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Report by William Rayner: Growing a better future for family-owned farms

The Churchill Fellows' Association of South Australia Churchill Fellowship to investigate alternative finance structures for Australian family farmers - USA, Canada, and China

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Signed: ……………………………………..

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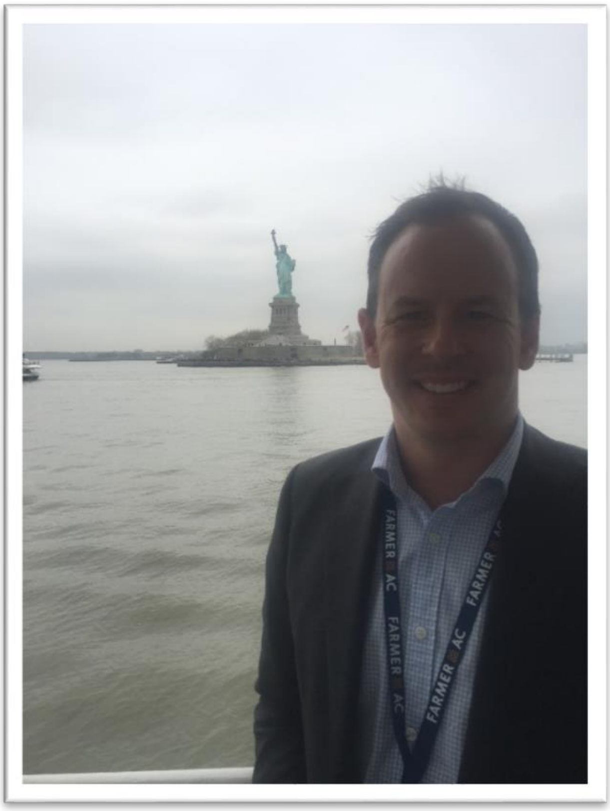


Caption: Will Rayner pictured near the Statue of Liberty, New York, USA, at the completion of the 2017 Global AgInvesting Conference.

Introduction

The future for agriculture is bright. Most experts predict a significant and sustained increase in global population, which will result in a commensurate increase in the demand for food and fibre for many years to come. Indeed, some of the structural factors influencing supply and demand for agricultural produce are being described as 'mega-trends' that are likely to influence global markets for the next 30 to 50 years or more. For the global farmer, there are many reasons to be optimistic.

For the Australian farmer to take advantage of these 'mega trends' the sector requires a continued and increasing injection of capital. Farmers need to become more efficient. They need to invest in the latest equipment, technology, infrastructure and research. They need the best production and marketing tools. They need an efficient system for the transfer of assets, and to allow new and high performing entrants into the sector. Each of these factors has been true since European settlement in Australia, and each is particularly true for the family farmer today.

Australian agriculture has largely been built around family farming units. This structure has provided the industry with the long-term continuity and flexibility required to manage the seasonal and price volatility inherent in farming in this country. And despite increased participation from corporate and international interests, it is likely family owned farms will continue to be the dominant form of farm ownership for the foreseeable future.

However, a challenge for our industry – and for the family farm in particular – is its reliance upon traditional bank debt as its primary source of external capital. Bank debt – by definition – is not always suited to the short term volatility of agriculture. Nor does it always meet the needs of the family farming unit dealing with issues of succession planning, cash flow variability, drought, and/or market disruption. The Australian farmer is unique in its reliance upon bank debt – with many of our overseas competitors enjoying a much higher level of investment from government, private equity, superannuation and pension funds, sovereign funds, and a combination of all of the above.

This report aims to provide an answer of where the Australian agricultural sector should be looking to encourage a broader and varied pool of capital to invest in the sector.

Executive summary

Acknowledgements: I would like to thank the many people and organisations that made this Fellowship and report possible. First, to the Churchill Fellows' Association of South Australia (who sponsored my Fellowship) for their continued support for research and study into the Australian agricultural sector. To my employer, Rural Bank, which allowed me to take six-weeks out of my 'day job' to investigate the topic, and have been instrumental in efforts to disseminate the findings of this report since my return. To Alexandra Gartmann (Chief Executive Officer and Managing Director of Rural Bank) and David Matthews (former Churchill Fellow and Director of Rural Bank) who not only encouraged me to apply for a fellowship, but were happy to provide references, guidance and support through the process. Finally, to my family, who have been tolerant, encouraging and understanding throughout an extended period of absence and while I have been writing this report. In particular I would like to thank my wife, Sophie, for her love and patience through the process. My Churchill experience has been thrilling and inspiring, and without her it would not have been possible.

