



# BlueSky

Alternative Thinking

The Blue Sky Strategic Australian Agriculture Fund offers investors an attractive opportunity to invest in Australia's globally competitive agriculture sector. The Fund, managed by a highly experienced team, employs a unique diversified strategy investing across Australian water entitlements, Australian farmland and associated businesses and Australian agricultural infrastructure.

## Introduction

The enduring feature of institutional investment allocations over the past 10 years has been the rise in patient capital (capital allocated to relatively illiquid investment strategies such as real assets, private equity and real estate). Against a backdrop of ever lower 'zero risk' yields and an ongoing search for returns and diversification, institutional interest in agriculture investment opportunities has increased.

Agriculture is far from a mainstream investment class (which is how we like it) yet we invest with high conviction into a sector that is underpinned by compelling structural fundamentals.

In this article we explore Australia's role in feeding the world, how sector returns have fared over the past ten years and the operational challenges to capturing investor returns in the sector. This enables us to provide insight into Blue Sky's strategy of investing locally rather than globally with a diversified rather than narrow sector focus.

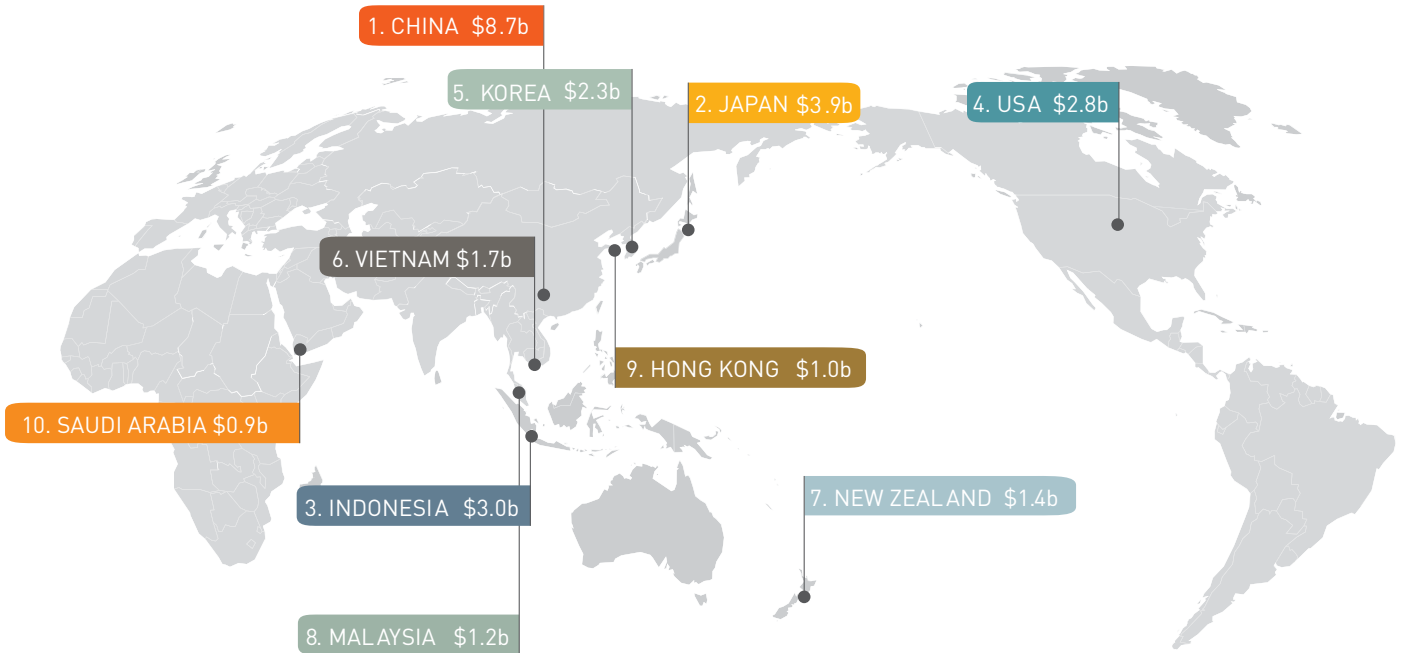
## Australia's Place in a Global Market

Australia is a major agricultural producer, one of the world's largest net food exporters<sup>1</sup> and the world's largest organic farmer by area<sup>2</sup>. With a comparative advantage in the production of several agricultural products<sup>3</sup>, a durable competitive advantage (geographic proximity) in supplying Asian markets and abundant per capita arable land, Australia has a substantial opportunity to meet growing world food and fibre demand.

Australian Agriculture's long term productivity growth, perhaps the most appropriate indicator of competitiveness, has risen broadly in line with the US and exceeded that of Canada over the last 50 years<sup>4</sup>. A 2014 McKinsey paper documenting Australia's global competitiveness identified agriculture as an industry where Australia is strongly competitive, particularly in the production of broad-acre agricultural goods that leverage Australia's large land mass.

