APRIL 2015

RESEARCH NOTE

TRIPLE A INVESTING .... AGRICULTURE, ASIA, AUSTRALIA

Tim McGavin and Steven Hall[1]

Agriculture is second only to land as the most ancient investment. Together, land and agriculture have outlasted most other investments as preservers of wealth and long-term generators of cash-flows. Yet to many institutional investors the rewards from agricultural investment have been marginal.

Some investors, however, have absorbed the lessons of past experience into their portfolio construction processes and recognised the advantages of Australian agriculture. Five practices stand out.

CAPTURE PROXIMAL AND ENVIRONMENTAL ADVANTAGES

The majority of income growth and unmet food demand is expected to occur in Asia. This provides Australia with the clear advantage of proximity re-enforced by trade and cultural connections. There is also the benefit of seasonal differentiation to food products produced in the northern hemisphere.

Other factors that should enhance risk-adjusted returns by allocating to Australia include:

- Land which is inexpensive on a yield basis but has yet to appreciate relative to fundamentals;
- A highly skilled and innovative workforce;
- A comparatively stable business, governance and regulatory environment, notwithstanding recent shifts in public policy towards greater transparency surrounding foreign investment in Australian agriculture;
- Absence of major pests and diseases, reducing production costs relative to other countries; and
- A history of strong productivity growth.

Current market conditions further support Australia. Many Australian farm businesses are highly geared and unable to fund growth with more debt. The sector needs innovative equity-based funding. Many traditional investors are now absent after a decade of tough operating conditions brought on by droughts and floods. Moreover, generational change coupled with a limited number of new family members willing to retain capital in the farm is causing a structural shift in farm ownership from existing familities to new entrants. Finally, many attractive assets are under-valued due to a poor understanding of productivity improvements achievable with modest capital improvements.

DIVERSIFY AND STRUCTURE PORTFOLIOS TO ENHANCE RISK WEIGHTED RETURNS

Australia's diverse climates and abundance of land allows for varied production systems and the ability to scale production. A portfolio spread across these climates and systems also mitigates the risk of adverse seasonal conditions.

Portfolio risk is also managed through exposures to different foods – cereals, meat (livestock), protein (chickens, pigs and aquaculture) and dairy. Because meat, for example, is an important dietary

1. Tim McGavin is CEO of Laguna Bay Pty Ltd and Steven Hall is Managing Director of Brookvine Pty Ltd. Brookine acts a Special Advisor with respect to the Laguna Bay Agricultural Fund.

component of the affluent its demand is largely driven by income growth. On the other hand cereals are the staples for those on lower incomes so its demand is largely driven by population growth. Different drivers ensure that food prices are less than perfectly correlated so a diversified portfolio is likely to reduce volatility.

Unlike many other asset classes the benefits of diversification within this class are quite pronounced. This is achieved through exposures across diverse climates and geographies, diverse foods with low price correlations, across irrigated and dry land assets, both permanent and annual, and to water, which can be allocated either to the highest margin user or to permanent crops during times of low allocations.

HIRE THE UNHIREABLE

Studies identify management capability as the key distinguishing characteristic of top 10% producers. Input costs and prices received vary little between elite and average producers, while management decisions and execution contribute to machinery and labour efficiency, timeliness of operation, production and price risk management, and the adoption of innovations.

Yet these skills have been largely inaccessible to institutional investors in Australian agriculture. The lesson is three-fold; the need for benchmarking to identify top-tier operators, the importance of the right deal structure, and incentives to be able to partner with the previously unhireable. This demands strong relationships and broad networks, a deep understanding of the needs of vendors, operators and tenants, and the ability to structure transactions so as to be mutually beneficial to them and to investors.

ADOPT A DISCIPLINED, COUNTER-CYCLICAL APPROACH

The confluence of the cyclicality of individual assets, variable climatic conditions and investors chasing last year's seasons and margins creates a powerful advantage for patient, disciplined, value-oriented investors. A lengthy investment period and perpetual capital further ensures they are not to be forced to buy/sell at the worst possible time.

Portfolio construction should focus on generating a stable, growing income yield, preserving capital and building the potential for long-term capital appreciation. This favours acquiring assets that are significantly undervalued relative to their intrinsic worth. It also demands a thorough analysis of the agricultural cycle to identify timing of entry and exit. At times assets can be out of favour with the market so investors will benefit from a contrarian mind-set. They will also benefit if they can act quickly.

Investors should also favour undervalued assets which:

- Have greater productivity potential than currently valued by the market;
- Have the potential to capitalise productivity gains realised via strategic infrastructure and resource investments (e.g. by the addition of water infrastructure to grazing land); and
- Have the potential to capitalise productivity via a change of use (e.g. by converting grazing land to farming land).

BRIDGE THE GAP BETWEEN FARMING AND FINANCE

Extracting maximum value from the interaction between finance and farming demands particular skills in both fields. This is required, for example, to identify attractive opportunities before assets come to market. Effective deal structuring needs to be coupled with thorough risk analysis and due diligence on potential assets. As well, extracting the maximum return for investors demands financial efficiency as well as knowledge and techniques to increase yields and reduce operating costs.