Highlights: The Churchill Fellowship took me through the United States of America, Canada and China over a six-week period in early 2017. I was able to visit and meet with a wide range of agricultural and capital market participants, including bankers, farmers, institutional investors, consultants, economists, and academics. In developing the itinerary I was determined to think outside the realms of 'traditional' banking and farm finance, and to explore what new or emerging funding options might have potential in the Australian context. I found that – without exception – the people I met, and organisations I contacted, were generous with their time and information. While I won't attempt to acknowledge all of those that assisted on the journey I would like to specifically recognise for their assistance: EY's offices in Hong Kong, Shanghai and Beijing (and in particular their Deputy Managing Partner, Asia Pacific, Patrick Winter); Goldman Sachs in Australia; the staff at Farm Credit Canada; Elders Limited; the staff in the Australian Embassy's in China and the United States; AusTrade; the organisers of the Global AgInvesting Conference in New York; Gary Pike from the Pike Management Group in Canada; Robert Rorrison, Chairman, Asia, Peloton Global; and staff from the global head office of John Deere Ltd.

Findings and recommendations: Australian farmers are more dependant than farmers in both the United States and Canada upon traditional bank debt to fund their ongoing operation and business growth. In order to realise the enormous potential for agriculture, and to fuel the economic and social benefits family farmers provide to the Australian economy, we should be investigating ways to deepen and broaden the sources of capital sources available to the sector. While there is no 'simple fix' that would provide for this outcome, this report provides four key

recommendations to encourage greater investment in agriculture and to ensure the ongoing vibrancy and competitiveness of our family farming sector. These recommendations are:

1) To encourage both family farmers and the institutional investment community to become 'investor ready'. This will be achieved by improving financial structures and literacy, and using better data and benchmarking tools to allow for better investment decisions. The application of better data will allow for better risk management, and therefore reduce the cost of capital to the sector. Becoming investor ready will also require market participants to pool assets and/or resources to provide the scale required to attract most institutional investors.
2) Contemplate and address cultural issues presented by (or preventing) greater use of alternative capital structures in the family farming unit.
3) Encourage government to reduce the structural barriers to institutional investment in the sector – with a particular focus on global funds management and asset allocation within the domestic superannuation sector.
4) Encourage a deeper 'fit for purpose' suite of risk management tools available to family farmers. This is likely to include a form of 'multi-peril' insurance to encourage broader investment in the sector, with an additional potential benefit being reducing the role of government in supporting farmers experiencing drought and other natural disasters.

Dissemination of findings: The interest among the farming community about this report and its findings has been significant (both prior to departing on the trip, and since my return). Prior to submitting this report I have delivered keynote presentations to the Australian Regional Development Conference (Coffs Harbour, September 11-12, 2017), and the Birchip Cropping Group Main Field Day (Birchip, September 13, 2017). I have been invited to present to the Australian Agribusiness Association at a planned event in Sydney in November. Once published, the report will be distributed both internally and externally through Rural Bank's own networks, with ongoing interest expected from the media and broader farming population.

Churchill Fellowship program and itinerary

Date	Location	Activity
April 18 - 23	New York, USA	Participated in one of the world's largest conferences dedicated to investment in agriculture, 'Global AgInvesting': www.globalaginvesting.com
April 24 - 29	Chicago and West Lafayette, USA	Meetings with agencies, banks, investors and agricultural academics. Program included visits with: • Austrade: www.austrade.gov.au • Purdue University Centre for Food and Agricultural Business: http://agribusiness.purdue.edu/ • Piper Jaffrey & Co: http://www.piperjaffray.com/ • Greater Western Bank: www.greatwesternbank.com
May 1 - 2	Moline, USA	A range of meetings with senior treasury, strategy and economics leaders within the global head office of John Deere: https://www.deere.com
May 3 - 6	Washington, USA	Meeting with bureaucrats, economics and agricultural advisors including meetings at: • Embassy of Australia, USA: http://usa.embassy.gov.au/ • American Farm Bureau: www.fb.org
May 7 - 10	Calgary, Canada	Meetings with farmers, farm advisers, farm consultants including: • Pike Management Group: http://www.pmgfarms.com/ • Area One Farms: www.areaonefarms.ca/ • Agri-Trend: http://www.agritrend.com/
May 11 - 15	Regina, Canada	Two days of meetings in the largest agricultural bank in Canada, and meetings with farmers and farm capital providers including: • Farm Credit Canada: www.fcc-fac.ca • Input Capital: http://inputcapital.com/
May 16 - 20	Hong Kong, Hong Kong	Meetings with investment funds, investment banks and advisors, including: EY: www.ey.com

May 21 - 23	Shanghai, China	Meetings with investment funds (government and private), Australian agricultural importers, and advisors, including: Elders China: www.elders.com.cn EY Shanghai: www.ey.com
May 23 - 25	Beijing, China	Meetings with investment funds, and trade advisors and economists, including: EY Beijing: www.ey.com Embassy of Australia, China: http://china.embassy.gov.au/

Caption: Will Rayner in the Chicago offices of AusTrade, speaking with Chris Knepler, Investment Manager and Post Manager, Australian Trade and Investment Commission (AusTrade), Chicago, USA

Growing a better future for family-owned farms

'Mega trends' in agriculture

Agriculture is on the cusp of a sustained period of growth and opportunity. Demographers expect significant and sustained increase in global population, which will result in a commensurate increase in the demand for food and fibre. The epicentre of this growth is expected to be in Asia where population growth, combined with an increase in wealth and living standards, means more than 1.3 billion people are expected to enter the middle class between now and 2050[1].

