FLAG

U.S. Farmland: Seeds of Change

The current and (potentially) future owners of farmland in the United States

In this edition of ***Insights*** we consider the trends that impact another emerging institutional asset class – agriculture. As part of the collection of sub-asset classes loosely referred to as "real assets," agriculture is a broad category that includes a myriad of sectors – commodities, agribusiness opportunities, farmland investments, *etc*. For purposes of this discussion, we focus on one aspect of agriculture investment – farmland investment in the United States (both row and permanent cropland).

FLAG recognizes that the practical implications of how to design, implement, and monitor a private real assets investment program inclusive of farmland investments can be difficult and elusive for many investors. There are a number of factors (both micro and macro) and risks (both endogenous and exogenous) to consider when investing in farmland assets. While many of these factors and risks, such as appropriate geographic / crop type diversification, active on-site management and current yield potential have been discussed broadly in the institutional investment community, FLAG has chosen to focus this edition of Insights on the composition and construct of the underlying ownership base in the U.S. farmland sector. It is FLAG's view that the evolution of the ownership base will greatly influence many of the areas mentioned above, making it a critical component to understand and consider when evaluating an investment in the asset class.

As a distinct institutional asset class, farmland investing appears similar to the relatively early days of institutional timberland investing, the features of which we explore below. A recent sentiment in the investment community is the belief that the evolution and institutionalization of farmland investing is following the same trajectory as institutional timberland investing. While FLAG recognizes that there are many strong similarities that would likely cause farmland to evolve in a comparable way to timber, there are also some key differences to consider, specifically related to each asset class' ownership base. We will explore and highlight these factors, as it is FLAG's belief that they are likely to influence the future path of U.S. farmland ownership. Finally, we conclude with areas of consideration for the U.S. farmland sector and how the evolution of timberland investment may (or may not) be used as a guidepost for the future of farmland investing.

The Case for Farmland Investment

Before jumping into the discussion of the factors that will likely influence the path of U.S. farmland ownership, let's step back and briefly outline the characteristics of the asset class. Readers of our 2006 inaugural real assets Insights piece, "Real Assets: A Natural Addition" will recall the fundamental benefits offered by investing in private "hard assets" (also referred to as "natural resources" and "real estate"): (1) strong risk-adjusted returns that compare favorably to other asset classes; (2) return profiles that are independent of other financial investments – providing portfolio diversification (as a result of low correlations); and (3) returns that are positively correlated with inflation. Indeed agriculture, and more specifically farmland, investing can provide similar benefits that can be additive in an institutional portfolio context.

Agriculture as an asset class has also benefitted from macro factors that offer attractive long-term trends for investment. The primary factor often cited is the growing global demand for protein, which is the direct result of the increase in the wealth of emerging countries and their citizenry. A secondary factor is the rise of biofuels in the energy value chain. Both of these trends lead to increased demand for a variety of agricultural products – including soybeans and corn, which are commodities produced in the U.S. (among other countries).

U.S. Farmland: The Path forward?

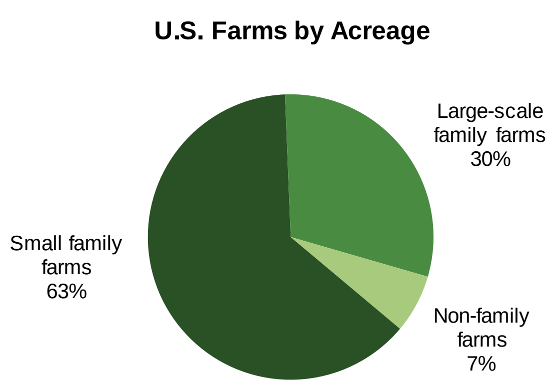
Given the attractive portfolio benefits and strong supply and demand fundamentals of U.S. farmland, a key area to consider is the evolutionary process of the sector as an asset class available for institutional investment. Despite the fact that agriculture is not a new industry (human land cultivation has been in existence for over 10,000 years), institutional investment in farmland remains in its infancy. When viewed from an investor's perspective, the landscape appears familiar. Farmland is a regenerating resource that provides portfolio and inflation-hedging benefits while offering attractive relative returns, yet institutional penetration is fairly limited today. It calls to mind the earlier days of institutional timberland investment – farmland's close cousin in the real assets world with whom it shares many of the same characteristics. But can we say that the path taken by U.S. timberland investing can (or should) offer a glimpse into the future of farmland investing?

