existing policy may provide an avenue to encourage investment and remove a material impediment to investment and industry consolidation.
6
DRIVING INVESTMENT IN AGRICULTURE
Australian agriculture must continue to invest to maintain its competitive position which has come under pressure in recent times. General commodity markets are the mainstay of the agricultural industry as it stands today and being able to profitably supply these markets is a key priority for farm businesses.

The emerging opportunity for Australian farm businesses lies to Australia’s north in Asia and the Middle East. Australia is well placed with its clean, regulated and internationally regarded productive environment and significant export potential to supply this growing wealthy population that is prepared to pay a premium for safe food.

However, Australia will not realise its full potential unless it attracts funding to support significant new investment to maintain or improve competitiveness and meet the needs of high value growing markets. It will not happen on its own, it requires action and Australia faces strong competition for investment capital from other nations seeking to capitalise on this opportunity.

HIGHLIGHTS

While there are numerous factors that will impact on funding for investment, of utmost importance is supporting:

1. Farming enterprises to become investment ready to attract funding from all available sources;
2. Optimising the use of existing funding deployed in the sector;
3. Development of the market for external equity investment structures to facilitate funding from alternative sources; and
4. Direct measures to enhance Australia’s competitiveness for agricultural investment capital, particularly for retail and institutional investors.
Becoming investment ready

The majority of Australian farm businesses are not investment ready and face challenges in attracting external equity due to:

- Poor financial performance and returns on invested capital; and
- A lack of skills and expertise to operate under more professional management structures required by external investors.

There are a number of factors contributing to these shortcomings and addressing them is of utmost importance to support the transition to an investment-ready industry.

The New Zealand ‘myfarm’ initiative, a joint program between universities and industry, is aimed at improving the financial performance of farm businesses. This initiative provides farm managers with practical tools and knowledge to support improved business analysis and outcomes.

Professional farm management structures, such as advisory boards, instil greater discipline in terms of governance, planning and reporting while complimenting farm manager’s operational expertise with broader business capabilities.

Governance requires decision making transparency and drives accountability. Planning requires consideration of all operational, financial and risk matters in the context of the short, medium and long term strategic objectives of the business. Reporting requires monitoring of operational, financial and risk matters to assess performance and decision making. These practices support improved business outcomes and performance. It also supports the development of capabilities necessary to manage more complex funding structures, so that Australian agriculture can utilise all sources of funding available.

Improving farm business performance and implementing professional management and governance structures requires access to business expertise. Leadership from industry advisors with the relevant expertise will support successful outcomes for early adopting farmers who are prepared to embrace change. It will be the success of these farm businesses that drives change within the broader industry.

CONSIDERATION

Industry should further develop specialised agribusiness advisory and legal services to support farm businesses implementing professional management structures and improve financial outcomes to encourage change within the sector.
Optimise existing financing

The primary sources of funding in the Australian agricultural sector are:
- Internal equity;
- Debt, in the form of bank and trade finance.

There is scope to increase this funding and improve its effectiveness to support further investment, while recognising it is unlikely to meet the total funding needs of the sector.

There is currently a shortfall of working capital funding due to limited specific debt facilities that are not reliant on broader farm land security. This is particularly relevant for farms that have experienced financial hardship primarily relating to external factors. This is causing systemic failure to maximise profit when favourable seasonal conditions arise which is a key difference between top performing farms and the rest.

Contributing to this, Australian farm businesses do not have access to the risk management tools necessary to effectively mitigate production risk. When combined with Australia’s seasonal variability, this gives rise to greater risk than other agricultural markets which impacts Australia’s competitiveness in terms of attracting funding for investment.

Production risk management insurance assists farm managers to mitigate this risk and reduce the variability of profits. While insurance would come at a cost, effective products should offset this cost through its benefits such as reduced seasonal risk and lower interest and other debt costs. Further, insurance could potentially support expanded debt levels, particularly through working capital funding that would have a materially lower risk profile when insured. Insurance would improve the ability of Australia’s rural services sector to provide seasonal funding given the lower risk exposure to lender balance sheets.

Improved risk management insurance has the potential to reduce future government drought assistance. The Australian Federal Government has spent billions on drought assistance programs for farmers over the last 10 years. A successful insurance market would allow the transfer of this risk to global insurers with the onus on Australian farmers to insure and mitigate such risk. Farmers who take responsibility for their own risk management through insurance would have the benefit of a ‘safety net’ in poor seasons. It is important that this insurance market develops based on commercial and not government support that can potentially distort the market and introduce uncertainty in respect of product longevity.

Finally, the reduction in variability of farm profits would go some way to addressing domestic institutional investor concerns in terms of the risk-return profile of agriculture and encourage this source of funds to consider investment in agriculture.
Develop the external equity market

External equity presents the greatest source of potential new funding for the Australian agricultural sector. However, so far Australia has had limited success attracting this capital into the sector. External equity has an important role to play in supporting succession and allowing investors unfamiliar with agricultural operations to co-invest alongside capable managers to achieve mutually beneficial outcomes.

