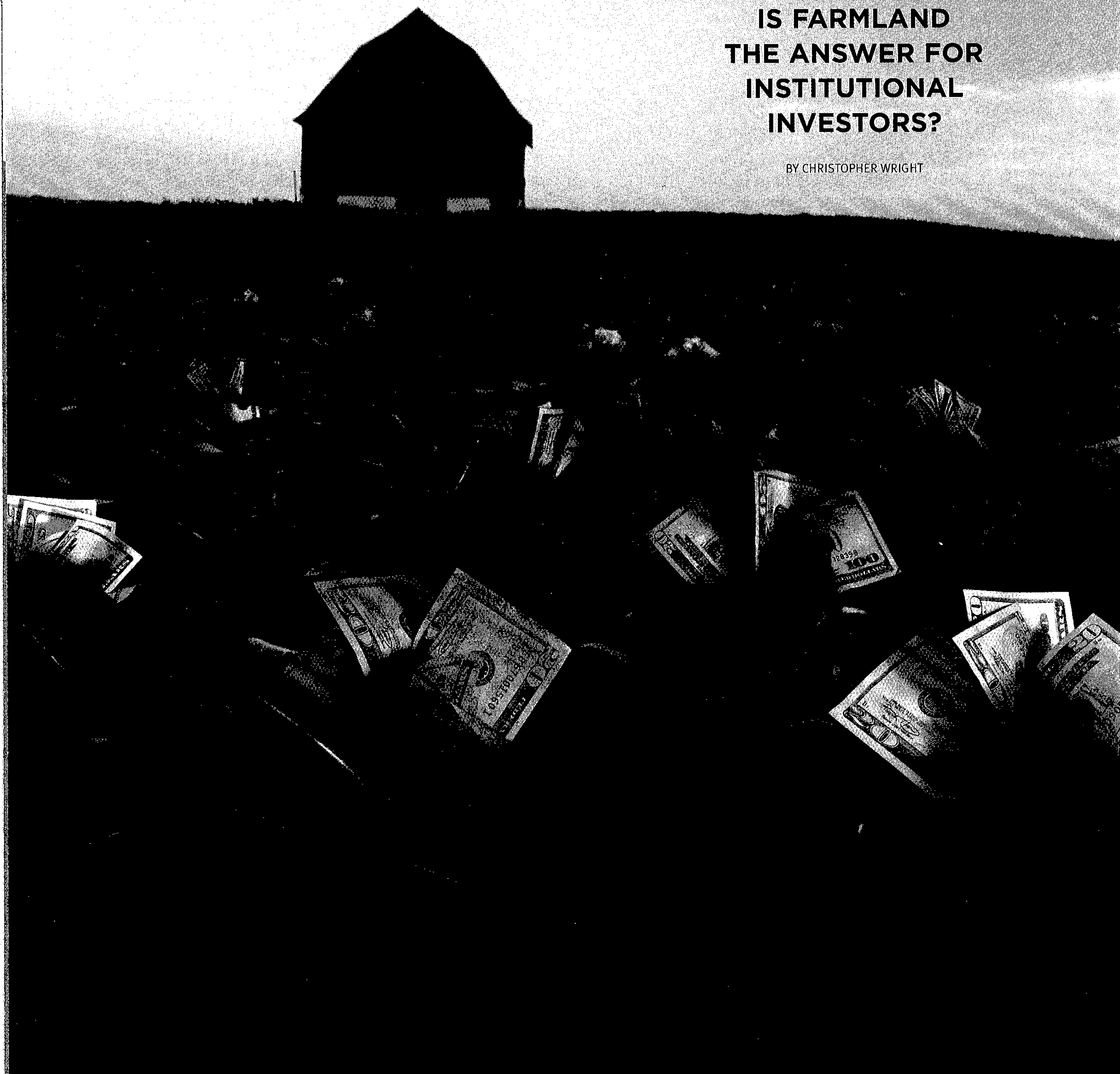
MONEY CROP

IS FARMLAND THE ANSWER FOR INSTITUTIONAL INVESTORS?

BY CHRISTOPHER WRIGHT



The thieves were very clever. They cut the fence at a farm truck yard and drove off in two of the owner's trucks loaded with 88,000 pounds of almonds worth US$260,000. They closed the gate behind them to keep anyone from noticing anything was amiss. They transferred the nuts to a larger truck and headed for the open road. If this recent case was like some of the dozen or so other nut-napping incidents in a five-county area in California in the last year and a half, the almonds were headed to advance buyers out of the country.

