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CANADIAN ALTERNATIVE INVESTMENTS IN PENSIONS

Practical Strategies and Investment Opportunities in the New Normal

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Sector in Brief:

Agriculture and Timberland

bfinance

Resource

"In the past three years, a distinctive new group of non-timber agriculture funds have come onto the scene."

What's new?

Facts & figures

Agriculture and Timberland have received strong attention from institutional investors in 2017, as have other "niche" real assets.

While Timberland is a relatively well-established sector, the past three years have seen a distinctive new group of non-timber agriculture funds coming onto the scene.

This research note tackles structures, fees, opportunity types and risks.

- The surge of investment in Real Assets has generated significant interest in the Timber and Agriculture asset classes amongst institutional investors.
- On the one hand, investors are looking for asset classes that provide strong yield and good diversification, and this is clearly the case for Timber and Agriculture. On the other, the two asset classes have grown significantly in scale and maturity over the past decade.
- Geographically, the focus remains on North America and Australasia with regions such as Europe remaining highly regulated and subsidised. But there is growing interest in emerging economies such as Latin America and parts of Eastern Europe.
- Implementation challenges. Although there are around 70-90 established managers in the space, few have scale and even less have long track records. Funds tend to be relatively small and fees relatively high. Great care needs to be taken when moving through the various stages of investment, from deciding the appropriate strategic approach to the all-important challenges of implementation.

Gather critical insight into this nascent asset class. Join **Dr. Peter Hobbs, Managing Director, Private Markets** for an exclusive session on ***Farmland VS Timberland – Distinguishing Myths from Reality*** at the upcoming CAIP East Forum.

For detailed information on this session, visit:

www.CAIPForum.com/EAST

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> *In the past three years, a distinctive new group of non-timber agriculture funds have come onto the scene.*

What's new?

Timberland is a well-established, if relatively small, part of the real asset investment landscape. Many North American pension funds and endowments have been active in this sector since the 1990s or early 2000s and, more recently, the hunger for real assets in the post-GFC years has led to a significant surge in appetite from investors around the world. These days, timber managers can raise billion-dollar funds: Twin Creeks was the latest to grab the industry's attention with a new $250m commitment from CalSTRS.

In past three years, however, a distinctive new group of non-timberland **agriculture funds** have come onto the scene. Previously, institutional investment in agriculture - timber aside - was largely implemented through private equity-type strategies. Now, asset managers are offering more real-estate-like or timberland-like agricultural investment vehicles that target around 10 - 12% net IRR, or closer to 8% in the case of more conservative land leasing approaches.

In addition, the investment opportunity within direct agriculture operations has evolved significantly during the past decade thanks to the emergence of new technologies and methods, such as the application of 'big data' to crop selection, planting, water usage and fertiliser application. With a large proportion of farming still in the hands of families or individuals that have been operating for several decades, such advances create scope for institutional investors to improve efficiency and add value through capital expenditure.

From bfinance's perspective, this space has received particularly strong attention during the last couple of years, as have other "niche" real assets. With an unprecedented level of capital chasing **real estate and infrastructure**, driving significant compression in returns, investors have increasingly looked towards less familiar, more nascent, and - ideally - more capital-constrained parts of the landscape.

Today, investors seeking what we might term 'natural resources real assets' exposure can **look at agriculture and timberland side by side**.

Facts & figures

- 8 - 12%: expected net returns for the majority of managers (excepting more aggressive private equity-like strategies) fall within this range.
- 70 - 90: number of asset managers in the universe, though a minority are usually fundraising at any one time.
- $350 - 400 million: average fund size; the majority are under $500 million.
- 10 - 15 years: usual lock-up period of closed-ended funds, though open-ended funds are available.
- 1.4% management fee + 15% performance fee: median quoted charges.

Despite the evident strong similarities, not all allocators currently take an integrated approach to implementation. Equally, the funds and managers for agriculture and timber are still largely separate: with only a handful of exceptions, most focus on either one or the other. Yet casting a wide net, evaluating different sub-sectors side by side and considering the possibility of multiple mandates can open up a richer opportunity set.

This note provides a brief overview of the agriculture and timber investment sectors and highlights key issues for investors. Further questions would be welcome.

For more insights visit:
www.bfinance.co.uk/publications

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What is it?

One of the most intuitive ways of understanding the agriculture and timber investment opportunity set is illustrated in Figure 1.