Key to the development of external equity markets in the Australian agricultural sector is standardised external equity structures that are supported and understood by all industry stakeholders. Standard terms would provide guidelines that protect all stakeholders to any agreement, including the manager, external equity investor and financier, to support successful outcomes and encourage greater adoption in the industry.

A key element of this is managing the inherent conflict between the land owner and farm manager when these roles are separated, such is the case with leasing and share farming. This conflict arises as the operating entity is responsible for farm costs, but does not share in the value retained or created in the land which can lead to asset degradation. These standardised terms should include protections to mitigate this conflict and balance the interest of both parties, particularly investors that may have less agricultural knowledge and expertise of agriculture, to support sustainable investment success.

Only when external equity markets have developed into fully functioning and liquid markets, where investors and managers can quickly and cost effectively move from one party to another, will Australia be able to fully leverage external equity sources and maximise retention of prior generation equity in the sector.

**Consideration**

Industry and Government should work together to develop innovative or contemporary frameworks for leasing, share farming and equity partnerships in collaboration with all stakeholders, including traditional finance and farm advisory providers, to provide a best practice template for use by farm businesses and investors to foster successful outcomes.

**Consideration**

Where land is leased or share farmed, measures are required to establish consistent conditions for the maintenance or improvement of the natural resource and infrastructure while the property is used by the land operator. Such documentation would assist parties to external equity contracts manage conflicts of interest. State Governments have measures for resource management which should be considered for inclusion in these contracts.
Institutional and foreign investment

Australian agriculture needs the support of domestic and foreign institutional investors to fulfil its funding requirements. However, this capital operates in a global market place where agriculture in Australia must compare favourably with other investment classes and agriculture in other countries.

Australian institutional investors are not satisfied with the data currently available for agriculture. It is not robust or timely and this limits an investor’s ability to accurately compare agriculture with other investment classes. Further, the lack of robust industry performance data makes it difficult for investors to distinguish between management and seasonal factors allowing poor investment managers to evade proper evaluation. These issues are contributing to a poor perception of agriculture within the investment community.

The ABARES national farm surveys and Planfarm Bankwest Benchmarks currently available for Western Australian broadacre agriculture show long term historical returns that compare favourably with other investment options. Further, the correlation of these returns with equity markets is low. This suggests that poor perceptions of agriculture are not warranted and robust and timely data would provide investors the tool they require to arrive at this conclusion.

In terms of foreign investors, investment in Australia must compare favourably with other options. Reducing stamp duty would directly enhance the competitiveness of Australian agricultural assets while supporting consolidation within the industry to increase the number of scaled operations sought by these investors.

A major concern of foreign investors relates to the complexity of operating in Australia where there are different sets of rules in each State which increase transaction and ongoing compliance costs. This is further complicated by multiple land ownership models within States that are perceived as having greater risk compared with freehold land. Australia is competing with the likes of New Zealand where there is one land ownership model, no stamp duty and common regulations across the entire country. Australia needs to simplify its regulatory framework and provide greater certainty to investors if it is to compete with other highly regarded agricultural markets.

CONSIDERATION

Industry requires a national agricultural performance index in Australia comparable to the successful NCREIF operating in the USA. Government could consider grant funding to assist the establishment of the index.

CONSIDERATION

Australia should enhance its appeal to international investors by harmonising state and federal regulations that impact farm ownership to simplify investment. Land tenure reform (along the lines undertaken in Queensland) and concessional Stamp Duty on agricultural land are key priorities and require a firmer resolve by Government to amend in order to facilitate investment.
CONCLUSION

Western Australia has experienced what some commentators believe to have been a once in a generation boom linked to mining investment. It would be easy for Western Australian’s to rest comfortably in the knowledge that our future prosperity is linked to the production phases of these enormous investments. However there is another view, one that proposes to use the skills sets, infrastructure and supply chains to our Asian customers established during the mining investment boom and to connect them more effectively to our smaller, yet no less determined agricultural producers. In order to take advantage of this potential opportunity Western Australian agribusinesses needs to overcome numerous challenges that cumulatively conspire to frighten investor capital away. In this report, we have outlined critical factors that need resolution to enhance investment prospects in WA agriculture, namely:

- **Farming enterprises to become investment ready to attract financing from all available sources;**
- **Optimising the use of financing already deployed in the sector;**
- **Development of the market for external equity structures to facilitate financing from alternative sources; and**
- **Direct measures to enhance Australia’s competitiveness for agricultural investment capital, particularly for retail and institutional investors.**

Agriculture often requires investors with patient capital and a long term vision. If we are to secure investment in agriculture we need to act with resolve and in haste in order to capitalise on an opportunity that will otherwise be embraced by our competitors. If we are successful, we may set the scene for the “second - once in a generation boom” for Western Australia, but this time in our agricultural sector with benefits spread more evenly to all of the regions across the State.
What does success look like?

An Australian agricultural sector with revenue double current levels having invested to grow production and develop a leading market share in Asia’s premium food markets by 2025.
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