Why almonds? There's gold in the dirt. Almonds, popular now for their putative health benefits, have become one of California's top five crops. California almonds now fetch about US$3 a pound, and sales totaled US$2.2 billion in the 2004–05 season. Some California farmers are switching over from apricots, olives, and prunes. Almond acreage has increased by 13 percent in the last five years.

Encapsulated in this little story are the characteristics of an asset class—the risks, the rewards, and the aggressive bets investors can make. All U.S. farmland combined has a value of about US$1.5 trillion, but the institutionally investable universe is approximately US$600 billion (after subtracting timber, farmland in metropolitan statistical areas, states where institutional investment is not allowed, etc.), according to Brian Webb of UBS AgriVest in Dallas, TX.

Thus, in the view of Webb, who is also chairman of the NCREIF (National Council of Real Estate Investment Fiduciaries) Farmland Index Committee, the institutionally investable farmland universe in the U.S. is roughly equivalent in size to the four main pillars of U.S. commercial real estate—office, retail, industrial, apartments—which, in his estimation, average about US$600 billion a piece (when limited to significant institutional-grade properties in the largest 65 markets). Farmland properties held by reporting tax-exempt institutional investors only total about US$1.2 billion (NCREIF Farmland Index, unleveraged basis) and are thus just a tiny fraction of the investable universe. Over 40 percent of U.S. farmland is held by absentee owners who do not work the land, and, Webb says, that figure is likely to increase.

Farmland investing is not just for individuals anymore. Big institutions are in the game. The Teachers Retirement System of the State of Illinois started investing in farmland more than 20 years ago and currently has holdings approaching US$350 million. CalPERS is committed for up to US$200 million in West Coast vineyards. John Hancock Life Insurance Co. (a Manulife affiliate) is an active buyer.

Farmland provides "attractive risk-adjusted returns with great diversification benefits," according to Jeffrey Conrad, CFA, president of the Hancock Agricultural Investment Group (HAIG, also a Manulife affiliate) and former co-chair of the NCREIF Farmland Index Committee. With a staff composed of ex-farmboys and CFA charterholders, Boston-based HAIG oversees US$781 million in farm real estate and commitments, representing 140,000 acres in the U.S. and Australia, for nine institutional investors including public and private pension plans and unions.

Farmland is, "first and foremost, an excellent inflation hedge" for Murray Wise, CEO of Cozad-Westchester Agricultural Asset Management and the Westchester Group, which has offices in Champaign, IL, and Naples, FL. "Historically," he says, "it has offered anywhere between 100 and 150 percent in total return above the inflation rate over many decades." Wise, who was born and raised on a Canadian farm, has written two books on farmland investing and now manages over US$470 million in agricultural investments for state government pension plans and other clients.

According to William Howard, CFA, consultant in the Denver office of San Francisco institutional investment consulting firm Callan Associates, farmland may be attractive to large, inflation-sensitive institutions seeking solid current income and alternatives to bonds. "It's hard to imagine returns getting any better than they have been recently," Howard says. "Those new to the asset class are certainly not investing at the bottom of a market cycle."

How Good Can It Get?

"Our one-year [returns] in almonds are over 100 percent," Conrad says, referring to 2005. The increased client interest is gratifying, he says, after finding few takers for the 10 and 12 percent farmland returns he was generating during the go-go stock market years of the late 1990s.

Farmland values in the U.S. generally have increased more than 10 percent a year for the past three years and as much as 20 percent in some areas, according to Lee Vermeer, vice president of real estate operations for Farmers National Company in Omaha, NE. As one of the largest farm management companies in the country, supervising more than 3,600 farms and ranches on about 1 million acres in 22 states, Farmers National has found properties and operated farms for insurance companies, charitable organizations, and a state government pension plan.

Vermeer points out that current income can be significant: "If you look strictly at cash returns, we're going to see farms this year that, because of good commodity prices, are probably going to exceed 10 percent in cash return based on current value. If you add on the appreciation that we had last year of 10–12 percent in a lot of states, you're going to be looking at total returns that could be in excess of 20 percent."

Farmland returns may be reaching for the sky at the moment, but what is a reasonable long-term return expectation for the asset class? The NCREIF Farmland Index shows income of 6.7 percent and appreciation of 3.5 percent for a total annualized return of 10.3 percent for the past 15 years (through September 2006), putting long-term farmland returns somewhere between bonds and equity.

There's a catch, however. The appreciation figures are primarily based on appraisal data (although transaction prices are included when a property sells, according to an NCREIF spokesperson). "Appraisal smoothing" overstates returns and understates volatility and correlations, presenting a distorted picture of asset class stability and attractiveness. HAIG's Conrad tells his clients they can expect annual returns in the range of 8–12 percent, most of it from current income.

