



Why Invest into Farming and Rural Equity Partnerships?

With over 500 Equity Partnerships (EP) formed in New Zealand over the last 10 years, EPs have become a common vehicle for those seeking to gain access to a farming investment in New Zealand. The trend looks set to continue into the future, as existing and aging New Zealand farm owners look to succeed their farming assets and the parcels of capital required get even larger.

500 EPs represents only about 4-5% of all dairy farms in New Zealand from a number perspective, but EPs are typically much larger than the average dairy farm. Based on The National Bank's estimates, EPs make up between 10-20% of New Zealand's total milk solids production.

While the number of EPs is growing, so is the range of people seeking to enter into them. Initially, it was mostly existing farmers looking for further growth or diversity outside the farm gate. Now, we have increasing numbers of EP participants from a non-farming background, as individuals seek to get investment access to one of New Zealand's biggest industries.

I often get asked by individuals looking to invest capital – why would I invest into a Farm EP? In this newsletter, I will cover off five major points to consider:

1. Access to investment in New Zealand Agriculture Inc.
2. Financial returns
3. Macroeconomic trends
4. Personal growth
5. Diversification.

1) Access to investment in New Zealand Agriculture Inc.

Agriculture is one of New Zealand's biggest industries and largest investment sectors. New Zealand farms are estimated to be valued at \$140-\$160 billion (land only, economic units only, based on Beef + Lamb, QV and Dairy New Zealand data estimates). Compare that to the market capitalisation of the New Zealand Stock Exchange (NZSE) of \$50.6 billion (as at July 31 2010), and listed vehicles related to Agriculture & Fisheries which total only \$1.35 billion. You have to go to the total assets held by New Zealand households (including equities and other investments), at \$214 billion, to find a bigger investment sector.

However, gaining access to the sector is increasingly difficult. The average South Island dairy farm is now approximately 200ha with an approximate value of \$7.5 – \$8.5 million (including Fonterra shares, but excluding livestock and plant). Applying a debt gearing ratio of say 50% and allowing for livestock and plant, you may need an equity parcel of \$4.6 million - a not inconsiderable sum of money.

Simply put, there are very few easily accessible ways to invest in New Zealand farms for the average investor with a smaller parcel of capital. However, EPs provide an opportunity to give both smaller investors and young people looking for a stepping stone an opportunity to get into the sector.

For investors, an EP as a vehicle will typically take an investment parcel of \$500,000, less in some cases, for eligible investors. This provides access to New Zealand agriculture at lower levels.

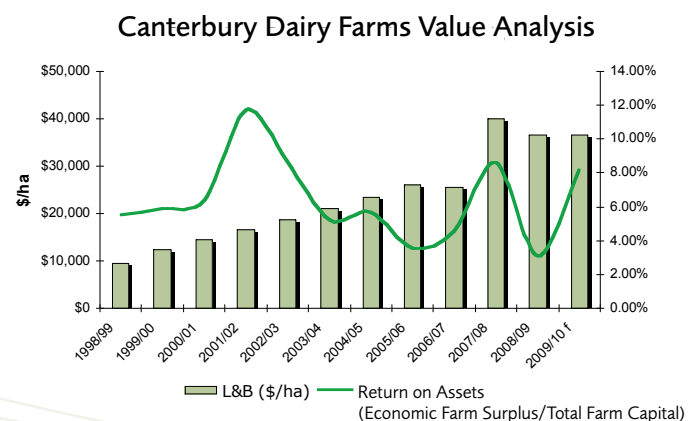
Likewise, young people coming through the dairy industry and seeking farm ownership will see equity ownership as a way of achieving this. On top of the increasing amount of capital required to get into a farm there has been a reduction in the number of sharemilking jobs. This means that there are very few managers (or sharemilkers) making the step directly into 100% farm ownership.

For the same reason, EP structures are commonplace when achieving family succession objectives and can be used as a way of treating all family members as fairly as possible. Using EP structures in family succession will be explored in greater detail in upcoming newsletters.