History suggests that the shift in the socio-economic status of this region will result in many opportunities for the Australian farmer. A primary driver of this will be a change in eating habits, as this demographic transitions from a diet that is principally legume and vegetable based, to one higher in meat and dairy protein[2].

An increase in demand for agricultural products, and for protein specifically, will come at the same time as supply of food and agricultural product faces structural headwinds. The global availability of arable land and fresh water for agricultural pursuits is expected to continue to fall, particularly in developing countries where urban sprawl continues to encroach on prime farming land.

In the context of increasing demand and structural constraints on supply of food and fibre, the issues of food security and food safety continue to increase in the mind of the modern consumer. Recent food safety scares in China (including surrounding the safety of infant milk formula) illustrate how issues relating to food safety can drastically influence global agricultural commodity markets and, consequently, farm profitability.

Closely linked to the focus on food security and safety comes an increased demand for food quality assurance and an increased focus on food provenance. The modern consumer wants to know that its food is prepared safely and with high health and safety attributes – and it wants to be assured of these traits through a range of factors including quality assurance, a strong rule of law, trust and quality control.

These trends are likely to continue for a sustained period of time. Indeed, some of the structural factors influencing supply and demand for agricultural produce are being described as 'mega-trends' that are likely to influence global markets for the next 30 to 50 years or more. For the global farmer, there are many reasons to be optimistic.

[1] 2017 Revision of World Population Prospects, United Nations, viewed at *https://esa.un.org/unpd/wpp/*

[2] KPMG Agribusiness Agenda 2016, Australia. *www.kpmg.com.au*

The opportunity for the Australian farmer

In this context, the Australian farmer would appear well-placed to take advantage of our global 'mega trends'. We remain relatively land-rich – albeit with significant constraints on water. We are efficient and innovative farmers, with high levels of adoption of technology and farming techniques. Importantly, we boast a highly refined and efficient rule of law, relative political stability, and a developed, transparent and open economy. This distinguishes the Australian agricultural economy from many of our competitors both in Asia and throughout the globe.

Caption: Will Rayner in the foyer of the global head office of John Deere, Moline, USA. While most people think of John Deere as a tractor and header manufacturer, many don't realise that is a substantial lender to farmers in its own right – with a loan book in excess of AUD$30 billion

The Australian agricultural industry has been a primary contributor to the domestic economy for more than 200 years. Agriculture and food production remains one of the largest single contributors to Australian GDP (at approximately 12 per cent of GDP), eclipsing even the mining and resources sector at approximately 8 per cent when measured on the same basis[3].

Agriculture plays a vital part in our export economy. Australia is a country of roughly 25 million people, and its farmers produce enough food to feed roughly 65 million people. The surplus food – enough to feed more than 40 million people – contributes more than $50 billion in export revenue to our economy, an increase of nearly $10 billion in just 10 years[4].

But, while the 'mega trends' auger well for our future, they do not, of themselves, ensure the future for Australian agriculture. To the contrary, recent developments in technology, marketing

[3] Australian Bureau of Statistics, viewed at *www.abs.gov.au*
[4] 'Farm Facts, National Farmers Federation, viewed at *www.nff.org.au*

and infrastructure, the global nature of capital flows, and the competitive dynamics of global agriculture mean Australian farmers have more competition than ever to feed our growing world population. Domestically the challenges of succession planning, encouraging new entrants into the sector, the capital intensity of farming, competing land and water use, R&D and infrastructure investment, and climate change, provide challenges to the modern farmer.

The role of the family corporate

The Australian agricultural sector is dominated by the 'family farm'. More than 99 per cent of all farms are family owned, and collectively they produce more than 93 per cent of domestic food supply[5]. The family farm – perhaps better described as the 'family corporate' – takes a long-term approach to its management. It typically aims to build and protect assets that sit within the family ownership structure, and for these assets to be passed from one generation to the next. While this structure may conjure stereotypical images (representations of an overall-clad farmer chewing straw and a few chooks in the backyard) the reality is much different. Modern family farms are significant businesses, with large cash-flows and sophisticated production and marketing techniques. They often operate sophisticated management and/or board structures, and utilise a range of external professional resources to assist in the management of the business.

Caption: Will Rayner in Washington DC, USA, pictured with Bob Young, Chief Economist, American Farm Bureau.

[5] Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES), viewed at *http://www.agriculture.gov.au/abares*

Importantly, this farming structure has proven to be very profitable and resilient. Recent data from the Australian Agricultural Bureau of Agricultural and Resource Economics and Sciences (ABARES), shows the family corporate has outperformed other forms of farming business over a five year period to 2015-16[6].