Higher-risk/higher-return segments are to be found in such permanent crops as almonds and in direct operation (as opposed to cash leasing). One reason permanent crops are riskier is that they cannot be switched from year to year as can row crops. Row crops in the Midwest have been consistent performers and constitute the stable portion of Wise's portfolio. But "our returns have gotten much more glitzy in the last 5–10 years in the permanent crop portion of our portfolio," he says. Almonds, which his firm brands and exports, have been performing best, but he is also in citrus, wine grapes, apples, pistachios, and cherries.

Wise directly operates his permanent crop land, usually outsourcing to a third-party manager but in some instances hiring employees to work the land. The risk of direct operation is mitigated through the use of 10–15 year supply contracts, such as providing Tropicana with citrus and Beringer with wine grapes. Wise calls long-term supply contracts a safe approach and relies on them heavily. Direct operation of permanent cropland (almonds, walnuts, macadamias, and wine grapes) is how HAIG puts clients with greater risk tolerance at the upper end of the expected-return spectrum.

Another way to boost returns is with leverage. While leverage may be routine in commercial real estate, it is not commonly employed by institutional farmland investors. Only one of Wise's institutional clients uses leverage, and that client added it only recently. HAIG, on the other hand, has a handful of institutional permanent cropland investors seeking higher returns that leverage up to 40 percent of asset value.

Wise points out that debt service is a challenge in a down market. As real estate adviser John Rutledge, president of Rutledge Company LLC in Wheaton, IL, observes, "There is some famous quotation—if you have a choice between building your business based on debt or facing a firing squad, choose the firing squad. There's always a chance they'll miss."

Busts in the Dust

Don't get the wrong idea. While there may have been a bumper crop of returns in recent years, plenty can go wrong in farmland investing—drought, pestilence, commodity price swings, rising interest rates, and trade disputes, to name but a few. In 1973, a cattle price collapse bankrupted ranchers, thrusting land titles into the hands of lenders. The farm crisis of the 1980s cut land values in half in some areas in the United States.

As with other asset classes, diversification helps manage risk. Callan's Howard agrees with the commonplace observation that a single farm property may be fairly risky but that a portfolio of farm properties is much less risky. "You can definitely diversify by crop type and by region," he says. As HAIG's Conrad puts it, "If I'm a farmer and I'm growing corn on 160 acres in one location, I'm taking a lot of risk. But if I have 15 properties growing 10 different commodities and I'm in five different states, I really start to minimize that risk." (Note, however, that laws in nine U.S. states designed to protect the family farm restrict institutional investing in farmland.)

Correlations

There is some support in academic journal articles for the proposition that farmland can increase the efficiency of mixed-asset portfolios. This advantage stems from farmland's low or negative correlation with other asset classes. According to Conrad, correlations are low, even with other commercial real estate segments—0.22 with retail, 0.32 with office, 0.28 with industrial, and 0.46 with apartments over the past 20 years. Howard notes that farmland has a low correlation with stocks (0.33) and is negatively correlated with bonds.

Once again, however, appraisal smoothing is at work. "The risk and correlation metrics for farmland have to be taken with a grain of salt because of the smoothing process. That dampens the volatility," Howard says. Conrad is less

bothered by appraisal smoothing, arguing that the problem is not serious enough to disturb conclusions about correlations and portfolio efficiency. "I will be the first to admit there is appraisal smoothing here," he says, "but I don't think it distorts the diversification benefits."

Super-Size Me

How much money do institutions need to acquire a diversified farmland portfolio, and how should they go about placing sizeable sums in agriculture?

Opinions vary as to the threshold for a diversified portfolio. At HAIG, the minimum investment is US$40 million, which, with the typical deal size ranging from US$2 million to US$5 million, would net 10–15 properties. "You're not getting up to 30 where you might like to be," Conrad says, "but nevertheless, at $40 million, you can get some measure of diversification." Howard agrees that investors need US$40 million to achieve adequate diversification, but Wise has a different view: "You can develop a very attractive, diversified portfolio of farmland for as low as $15 million." In his view, buying 10 properties at US$1.5 million apiece yields "very significant diversification."

But all agree that it's not easy to place the money in a hurry. "It's a very slow, methodical process," Wise says. "I'll warn you of that in advance." Howard points out that investors need to understand the illiquid nature of the assets and the long lead time required to ramp up. "It's a big issue," he says. "It can take two to five years to get a diversified farmland portfolio completely invested. You've got to have a long-term commitment."