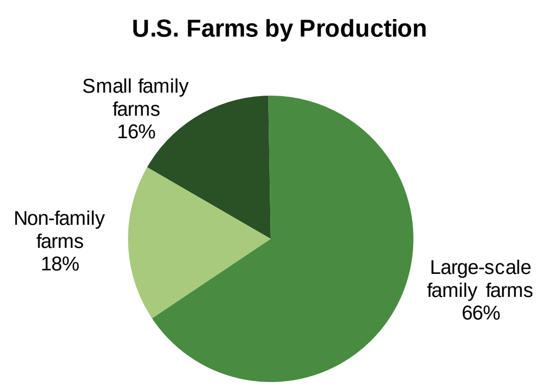
Let's examine this question more closely and consider some specific factors: (i) the current status and ownership structure of U.S. farmland, (ii) the historic drivers that impacted the shift of ownership in the U.S. timber sector and (iii) some of the key issues that will likely impact the path forward for U.S. farmland ownership and how it may or may not diverge from its real asset counterpart.

U.S. Farmland Ownership Overview

The U.S. farmland market is an extremely large and diverse segment consisting of approximately 922 million acres, which is roughly double the size of the U.S. timberland market[1, 2]. From an ownership perspective, the sector is highly fragmented, as U.S. farming is largely owned by families who often pass farms on from generation to generation. As shown in the charts below, over 90% of all U.S. farms are family operations with approximately two-thirds of the sector's acreage being owned by small family farms. Despite owning the majority of the land in the market, small family farms account for merely 16% of total U.S. agriculture production. In many cases, these small farms are owned by part-time farmers or absentee landlords. These owners typically have little desire and / or ability to invest capital in the underlying land or acquire the most modern equipment and technologies. In contrast, large-scale farms (family owned or otherwise) are able to benefit from economies of scale and typically have the capital to invest in the latest techniques and equipment, resulting in an increase in farmland yields. Currently, institutional investor ownership accounts for just a fraction of the sizeable U.S. farmland market due to the long-established ownership base within families.

Figure 1: U.S. Farmland Ownership by Acreage & Production[3]





The sector's fragmented ownership base presents some significant challenges in the current environment, particularly from a farm management and labor perspective, as the U.S. agriculture sector is facing an aging operator base. Over the past 30 years, the percentage of farm operators 65 years of age and over has increased from approximately 16% to nearly 30% of all U.S. farmers[4]. This comes at a time when the expansion of the middle class in many developing countries has produced a need for increasing amounts of agriculture supply from productive farmland. This expected supply shortfall will likely be filled by outside markets (such as the U.S.) due to the fact that the overall available arable land in these developing countries is shrinking due to urbanization. As global supply and demand continues to tighten, more and more financial investors will likely target the U.S. farmland space as an interesting and emerging sub-asset class with strong portfolio benefits.

With an increasing number of institutional investors focused on farmland investing, the key question of how (and in what timeframe) the current ownership base will transfer to more financially-oriented investors remains unanswered. The U.S. timber sector is often used as a guidepost for agriculture, due to its relatively recent shift in ownership to financially-oriented investors. Next, we briefly discuss the history and key issues in this shift before concluding with how these items may or may not predict the future ownership of U.S. farmland.