The family corporate provides additional benefits to rural and regional communities from a social and environmental perspective. Family farmers own and manage the majority of Australia's land (combining both freehold and leasehold country), and have a positive obligation to manage the environmental health of that land. Weed management, water and natural resources management, and pest and disease management all fall within the remit of the family farming operation. These functions are largely performed without taxpayer support.

From a social perspective, the family corporate provides much of the stability and continuity of social capital in regional areas. They provide local employment, retain profits in regional areas, and often form the backbone of local institutions and volunteer organisations like fire services, school, local councils, and sporting clubs. This is in stark contrast to some other parts of the economy that experience regular 'boom and bust' cycles, which in turn leads to variability (and transiency) for much of its workforce. These other industries are less likely to retain profits in the regions, and the multiplier effect on the local economy is therefore less.

Australian farm financing

Australian farmers are among the least protected of all farmers globally[7]. They receive less direct and indirect government support and some of the lowest levels of domestic trade protection of all industries in the developed world. Despite this, Australian famers compete successfully against global competitors (particularly from the United States and European Union) who enjoy significant and distorting subsidies and government support. This overseas support takes various forms – from direct cash payments, to subsidies for equipment and insurance, to domestic quota and import tariffs.

It is both unreasonable and unrealistic to expect the Australian taxpayer to support the Australian agricultural industry in the same way as the American or European taxpayer supports farmers in those regions. The relative size of our taxpayer base would make it virtually impossible to replicate without material impacts on essential government services like health and emergency services. And, even if it were plausible from a monetary perspective, the political realities of the

[6] Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES), viewed at *http://www.agriculture.gov.au/abares*
[7] OECD, Agricultural Policy Monitoring and Evaluation 2013, viewed at *http://dx.doi.org/10.1787/agr_pol-2013-en*

Australian system would make it virtually impossible to replicate the spending contained in programs like – for instance – the US Farm Bill.

Caption: Will Rayner outside the Australian Embassy in Washgington DC, USA

Australian farmers are therefore reliant upon private investment and capital to fund investment and growth in the sector.

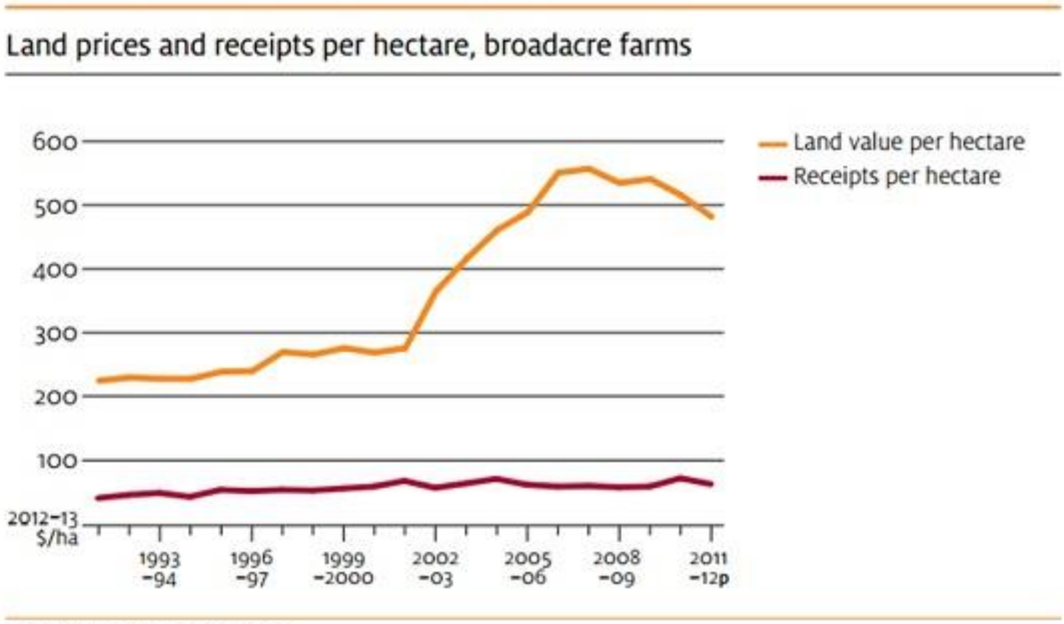
Family farmers are almost entirely dependent upon the domestic banking sector to provide this investment. More than 98 per cent of all farm finance is provides by just six banks (five Australian banks, and an additional foreign-owned agricultural specialist bank). Government provides approximately 1 per cent of funding needs (primarily through state and federally managed drought and hardship assistance programs), and the remainder is mainly provided by non-bank lenders in the form of trade facilities, harvest advances, and other specialist products. These six banks lend more than $60 billion to Australian farm businesses, supporting the sector to become one of the most innovative, sustainable and successful in the world. Farmers have developed and/or adopted best practice technologies and production systems in the cropping, dairy, intensive irrigation and red meat sectors (among others). This has enabled the Australian family farmer to successfully compete in a globally distorted market, to increase production and yields and ensure long term profitability despite the short term volatility and risks posed by the harsh Australian climate.