TOP 10 EXPORT DESTINATIONS FOR AUSTRALIAN FOOD AND FIBRE

A\$ billion



Source: Austrade 2015, Why Australia Benchmark Report, 2015 Australian Government

Australia’s prominent role as a large agricultural exporter is primarily a derivative of its relative population size. Australia exports ~60% of its agricultural produce<sup>5</sup>. By comparison the US exports ~22% of agricultural produce<sup>6</sup>. Asian countries, driven by favorable demand fundamentals and supported by established free trade agreements that are progressively lowering historical trade barriers, now account for 7 out of 10 of Australia’s top agricultural export markets. China is just one example of the growth in demand for food from Asia nations. In 2014, the World Bank reported that the average annual growth rate of China’s Food and Beverage imports was approximately 15% in the five years to 2012. Australia supplied 8% of China’s US\$112 billion of agricultural imports in 2013 and was the third largest supplier of agricultural products to China behind the United States and Brazil.

Australia, along with Argentina, Brazil, Canada, the EU and US, will remain important global suppliers of agriculture goods in the coming decade. In the future, Australia will not produce vast quantities of produce on the scale of the US or Brazil, but rather it will continue to play a key role in providing premium traceable agricultural goods to the world (and increasingly Asia).

The globally competitive Australian agriculture sector represents an attractive opportunity to directly invest in, and capture returns from, real assets (many of them scarce and not replicable) that in themselves provide exposure to the favorable supply and demand dynamic that exists in the Asian region and worldwide.

### Australia’s Operational Challenges

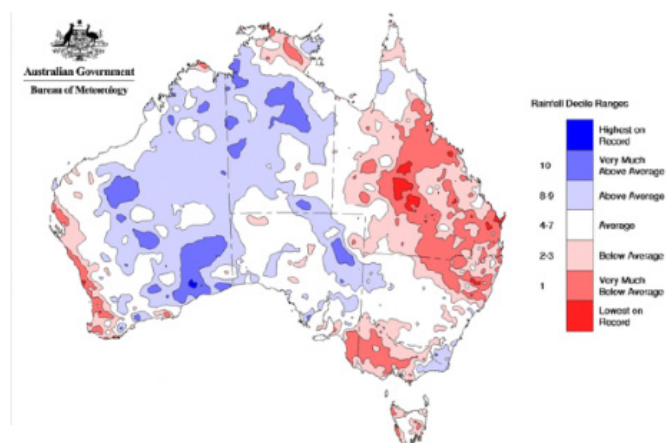
Deriving sustainable returns from Australia’s agriculture sector can be challenging given the dominance of private family farming businesses, scarcity of leasehold farm operations at scale, diversity of farming systems, industry fragmentation, ever present agricultural commodity cycles and an expectation of production volatility arising from the variability of Australia’s climate.

Family or individual owner-operators currently manage ~99% of all farm business in Australia where in the US 39% of all farmland is rented or leased<sup>7</sup>. This is evolving, however, the general lack of well-established leasing structures limits the number of passive investment opportunities available to financial investors and necessitates the need to partner with local farm managers.

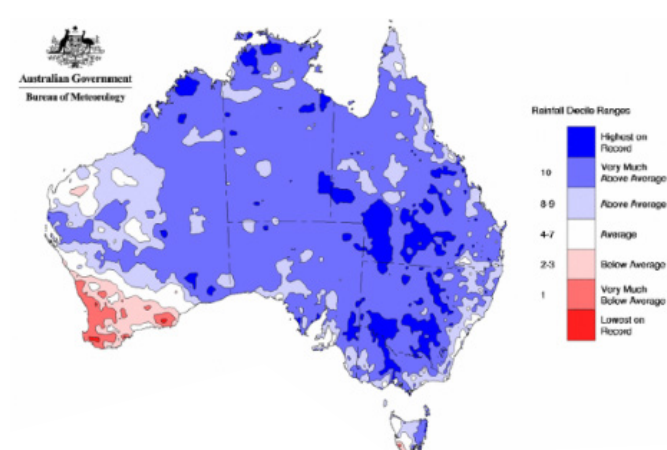
Volatility in agricultural commodity prices peaked in the decade leading up to 2009. Although volatility in agriculture is thought to be lower than energy and metals<sup>8</sup>, annualized historical volatility of corn, wheat and soybeans prices, per futures contracts, averaged ~30% between 1997 and 2013<sup>9</sup>. The level of volatility will vary between agricultural commodities and at the margins there will be differences in the volatility of cash prices paid across different locations due to the impact of local supply and demand. Volatility in agricultural commodity prices, an inherent aspect to the agriculture sector, is both a source of opportunity and additional risk.