CONCLUSION

The effect of rising populations will be further compounded by greater incomes, resulting in exponential demand growth for agricultural products. In fact, *The Economist* predicts that over the next 40 years humans will need to produce more food than they did in the previous 10,000 years combined[1]. Australia, as a cost-effective supplier to the world's biggest and fastest growing regional economy, is in an unchallenged position to reap the benefits.

A thoughtfully structured portfolio of Australian agricultural assets diversified across different markets, economic factors and risks is likely to generate a stable and growing income yield and long-term capital appreciation.

A mix of leaseback, joint venture and manager-operated assets aligns well with this proposition. Similarly there is considerable merit in a broad mandate which has the flexibility to include investment in water entitlements, agricultural infrastructure and in up/ down stream operations.

We are confident that such a mandate will generate strong returns, with at least 50% being in the form of income. Furthermore, we believe there is an added return to doing all this at an elite level. That is, by purchasing and structuring well, exiting certain assets at opportune times, expanding productivity potential and improving operating efficiency.

Finally, agriculture is an asset class that generates a cash yield, offers an inflation hedge and provides genuine diversification benefits with respect to most other asset classes. In other words it enhances overall portfolio efficiency.

1. The Economist 2015 "Barbarians at the farm gate: Hardy investors are seeking a way to grow their money", 3 January, viewed 9 January 2015, <http://economist.com/news/finance-and-economics/21637379-hardy-investors-are-seeking-way-grow-their-money-barbarians-farm-gate>

Laguna Bay

Tim McGavin
CEO

Ph: +61 7 5447 2685
M: +61 409 600 234
E: tim.mcgavin@lagunabaypastoral.com.au

Brookvine Pty Limited

Steven Hall
Managing Director

Ph: +61 2 9328 6445
M: +61 401 232 422
E: stevenhall@brookvine.com.au

IMPORTANT NOTE

This document has been prepared by Brookvine Pty Limited ("Brookvine) and Laguna Bay Pastoral Company Pty Ltd ("Laguna Bay"). It is only available to persons who are professional, sophisticated or wholesale clients under the Australian Corporations Act. The information contained in this document is provided to you solely for your information and by receiving the information you agree that you will treat the information confidentially. The information may not be reproduced, disclosed or distributed to any third party or published in whole or in part for any purpose. The information contained in this document is not intended as investment or financial advice. You should seek independent professional advice on the legal, financial and taxation consequences of any investment decision as you deem necessary.

Certain information contained in this document is based on forward-looking statements or information, including descriptions of anticipated market changes and expectations of future activity. Brookvine and Laguna Bay believe that such statements and information are based upon reasonable estimates and assumptions. However, forward-looking statements and information are inherently uncertain and actual events or results may differ materially from those reflected in the forward-looking statements. Therefore, undue reliance should not be placed on such forward-looking statements and information.

No representation or warranty, express or implied, is made in relation to the accuracy or completeness of the information contained in this document. The information contained in this presentation is subject to change without notification. No responsibility is accepted by Brookvine, Laguna Bay or any of their related entities, employees, agents or advisors, for any of the information or for any action taken by you on the basis of the information or opinions expressed in this document.

US Regulatory Notice

Information including any information on the Laguna Bay Agricultural Fund ("the Fund") is presented for illustration purposes and is not an offer to sell or purchase an interest in the Fund. The Shares and Units have not been approved or disapproved by the U.S. Securities and Exchange Commission (the "SEC") or by the securities regulatory authority of any state or of any other U.S. or non-U.S. jurisdiction. Any representation to the contrary is a criminal offense. The Shares and Units have not been and will not be registered under the Securities Act of 1933, as amended (the "Securities Act"), or any state securities laws or the laws of any other jurisdiction. Furthermore, the foregoing authorities have not confirmed the accuracy or determined the adequacy of this document. Any representation to the contrary is a criminal offence in the United States.

The Shares and Units will be offered and sold under in the United States or to US Persons pursuant to the exemption provided by section 4(2) of the Securities Act and Regulation D promulgated thereunder and other exemptions of similar import under the laws of the United States and other jurisdictions where the offering will be made. The Shares and Units are to be offered as an investment for sophisticated investors who have the ability to evaluate the merits and risks of an investment in the Shares and Units and the ability to assume the economic risks involved in such an investment. There is no secondary market for the shares or units, and none is expected to develop. In making an investment decision, investors must rely on their own examination of the Fund and the terms of the offering, including the merits and risks involved. Prospective investors should not construe the contents of this document as legal, tax, investment or accounting advice, and each prospective investor is urged to consult with its own advisors in the appropriate jurisdiction with respect to legal, tax, regulatory, financial and accounting consequences of its investment in the Fund. Certain information contained herein relating to the Fund's targets, including with respect to the size of the Fund, is subject to change and no assurance can be given that such targets will be met.

The Fund is not and will not be registered as an investment company under the Investment Company Act of 1940, as amended (the "Investment Company Act"). In addition, Laguna Bay is not currently registered as an investment adviser under the US Investment Advisers Act of 1940, as amended (the "Advisers Act"). Consequently, investors will not be afforded the protections of the Investment Company Act or the Advisers Act.