Australian agricultural debt levels have increased by more than 400 per cent over the past 30 years[8]. This has enabled substantial investment in the sector, and facilitated rapid consolidation in the family farming sector. Farms are now considerably larger than they were historically, and this consolidation continues to occur.

While debt levels have appreciated markedly since 1990, family farm equity ratios have remained relatively constant over this period. This is primarily due to a parallel increase in land values over

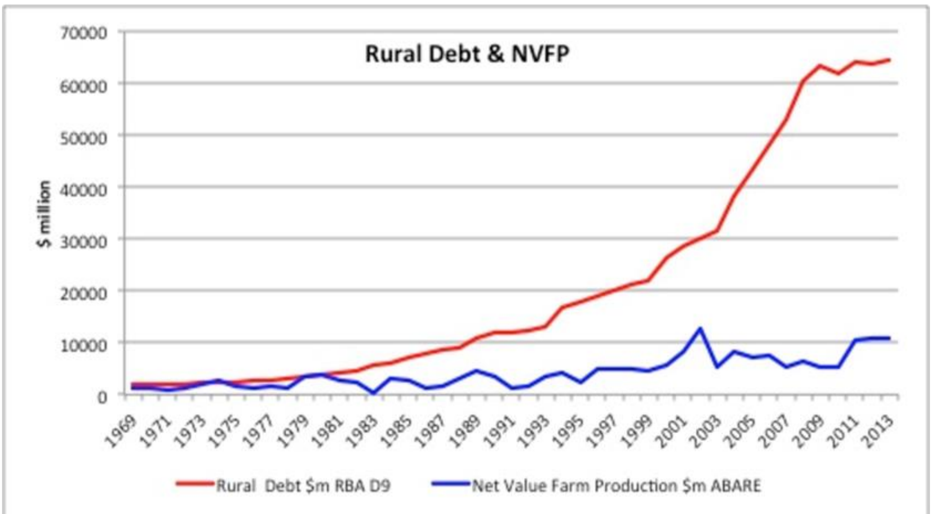
[8] ABARES

this period. Rural Bank research – through its AgAnswers insights team – shows the average price increase for Australian farmland (excluding the value of capital improvements) has average 6.4 per cent over the past 20 years[9].



p ABARES preliminary estimate.

However, while farmland values have adequately supported this increase in debt (bank lending into the agricultural sector typically relies upon a first mortgage over land as security[10]), farm productivity and profitability has failed to keep pace.



In order for the Australian farmer to take advantage of the global 'mega-trends' for agriculture, it will require continued and growing levels of capital investment[11]. Reports suggest that while the

[9] Rural Bank, AgAnswers 2016 Australian Farmland Values, viewed at *www.ruralbank.com.au*
[10] Rural Bank
[11] ANZ 'Greener Pastures' report, viewed at *www.anzbusiness.com*

Australian economy has the potential to receive more than $1.7 trillion in agricultural export revenue between now and 2050 (for the reasons outlined above), there currently exists an annual $9 billion shortfall in investment to make this occur.

The sector would therefore be well-served answering two questions. First, are current farm debt levels sustainable? Second, can the growth trajectory in farm debt be sustained without a commensurate increase in farm productivity and profitability?

Are current farm debt levels sustainable?

Farm equity levels have remained steady over the past 20 years despite a material increase in farm debt over this period (see 'rural debt' graph above). Debt serviceability (measured as the proportion of farm income required to service principle and interest repayments on debt) have also remained relatively constant over this period[12]. However, the range of factors that have led to this outcome are not guaranteed to continue into the future. Global interest rates are the lowest they have been for more than 3000 years as a direct result of the efforts of central banks globally to stimulate the economy in a post-GFC world. At the same time many agricultural commodity prices are at or above long term historical averages, and the weakness of the Australian dollar relative to the US dollar since 2010 has provided further support for Australian farmers. Each of these factors suggest current farm debt levels would appear appropriate. However, the longer-term question for Australian family farmers remains what these serviceability levels look like if, and when, global interest rates return to historical norms; when there is a sustained fall in global commodity prices; or upon a longer-term structural appreciation of the Australian dollar.

Caption: Will Rayner (right) at the Shanghai offices of Elders. Pictured with Will were Craig Aldous, CEO and Managing Director, Elders China, and Joey Zhou, Agribusiness Investment Manager, Elders China.

[12] ABARES

The other important consideration is the *composition* of capital invested into agriculture, rather than the *quantum* of debt as a proportion of that capital investment. In other words, what other forms of capital should the family farm be looking to access other than traditional bank debt?

Debt, by definition, requires the payment of principle and interest (P&I) to the lender over a prescribed term. For most Australian farmers, these P&I repayments are on a regular monthly or quarterly basis, with loan terms typically less than ten years[13]. By inference then, most Australian farmers (at least, those with debt), have arrangements with their lender that impose frequent claims on short-term cash-flow, and a short-term investment horizon. These factors have the potential to be at odds with an industry that frequently experiences extreme volatility in cash flow and profitability, and with the long-term intergenerational view of the typical family farming unit.