2) Financial Returns

Returns in farming can be broken down into cash and capital growth.

The following graph is taken from a recent study by Property Advisory of Canterbury dairy farm sale prices and their cash returns over the past 11 years.



The graph tells us a number of things about Canterbury farming businesses:

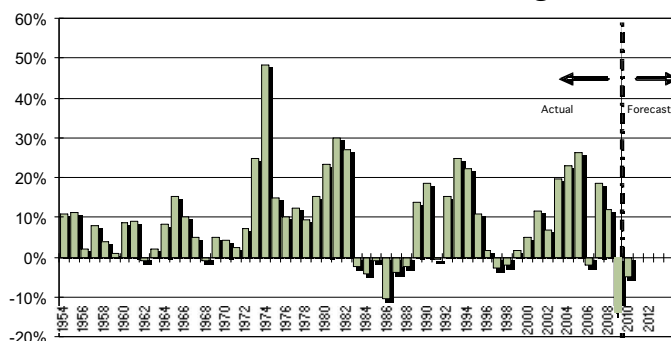
- Land values, excluding Fonterra shares, have risen from about \$10,000/ha in 1999 to \$36,500/ha in 2010. That is an average rate of return of 11.87% p.a. even factoring in the most recent drops in land value.
- Return on Assets (ROA) has generally kept pace with appreciating land value. The average return on a cash basis (return on assets, or economic farm surplus/total farm capital or yield) is around 6.5%. Based on current values and last year's payout, current ROA is over 8% and over the long run average.
- If you invested \$1 into the average Canterbury dairy farm in 1999, had no debt and reinvested the cashflows, you would have \$8 back at the end of that period. This represents a nominal internal rate of return of approximately 21%.

The question then becomes "how does an investor extrapolate this forward into the future?"

Looking at capital growth in more detail, let's consider historical capital growth in land value over time.

Land value growth primarily comes from the increase in value of the farming asset over time, from either general changes in value (market shifts), productivity (increasing production of the same asset) or by developmental changes (e.g. irrigation development). The following graph shows change in farm value as noted by QV over a 50+ year period, that on average farms have appreciated by 8.36% p.a since 1954.

QV All Rural Land Index - % Change



Source: NBNZ, using QV data

However, it's important to consider that:

- Unsurprisingly, farms don't always increase in value and following large increases, we can expect a period of decline. This has happened more than once.
- You need to have a reasonably long-term investment horizon when investing in land to smooth out some of the volatility in land value shifts.
- Your business needs to be strong enough to weather volatility in your land price, in order to access those returns over a longer period of time.
- Individual farms don't necessarily follow the "average" – market perceptions of one property may see it changing in value at better or worse than average.

Different payouts, different cash returns

The cash return (as a %) depends on the farm purchase price, payout levels, costs and amount of debt. All of these factors can lead to highly different cash returns as a percentage of total assets.

For example, the following table shows the effect of different payout levels on the pre tax cash returns for a farm valued at \$40 per kgms (including all land, shares and livestock and plant)

PAYOUT	\$4.00	\$5.00	\$6.00	\$7.00	\$8.00
Farm income (including stock sales)	\$4.30	\$5.30	\$6.30	\$7.30	\$8.30
Farm Working expenses (including plant replacement)	\$3.75	\$3.75	\$3.75	\$3.75	\$3.75
EBIT	\$0.55	\$1.55	\$2.55	\$3.55	\$4.55
Return on Assets (ROA)	1.38%	3.88%	6.38%	8.88%	11.38%
Equity Ratio	50%	50%	50%	50%	50%
Interest bill (including OD)	\$1.70	\$1.70	\$1.70	\$1.70	\$1.70
Net profit before Tax	-\$1.15	-\$0.15	\$0.85	\$1.85	\$2.85
Pre-tax Cash Return on Equity (ROE)	-5.75%	-0.75%	4.25%	9.25%	14.25%

As the table shows, cash return on asset value is significant when above \$6.00 per kgms, but marginal when below. At current payout expectations, cash return on asset is approximately 7.5%.