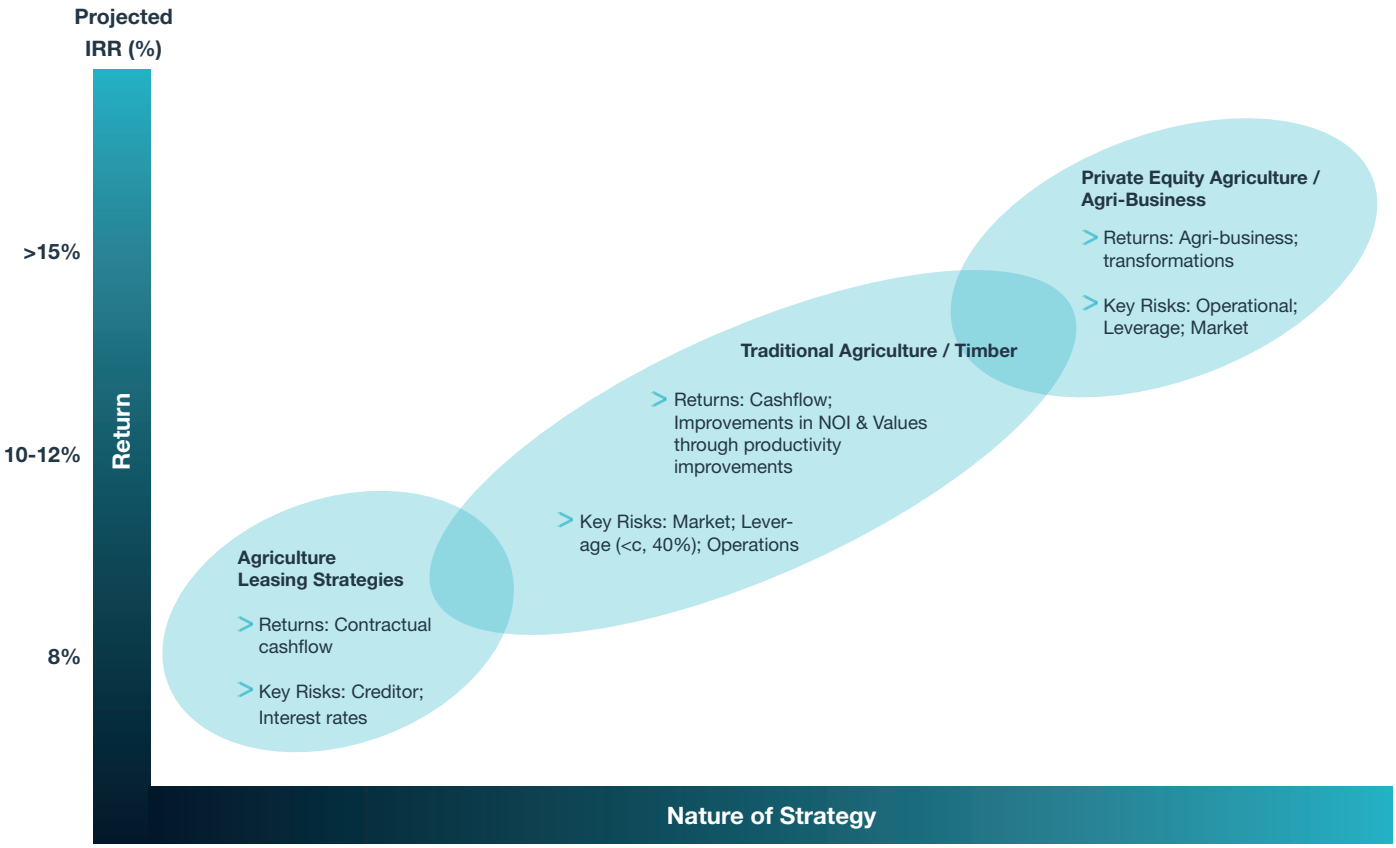
On the left hand side, with lower expected net IRRs, we find **leasing strategies:** the investor buys agricultural land, which is then leased to farmers. In some cases these are solely cash leases, essentially delivering a fixed coupon every year. In other cases, the returns are aligned with the profits of the operating partner that leases the land. In a number of leasing strategies, additional investment capital is devoted to operational improvement such as better irrigation and new technology.

At the other end of the spectrum is **agribusiness private equity** - a part of the market that we have largely omitted from recent agriculture/timber searches for investors, given the desired investment profile. Here, the investor takes stakes in companies that are involved in various parts of the agricultural value chain: those companies might own the land, might buy/process the crop, might make the fertiliser that's sold to producers. In the middle, with some overlap on either side, you find what might be termed **"traditional" strategies:** ownership/ direct operation of the land, with involvement in various parts of the value chain depending on the investment.

Interestingly, while timber and agriculture offer broadly similar expected returns for similar strategies, **agriculture funds anticipate generating more of that return from cash yields** than their timberland counterparts. For example, in two strategies with 8% net returns, the agriculture fund may look for a 4 - 5% yield where the timber fund anticipates a 2 - 3%.

The investment opportunities tend to lie in regions with minimal governmental subsidies and, for the most part, strong agricultural exports. As such, subsidy-heavy Western Europe has a minimal presence. North America, South America and Australasia are the three primary destinations for investment capital, with a modest amount also targeting Eastern Europe. In terms of type, agriculture investment strategies tend to lean towards row crops (planted annually) rather than permanent or semi-permanent crops (vines, orchards, etc).