Where should future farm funding come from?

This author contends that traditional bank debt should remain a significant (and primary) vehicle for capital flows into the agricultural sector. Bank debt is well-suited to many of the funding needs of farmers, and in particular for shorter-term working capital and trade facilities. At current interest rates (and even at historical average interest rates) family farmers have been able to access bank debt to build and grow sustainable businesses.

However, family farmers would benefit from alternative capital flows to *supplement* and *complement* bank debt. Non-debt capital (in the form of funding from private equity, superannuation funds, global investment funds, sovereign wealth funds, self-managed superannuation, middle market and other capital sources) has the ability to provide alternative benefits of term, tenor and improved (reduced) cash-flow requirements. Alternative capital sources would also provide competitive tension to the current debt providers, allowing for an overall lower cost of capital for the sector, and therefore providing for a more level playing field with our overseas competitors.

Farm finance in the USA

While 90 per cent of farms in the United States are small family-owned business (similar to Australia), farmers in the USA are less reliant upon traditional bank debt to fund their investment and operating capital needs, and they are also less likely to own their own property.

Farmers in this market benefit from three main funding or capital sources – traditional bank debt; the US Government farm credit system; and a mature farm land investment / leasing market.

[13] Rural Bank

Each of these is supported by a robust farm insurance program – typically subsidised by the US taxpayer – and other associated tax benefits afforded to investors in farm land.

The farm credit system was established by an act of the US Congress in 1916, with the express purpose of providing credit for American agriculture at competitive rates, as well as offering insurance and other related services. It has since grown to become a nation-wide network of specialist agricultural lenders and service providers (typically operating under a customer-owned or mutual business structure)[14]. The farm credit system currently provides approximately 55 per cent of all farm debt in the US market – and is the dominant player in term funding for land purchases. Commercial banks provide the other 45 per cent of farm debt (out of a total US$360 billion marke), but given the government mandated/sponsored nature of the farm credit system these players tend to compete most in the working-capital segment rather than term-debt for land purchases.

The commercial leasing or farm land market in the US is deeper and more established than in Australia[15]. High property values and the capital intensity of farming has been identified as a barrier to young and emerging farmers – and this is supporting a shift from a traditional owner-occupier model to a renter-operator model. Consequently, the levels of renter-operator farmers is much higher than in Australia. According to research from the Australian Farm Institute, this may be due to a lack of risk management insurance for this market segment, and the taxation arrangements applicable to capital assets in Australia[16].

Caption: Will Rayner outside the Australian Embassy in Beijing, China.

[14] Farm Credit System, viewed at *www.farmcreditnetwork.com*

[15] Noonan G, A Perspective from the US, Proceedings of the Funding Agriculture's Future conference, 2014, Australian Farm Institute, Canberra

[16] Australian Farm Institute, A Review of Farm Funding Models and Business Structures in Australia, 2016

The role of multi-peril insurance

Higher levels of renter-operators in the US agricultural sector are both a causation and consequence of lower equity levels than their Australian counterparts. Young and emerging farmers begin their careers with less landed assets to use as security for borrowings, and established farmers gain capital efficiency in their business by continuously leasing land rather than owning it outright. The prevalence and commercial viability of a range of risk management and insurance products has supported this evolution.

While Australian farmers have access to a limited range of insurance products, the US farmer has a much broader range of multi-peril or quasi income insurance products. These include crop revenue coverage, revenue assurance, income protection, livestock risk protection, and livestock gross margin insurance[17]. These broad-based insurance products allow the American farmer to significantly reduce the risk and volatility of their income – particularly in an environment where they have typically lower equity levels and a higher proportion of fixed rental (or lease) costs. From a commercial banking perspective, this insurance allows the lender to reduce the risk of lending to an individual business, and therefore underpins both the supply and cost of debt (particularly for working capital) into the sector.

However, while these insurance products are used widely in both the US and Canadian farming sector, they remain heavily government subsidised. In some cases government farm subsidies are only made available if these insurance products are purchased (effectively making them government mandated). Similar products in Australia are either not available, remain cost prohibitive to purchase, or are yet to achieve the scale and adoption that would ensure their continued support and availability from insurers and re-insurers in the Australian market.

What other forms of capital are available?

Since the Global Financial Crisis there has been an unprecedented injection of cash into the global economy – a direct result of central banks across the globe undertaking ‘quantitative easing’ in an attempt to stimulate economic growth. It is estimated that more than $13.7 trillion has been injected into the global economy since 2007.

Efforts to stimulate global growth have been largely ineffective, with global interest rates still at historical lows and much of the developed world still experiencing real negative interest rates. Global capital markets are therefore dealing with duel impact of inflated liquidity levels, and a lack of yield in their investment portfolios. Despite this – and despite the ‘mega trends’ referred to above – this is yet to translate into significant investment flows into Australian agriculture.