Let's compare this to some cash returns of different asset classes:

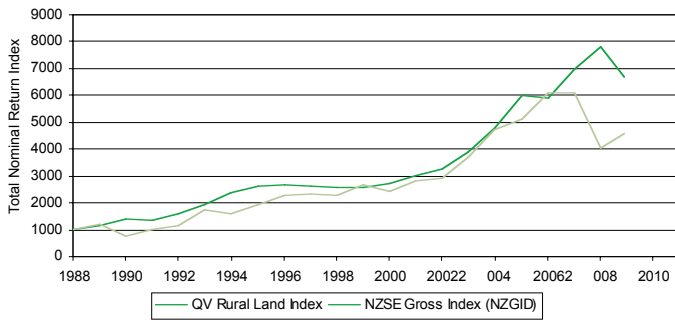
Asset class	Return
Residential property	4.4% (based on median house price of \$352,000 and median rent of \$300 per week, before any house costs)
Shares (NZSE listed companies)	5.5% (based on current P/E ratio for all NZSE listed companies of around 18 times)
Commercial property	6-10% (current yield on commercial properties)
Bank term deposits	3-6% p.a.

At below \$5.75 per kgms, dairy farming as a cash activity doesn't compare any better than the above activities. However, above \$6.00/kg the returns compare favourably. So, the argument as to whether or not farming is a good cash investment depends on your view of payout in the future.

Lastly, the following graph compares the returns from land to returns from the New Zealand sharemarket since 1988. The graph shows the increase in land value (but not any cash returns) and compares it to the total returns from the New Zealand sharemarket (including dividends). One dollar invested for that period in the sharemarket would have returned you \$3.62, whereas an investment in land would have returned \$5.38. This is assuming no cash returns from farming, which should add to that figure.

20 Years Comparison:

Nominal Return QV All Rural Index Vs NZSE Gross Index 1989-2009



Data Source: Private Banking, QVNZ

3) Macroeconomic Trends

So far, we've discussed access to the New Zealand agricultural sector and investment performance. But how will land and farming perform in the future?

Let's take a very quick and high level macroeconomic view of the world as it relates to agriculture and particularly to the likelihood of increases in rural land prices.

The case for land price increase	The case against land price increase
Increasing world population means more mouths to feed	Higher prices for commodities stimulates more production and potential oversupply
Increased urbanisation and desertification of land means less productive area	Large tracts of more marginal land brought into supply land
Growing wealth in the growing populations of more recent trade partners e.g. China	Global trading partners' growth slows dramatically, decreasing purchasing power. New Zealand is too dependant on too few markets. e.g. China
Decreasing world water supply reduces ability to grow protein	Returns for higher commodity prices are not captured by growers, but by intermediaries such as supermarkets
Technology improvements do not deliver necessary productivity changes to keep pace with demand	Global credit supply more constrained Investors demand higher cash returns
World trade restrictions lessen	World trade restrictions increase

There is little doubt that the recipe for change in land value is indeed a complex one.

The price of any asset, be it land or a piece of fine art, is largely determined by investors' *perceptions* of the supply and demand of that asset, or the perceptions of the associated factors around that asset.

It is the *perception* that will end up driving the *sentiment* which in turn will drive the value. Therefore it is the medium to long term *sentiment* that investors need to take a view on when investing in land.

Having taken a view on that, the question that remains for an investor is "How much of this is already factored into the value of land"?

4) Personal Growth

Investing into an EP is, in essence, investing into a private company or limited partnership. Because of the relatively large amount of capital invested when entering and the relatively few investors in the EP, it is likely that the EP investor will have a meaningful say in the governance or the management of the farm.