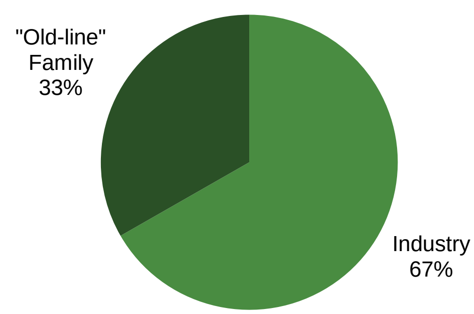
Only Yesterday: Ownership in the U.S. Timber Sector

In our previous 2011 Insights piece, "International Timber – The New Frontier," we outlined the historic transfer of U.S. timber ownership from the vertically integrated forest products companies to a diverse and diffuse set of owners (including financial investors). Two key drivers that greatly influenced this transition were identified: regulatory changes and timberland management. From a regulatory perspective, the passage of the Employee Retirement Income Security Act (ERISA) in 1974 drove institutional investors to consider a broader investable universe (away from simply stocks and bonds) to better diversify their portfolios and hedge against inflation. At the same time, from a management perspective, institutional investors recognized that the vertically integrated forest products companies were first and foremost using their timberlands as a source of supply for their processing facilities – looking to maximize *volume production* of the timber. Financial investors identified an opportunity to acquire timber with the sole goal of maximizing *value*. This would include leaving timber on the stand if prices were low and allow the trees to gain in value through ongoing growth – a key advantage in managing the return profile of timber investments.

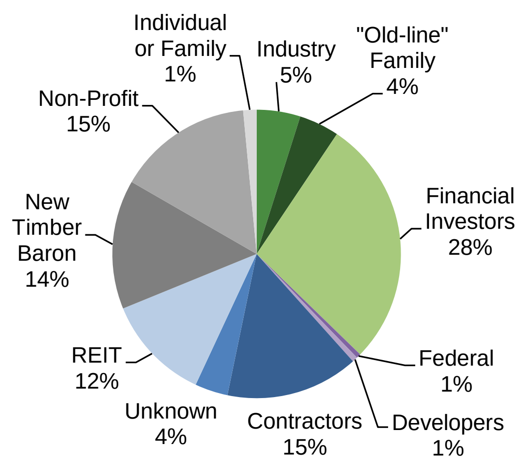
These key shifts resulted in an increase in the number of investment management groups solely focused on managing and maximizing the value of acquired timberland. Over a period of 25 years (from 1980 – 2005) Timber Investment Management Companies (TIMOs) and Real Estate Investment Trusts (REITs) increased their timber ownership from $1 billion to $25 billion[5]. Furthermore, over the same period the vertically integrated forest products companies' timberland ownership decreased from 58 million to 21 million acres in the U.S.[6] Timberland in the U.S. went from an asset class that was mostly held by a relatively small number of companies to a diverse set of owners. This is highlighted in the charts to the right depicting the acquisitions and dispositions of the Hancock Timber Resources Group (one of the earliest movers in timber investing) in the Northern Forest Region from the mid-1990s to the mid-2000s.

Figure 2: Acquisitions & Dispositions of Hancock Timber Resources Group[7]

Sellers to John Hancock (1993 - 1997)



Buyers from John Hancock (1995 - 2004)



As a part of this emergence in the operator base, many REITs became listed as public vehicles. This provided retail investors with access to REITs, which was one factor contributing to the substantial amount of growth experienced in the sector. Since January 2004, the aggregate market capitalizations of two of the most well-known timber REITs – Plum Creek and Rayonier – have increased from approximately $6 billion to over $13 billion (as of December 2012)[8]. In addition, during 2010, Weyerhaeuser (the second largest owner of U.S. timberland[9]) decided to convert to a REIT structure in order to access a new class of yield-oriented investors. The emergence of and continued growth in the timber REIT sector, alongside the TIMOs, contributed to the ownership shift experienced throughout the U.S. timber sector.

Back to the Future?