[17] Australian Farm Institute, A Review of Farm Funding Models and Business Structures in Australia, 2016

In additional to the cash flows from quantitative easing, Australia also has access to one of the world's largest superannuation industries, courtesy of the compulsory superannuation obligations of most employers. This scheme has provided a pool of more than AUD$2.2 trillion to invest in long-term assets for the retirement benefit of Australian workers, and yet less than 0.3 per cent of these funds are finding their way into agricultural assets.

The current low levels of investment contrast with a reasonable history of institutional interest in large scale Australian agricultural investments going back to at least the 1960's. But, according to a discussion paper by Industry Super Australia titled '*Driving Super Fund Investment in Agriculture'*, efforts to invest in the sector have remained largely unsuccessful[18]. This is despite the same report suggesting potential returns of 6 to 9 per cent in a buy-lease operating model, and 8 to 12 per cent in a buy-operate model; and highlighting the potential for farm land, timberland and other real assets to provide diversification, lower volatility and increased returns within a balanced investment portfolio[19].

Even if it is accepted that some of the institutional interests referred to above continue to operate and invest in Australia (and therefore it remains too early to determine whether they have been successful over the long term), it is clear that this investment still remains out of reach for the family farm. The costs associated with large scale institutional ownership, the scale required to undertake traditional due diligence, and bias against the sector due to historical underperformance or investment failure, are contributing factors to this.

The challenge for the agricultural sector is to address the issues which have prevented investment in agriculture at an institutional level, while also contemplating how future investment might filter down to the family farming sector.

Non-traditional sources of capital

As previously discussed, one of the by-products of a vibrant farm land leasing sector in the United States and Canada is a family farm sector with lower levels of equity (primarily landed assets) than their Australian counterparts. This has provided for capital efficiency on the part of the family farmer, and reduced the barriers for both young and emerging farmers to enter the market.

It has also provided an attractive environment for non-bank financiers to meet the finance needs of farmers who may not qualify for debt through traditional sources. These funders include, but are not limited to: farm-input providers providing advances on seed, fertiliser and chemical; grain

[18] Industry Super Australia, Discussion Paper, Driving Super Fund Investment in Agriculture, viewed at *www.industrysuperaustralia.com*
[19] Industry Super Australia, Discussion Paper, Driving Super Fund Investment in Agriculture, viewed at *www.industrysuperaustralia.com*

and livestock merchants providing finance for stock trading and/or purchase of farm inputs; farm machinery providers providing finance for plant and equipment; and non-bank lenders providing short-term unsecured loans.

The majority of these organisations provide valued and legitimate funding alternatives for the family farming unit. However, the unregulated nature of this market means the potential for miss-selling or misrepresentation of the nature of the financial product is significant, and/or there are unintended impacts on the broader agricultural debt market. The effective interest rate on some pre-harvest advances would appear punitive, while the contractual terms for some pre-harvest products (which effectively lock the farmer into a forward physical contract for delivery of grain) have sometimes acted contrary to the interests (or understanding) of the farmer taking out the contract. From a traditional banking perspective, many of these products have the effect of subordinating the security that may already be held by the bank.

Notwithstanding these risks, it is clear than non-bank financiers can and have built substantial financing businesses, with significant market share and market power. John Deere is a well-known business with a market capitalisation of more than US$40 billion[20]. While it is famous for building tractors and harvesters (and more recently autonomous steering and data collection technology) it also has a global loan portfolio in excess of AUD$30 billion. To put this in context, the entire Australian agricultural debt market is approximately $64 billion[21].

Conclusion and recommendations

While it is clear the issues surrounding farm finance are complex and varied, this author suggests four key areas of focus to improve, broaden and deepen the sources of capital available for Australian family farmers.

a) Get investor ready

I. *Family farmers*: The Australian family farmer has a strong track record of innovation and excellence ‘at the farm gate’ – namely in food and fibre production and marketing. As a sector we need to ensure the same level of innovation and evolution is experienced in farm business structures, financial literacy, and risk management. A sector that is better able to manage risks associated with variable cash flows (among others), that provides long-term profitability and capital appreciation, and most significantly can demonstrate this with accurate

[20] John Deere website, viewed at *https://investor.deere.com/home/default.aspx*
[21] Reserve Bank of Australia viewed at *www.rba.gov.au*

and robust financial reporting, is vital to ensure institutional capital flows into the sector.

II. *Institutional investors:* The other side of this same coin is ensuring institutional investors have the skills and experience to properly assess the value of agricultural assets and investment opportunities. The domestic superannuation sector accepts there is a lack of knowledge in the sector by fund trustees, executives and asset managers[22], and the lack of foreign investment would suggest there is much to be learnt from a global perspective as well. Agriculture is a unique asset class, and requires a specific skill set to properly assess and manage.