EPs often have reasonably formal structures and systems in respect to the shareholders, the directors and the governance who all influence decision making, reporting and control. Being exposed to this type of business structure has a number of different personal growth opportunities:

- Collaboration: Being exposed to the challenges and benefits of team decision making. Whilst this often allows for better decision-making and new processes around decision making, it's also a chance to learn how to deal with conflict and different thinking styles.
- Cross pollination of skills: In an EP, you are exposed to different management, governance and personalities of the company board, providing a chance to learn new skills.
- Network: Being exposed to a wider network of business contacts may present future opportunities.
- Scale/type of business: A greater scale business may mean greater reporting requirements and more complex systems whether it be dealing with shareholders, banks or other stakeholders.
- Leadership: Having to front a shareholder group or having to influence the governance team increases the need for leadership skills.
- And the list could go on...

5) Diversification

There are two aspects to diversification: The opportunity to invest in different industries, and the opportunity to reduce individual business risk.

Investing in a different industry: Investors in an EP often see it as an opportunity to get exposure to another industry without having to buy that business outright. They may be from a farming background, but a different farming industry, or they may be non-farming investors who seek a way to invest in the farming sector.

Reducing individual business risk: EPs allow investors to manage risk by exposing a smaller part of their portfolio to a particular business. Often we speak to investors that are in a number of EPs, but within the same industry, lowering the people or individual business risk.

Summary

The decision to invest into farming should not be taken lightly. As with any investment, the preparation you undertake is of great importance and will pay significant dividends down the track to enable a successful venture.

Historical returns suggest farming compares favourably to other investment alternatives in New Zealand, however, history is no indication of future performance. The future story is driven by some sound fundamentals, but there are indications of a high degree of volatility down that path.

Some of the key factors for success are:

- Do not rush
- Take care during due diligence and seek advice from professionals

- Understand the value proposition for the investment
- Clearly identify and prioritise your needs as an investor
- Take care choosing your fellow investors – their attributes are more important than the capital they provide
- Agree on a Business Plan
- Complete a Shareholders' Agreement, Partnership Agreement or similar prior to investment.

Following a process like this does not guarantee that an investment will be successful. However, it does greatly increase the chances of success.

Sources: Reserve Bank, QV New Zealand, LIC, Property Advisory Ltd, NZX, The National Bank.

Current Opportunities:

- 1) Across New Zealand: (Waikato, Southland, Canterbury plus others).** There are EP groups forming throughout New Zealand. These groups are forming so that when they go to bid on a farm, they have most of their capital together, rather than the more traditional route of contracting a farm, and then seeking equity afterwards. If you would like to be introduced to an EP group or leader in your area, contact us.
- 2) Southland:** A developing opportunity to invest in a 300ha+ conversion opportunity using the latest technology to house and feed dairy cows. Projected productivity per cow is at the very top end. This farm is the result of considerable input from some of New Zealand's leading farm management and veterinary consultants. Equity Management is in place. An Information Memorandum will be available soon.
- 3) Central Southland:** An existing, fully managed 290ha dairy farm with low gearing seeks new shareholders. Cash dividends have been paid annually since 2003.
- 4) Western Southland:** An existing 172ha sheep and beef farm seeking an equity manager and or/investor to convert to dairy.
- 5) Westland:** An expansion opportunity to see the completion of a conversion project that will result in 930 ha over two dairy farms plus a share of a 170 ha grazing block in North Canterbury. This business will be a significant supplier to Westland Milk Products. Land is still being developed and the farm is currently milking 1900 cows. This is an opportunity to share in the land development and milk production gains in this significant dairy farming business.
- 6) Otago sheep and beef:** A large scale, 10,000 SU (approx) existing sheep and beef, breeding and finishing operation with proven management in place is seeking an investor of \$1.5m. A good mix of freehold and leasehold land is delivering higher than average cash ROA. Approximately 75% equity on completion.
- 7) Sheep and Beef Equity Managers:** We have a number of young farmers with capital seeking part ownership options on sheep and beef farms, including high country farms. This could be an option for a farmer looking to sell part of the ownership of their farming business as part of a retirement/succession plan.



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