As discussed above, the U.S. farmland sector is garnering more and more interest from institutional investors due to many of the asset class' portfolio benefits (strong risk-adjusted returns, diversification, inflation-hedging properties), which are similar to the benefits of timber investing (and "real assets" in general). This fact often leads many financial investors to evaluate both timber and farmland investments together when targeting inflation-sensitive assets for inclusion in their portfolio. That being said, when we use the transition in ownership that occurred in U.S. timber as a general guidepost for that of the U.S. farmland industry, some key differences and trends become readily apparent and are worthy of consideration.

Differences in Ownership Construct

- Highly Fragmented vs. Concentrated: Currently, the U.S. farmland sector is extremely fragmented, with the majority of farms owned by small family operations; therefore, any potential ownership shift would have to be "bottom up" in nature, whereby a large number of owners would likely be consolidated into a smaller group. This is in contrast to the transfer of ownership in the U.S. timber sector that started from a "top down" perspective, as the majority of U.S. timberland was owned by vertically integrated companies. When financial investors began acquiring timberland, the ownership pool went from a concentrated group to a more diverse and diffuse ownership base.

- Family-Owned vs. Corporate-Owned: The U.S. farmland sector has a deep history of family ownership with a number of farms having been passed down from generation to generation. By comparison, the majority of U.S. timber assets were owned by corporations whose sole purpose was to maximize shareholder value. Given the family ties involved in the farmland sector, there may be multiple interests (not just financial) that could potentially create challenges in the ownership shift to purely financial owners.

Key Trends for Evaluation

- Due to the current trend in the age of farmers in the U.S. today, the sector would need an emergence of, or growth in, the operator base in order to manage the assets on an ongoing basis for financial investors. One of the reasons the transfer of ownership in the timber sector was successful was due to the emergence of many TIMOs and skilled operators that were able to manage a portfolio of timberland at the asset level.

- It is currently very difficult for investors to acquire U.S. farmland through the public markets. The emergence and growth of public timber REITs allowed more and more individuals to invest in the sector, which among other things, created a potential exit option for financial investors.

Concluding Thoughts

While the transition witnessed in U.S. timber can be used as a *general* guidepost for the U.S. farmland sector, any potential ownership shift in farmland will likely follow its own path (and timeline) because of some unique characteristics of the asset class. Additional questions remain that are likely to impact the evolution of ownership in the U.S. farmland market: Will this asset class be impacted by future regulatory decisions as was the U.S. timber sector? How will the public REIT market evolve and will it be a viable exit option for farmland owners? Will lawmakers seek to protect the asset class as being the domain of "family-run" businesses and limit ownership penetration by financial / institutional owners? Given all of these outstanding questions, it is extremely important to understand and consider the current ownership structure and key similarities and differences to other related sub-asset classes. The prospective ownership base will likely influence acquisition values as well as the eventual depth and breadth of the exit market. These various factors are ever changing and must be considered on an ongoing basis as the U.S. farmland ownership base evolves over time.

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[1] Hoppe, Robert and Banker, David, *Structure and Finances of U.S. Farms: Family Farm Report 2010 Edition,* USDA, July 2010
[2] U.S. Environmental Protection Agency – Forestry: *Facts and Figures*
[3] Hoppe, Robert and Banker, David, *Structure and Finances of U.S. Farms: Family Farm Report 2010 Edition,* USDA, July 2010
[4] United States Department of Agriculture – Economic Research Service: *Beginning Farmers & Age Distribution of Farmers*, 2012
[5] Hickman, Cliff, *TIMOs and REITs,* March 19, 2007
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[7] Hagan, John, Irland, Lloyd and Whitman, Andrew, *Changing Timberland Ownership in the Northern Forest and Implications for Biodiversity,* Manomet Center for Conservation Sciences, 2005
[8] 10-K Annual Reports – Rayonier and Plum Creek; Yahoo Finance: Rayonier, Inc. (RYN) and Plum Creek (PLC)
[9] *Who are the Top Owners and Managers of Timberland in the US?,* Forisk Consulting