FIGURE 1: AGRICULTURE AND TIMBER INVESTMENT STRATEGIES – A CONCEPTUAL ILLUSTRATION



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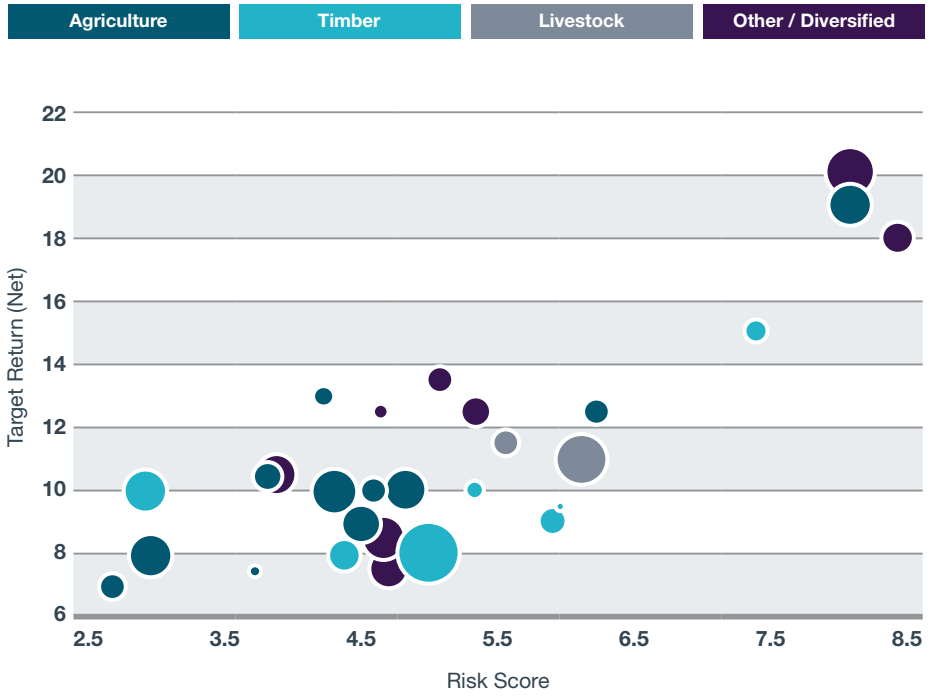
Investment challenge

Although diagrams like Figure 1 can be helpful, they might also be misleading for an investor planning where to focus attention with their own risk appetite and return requirements in mind. **The strategy type does not dictate how "risky" the investment is**, although of course it does play a contributing role.

Understanding risks means considering a range of other factors alongside the strategy: the nature of the operations (potential for M&A, vertical integration); the structure and nature of the cashflows; the amount of leverage; the region (political risk, climactic risk); the amount of diversification; the degree of exposure to market risk; the type of crop (row crops planted annually, permanent crops with a longer lifespan). To illustrate the point, it is important to note that Figure 1 does not map - **at all** - onto Figure 2, which provides a more granular risk assessment of 29 real offerings available in November 2017.

The risk assessment challenge is a significant one. Even setting aside the ups and downs of commodity prices, investors must weigh up the danger of excessive rainfall or fire, the reliance on trade agreements between countries, among other new and unfamiliar questions. Comparing managers' very, very different offerings from a risk perspective is, to say the least, a grey area.

FIGURE 2: MANAGERS AT A GLANCE - 29 AGRICULTURE / TIMBER MANAGERS LONG-LISTED FOR A MANDATE IN NOVEMBER 2017



Source: bfinance manager analysis for a Canadian investor, November 2017. Proprietary risk score calculated using a range of variables.

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Manager selection

Right now, we estimate that there are between 70 and 90 managers in the universe, although fewer than half will usually be looking for funding at any one time.

Among these:

- Funds (and segregated accounts) fall into four main groups: timber, agriculture, livestock or "other/ diversified."
- The majority are closed-ended with a 10 - 15 year horizon, in line with infrastructure counterparts. The open-ended vehicles usually feature a 2 - 5 year lock-up.
- The secondaries market is evolving slowly, although there are more opportunities in timberland than agriculture. There are a handful of fund-of-fund or multi-manager products available.
- Most are regional, although there are 'global' vehicles.

The fund sizes, are modest relative to infrastructure, with the majority under $500 million and an average of $350 - 400 million. Low minimum investment sizes - often $5 million - are good news for smaller investors, but bigger allocators that prefer not to represent a large proportion of AuM can find the universe constrained.

That being said, spreading an allocation among multiple managers may actually be preferable in this sector.

Fees are high by real asset standards, but vary widely: some managers charge a flat rate of 1 - 1.5%, while others expect 1.5%+20%.

On the plus side, managers tend to set hurdle rates in line with performance targets rather than - as happens elsewhere - below them. In other words, investors pay performance fees only on outperformance.

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Founded in 1999, the London-headquartered firm has conducted engagements for more than 300 clients in 33 countries and now has eight offices in seven countries. Services include manager search and selection, fee analysis,performance monitoring, risk analytics and other portfolio solutions. With customised processes tailored to each individual client, the firm seeks to empower investors with the resources and information to take key decisions. The team is drawn from portfolio management, research, consultancy and academia, combining deep sector-specific expertise with global perspective.