**Figure 1 - Australian rainfall deciles: 36 months ending May 2016 vs ending May 2012**

1 June 2013 - 31 May 2016



1 June 2009 - 31 May 2012



Analysis provided by the Institute on the Environment at the University of Minnesota<sup>10</sup> shows yield variability of key commodity crops in the midwestern United States (corn & soybeans) is lower than the yield variability of wheat in Australia (wheat is one of Australia's largest annual seasonal crops). It is estimated that climate variability explains up to ~60% of Australia's wheat yield variations and ~40% of a much smaller variation in corn and soybeans in the Midwest. Climate variability, in rainfall terms, is illustrated by Australian rainfall deciles as published by the Bureau of Metrology (figure 1)<sup>11</sup>. This variability highlights the importance of water as an input to agricultural production. It is also one reason why Blue Sky has dedicated resources to building water market capability over ~10 years and why we have a natural preference for irrigated farming opportunities over dryland alternatives.

The ability to derive stable returns from a complex operating environment requires significant sector expertise. As is commonly the case we've found interesting opportunities appear in niche sectors when we delve into the details and have a well-positioned team.

### Average returns are just average!

Land has been a sustainable creator and store of wealth over an extended period. Patient capital is the ultimate beneficiary. The weighted average annual capital return for farms located in the state of New South Wales (used here as a proxy for Australian farms as the New South Wales sample accounts for 30% of all farms) was 5.55% between 1990 and 2014<sup>12</sup>.

Operating returns on the other hand suggest farming has been a challenging business for the average participant, many producing commodity products at a small margin with little operational scale and little ability to fully mitigate inherent risks of climate and commodity price fluctuations. Using the same New South Wales data set over 25 years, the average farm operating returns have barely surpassed zero risk yields (according to the Australian Farm Institute, averaging at 2.97%). However, the majority of the sector's financial returns are accruing to top quartile farmers, recording operating returns over 3 times higher than the average producer. This is a critical bifurcation of return profiles that provides opportunity but equally necessitates deployment of investment capital through proven teams and structures.

### Structuring a Real Assets Fund to Achieve Stable Returns in Agriculture

Blue Sky Real Assets have delivered net returns of 17.7% since inception<sup>14</sup>. Our long term objective is to deliver a stable return profile (targeting annualized net returns of 12% - 15%) comprising both capital growth and annual distributions. It is our view, in the context of the Australian agriculture sector, that:

- Being sector agnostic (permanent crop vs row crop vs protein) allows financial participants to be opportunistic in building geographic and sector diversified portfolios of large-scale assets with competitive cost structures.
- Identifying and partnering with high quality aligned management teams provides the opportunity to capture outsized returns.
- Strong in-house sector expertise, broad networks and adequate capital capacity provide insights and opportunities to drive returns that regionally focused operators sometimes overlook or are not in a position to execute.
- Portfolio diversification provides the ability to mitigate risks in individual commodities, locations and management teams.
- Mid-market focus provides higher level deal flow, ability to diversify, opportunity to develop attractive assets and greater likelihood to gain majority control over assets.

Water as the limiting input into Australian agriculture is at the core of our real assets business and our investment strategy. The information and insights derived from being a pioneer in a unique marketplace found nowhere else in the world has led Blue Sky to capitalize on adjacent opportunities in farmland (predominantly irrigated farmland), associated agribusinesses and regional mid-market infrastructure that supports the agriculture supply chain.

The relative strengths of Australia's agriculture sector provide an obvious opportunity in a global sector supported by compelling macro fundamentals. A diversified Australian investment strategy provides an ability to achieve a favorable return profile and included as part of a global agriculture portfolio will provide exposure to a variety of markets, consumers, crops and growing seasons enhancing the risk return profile.

- 1 Food and Agriculture Organization of the United Nations
- 2 Research Institute of Organic Agriculture
- 3 Nossal, K & Sheng, Y, 2013, Cross-country comparison of agricultural productivity, RIRDC Research Paper, Publication No. 13/011
- 4 Rural Industries Research and Development Corporation
- 5 Rural Industries Research and Development Corporation Research Paper (2013), Cross-Country comparison of agricultural productivity
- 6 United States Department of Agriculture Economic Research Service
- 7 National Sustainable Agriculture Coalition & National Farmers Federation
- 8 European Commission (2015), Price developments and links to food security – price level and volatility.
- 9 CME Group (2013), Risks Associated with Marketing.
- 10 Ray et. al., 2015, Climate variation explains a third of global crop yield variability, Institute on the Environment, University of Minnesota
- 11 Australian Government, Bureau of Metrology
- 12 Australian Farm Institute, Understanding the value of agricultural land, Farm Policy Journal Vol 13, No.2, Winter Quarter 2016
- 13 Australian Farm Institute, Understanding the value of agricultural land, farm policy journal Vol 13, No.2, Winter Quarter 2016
- 14 Blue Sky Alternative Investments Limited. Past performance is not indicative of future results, which may vary. Results as at the June 30, 2016

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