III. *The role of data:* In order to both manage and invest in agriculture the sector requires better and freely available industry-wide data. Unlike many competing asset classes, a lack of appropriate data means the ability to accurately benchmark agricultural sectoral performance is virtually impossible. Current efforts to calculate farm profitability from district-to-district, and from commodity-to-commodity is either incomplete or non-existent. In contrast, providing farm data to a centralised body is a prerequisite to qualify for many programs under the US Farm Bill. Consequently the availability and accuracy of US industry data is much more prevalent. While better data would benefit the investment community, it would also have significant benefits for the creation of public policy, regulation and legislation relating to the sector.

IV. *Aggregation:* Most institutional investors require significant scale in order to contemplate appropriate due diligence and investment in any particular asset class. Institutional fund managers in Australia (for instance) would rarely look at investment opportunities for less than AUD$100 million. By definition, almost all family farms would fail to meet this criteria, and are therefore excluded from this part of the market. An opportunity exists for third party industry participants (potentially fund managers and/or current financial institutions) to act as asset aggregators for institutional investors. This has the potential to provide scale, and also potential benefits of diversity by both geography, commodity, and farm type.

b) Contemplate cultural issues

I. *The 'great Aussie dream':* While it is relatively easy to quantify the formal financial structures and data that would promote alternative investment in agriculture – it is less clear what cultural barriers would prevent the typical family farm from contemplating alternative finance or capital structures. Central to this is

[22] Industry Super Australia, Discussion Paper, Driving Super Fund Investment in Agriculture, viewed at *www.industrysuperaustralia.com*

likely to be a transition from the 'great Aussie dream' of owning your own family farm in its entirety, to a structure where farmers may rely on significantly higher levels of rented or leased land. Alternative finance structures may also include third-party equity contribution; third-party influence on decision making and strategic planning; increased requirements for reporting; or a combination of all the above. The cultural impact of these factors on the family farming unit would need to be considered as part of any alternative finance model.

II. *Shared value models*: Past forays into agricultural investing from the institutional sector have typically underperformed the theoretical returns available[23]. While there are many contributing factors to this underperformance, this author contends that historical 'buyout' or 'buy-leaseback' models of the institutional investor has played a significant role. A multi-generational family farm contains significant intellectual property and skills that are not easily replicated in a corporate sense. Additionally, the shorter investment horizon of the typical institutional investor may be at odds with the extended business cycles experienced in agriculture. It is likely that a shared value model of ownership or investment (where investors and traditional family farms partner for joint success) is better suited to these vagaries. Shared value economics are more likely to align the interests of the farmer with the investor – with both sharing in the business profitability *and* capital appreciation of farm land, rather than the interest of each being played against each other (as might be the case in a traditional buy-leaseback model).

c) The role of government

I. *Superannuation, funds management, and asset allocation*: Australia is fortunate to have one of the largest superannuation industries in the world. It performs a significant and valuable role in protecting the livelihoods of millions of Australian people, and provides a valuable source of capital to invest in infrastructure and the real economy. However, as discussed earlier in this paper, the agricultural industry has not benefited from these capital flows or investment. While this author does not contend that government should seek to artificially incentivise investment in agriculture, or to distort normal market forces, it should explore the structural impediments to agriculture competing on a level footing with other asset classes. Specifically, consideration should be given to aligning the investment horizon (and remuneration and reward structures) of the fund management and asset allocation sector to the needs of the Australian

[23] Industry Super Australia, Discussion Paper, Driving Super Fund Investment in Agriculture, viewed at *www.industrysuperaustralia.com*

superannuation participant. In other words, reward the sector for taking long-term investment decisions over shorter-term and yield driven decisions that may not contribute to the overall efficiency of the Australian economy (or where, for instance, investment is better suited to traditional bank debt). This would particularly benefit agriculture, with significant opportunity for long-term returns despite short term volatility due to seasonality and commodity prices.

d) Fit for purpose insurance

I. *Risk management options:* Australian farmers operate in a variable and volatile industry, where the ability to manage through natural disasters and commodity price cycles should be viewed as a core competency. While the Australian farmer has a track record of more than 200-years successfully managing risk, this has primarily been achieved by high equity ratios (land values) being leveraged (through bank debt) to manage short term cash flow variability. Consideration should be given to alternative risk management tools and strategies that allow industry participants with lower equity ratios (or new and emerging industry participants with little or no equity backing) to manage risks appropriately. In addition, the use and adoption of risk management tools that allow for the smoothing of cash flows (for instance, multi-peril crop insurance) will provide the institutional investor with greater confidence to invest in the sector. These risk management tools are widely adopted in both the US and Canada – but are dependent on significant government support and subsidies. The question for the Australian industry (and government) remains whether the cost of support for schemes like multi-peril insurance outweighs the real and hidden costs of issues like drought in an Australian context.

Appendix – media clipping

Australian Financial Review, April 23, 2017

'Rural Bank's Will Rayner looks to avoid 'Kodak moment'

http://online.isentialink.com/afr.com/2017/04/23/2cf7eb5d-7285-4f30-888c-5e58d5de555c.html