Many farms sell at auction for US$400,000 to US$500,000, and not all are considered investment-grade properties. Vermeer at Farmers National advises limiting purchases to "high-quality properties that have very productive land, will be consistent in their return, and provide a higher level of return than the average property."

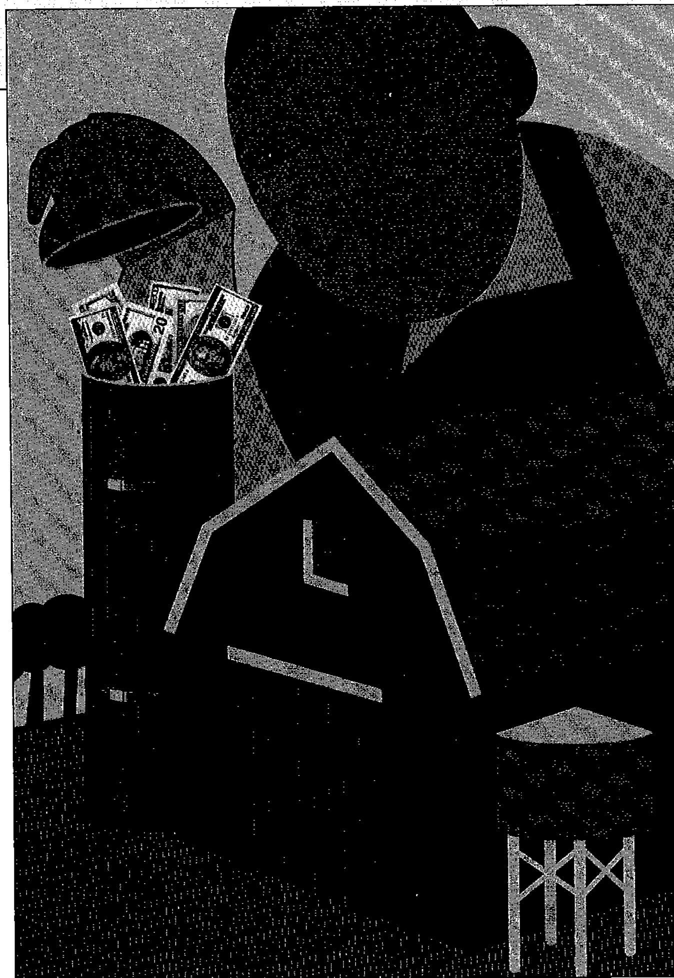
Big blocks of land seldom come on the market and they can command a premium when they do. "Especially if there are two bidders," Vermeer says. But premiums do not always occur, he says, because "there are a lot fewer potential buyers." Rutledge has seen institutional money generate premium prices on big blocks. Institutions "don't want to buy 160 acres for $600,000," he says. "[They] want to put out bigger chunks of money, and the only way you can do it is to find a larger block of land, and there's not that many out there."

Wise has also seen institutional premiums for large farms, but he won't pay up for large blocks. "We see no point in chasing after a $10 million farm if you can buy five $2 million farms," he says. The premium is much greater than the combined closing costs on multiple smaller properties.

Compounding the problem of placing big money is the fact that there are only three or four investment managers in the U.S. capable of putting together a diversified portfolio for institutional investors. Wise says there were 11 or 12 when he got his first institutional client in 1989. Consolidation, buyouts, and underperformance thinned the ranks. One option is to use specialty managers operating in different segments (Premier Pacific for vineyards, for example) or to engage more than one full-spectrum manager at the same time, as the Alaska State Pension Investment Board decided to do in 2004.

Another option for getting in quickly is by investing in a commingled fund, such as those offered by UBS AgriVest. Such funds are a way to place smaller bets and still get access to a diversified farmland portfolio. While there is a place in the market for such funds, according to Conrad, they don't give the client any say in the strategic direction of their investment. HAIG formerly offered a commingled fund only to have the two participating institutions eventually switch to separate accounts because they had divergent views about the

types of agricultural investments they wished to make. "With a separate account, you have the ability to change your investment focus and add or liquidate assets over time," he says.



Aggressive Bets

Market Timing. Looking for an aggressive way to play agriculture? Wise and Conrad agree there is no single 'agricultural cycle'. "You have to look at each commodity group, and they'll have their own cycles," Conrad says. "We can buy apple properties today for less than they were selling for, let's say, 10 years ago. Cranberries, the same way. But now almonds and pistachios are much more expensive today." He generally advises against market timing in agriculture because investors can't get in or out fast enough.

But for those determined to aggressively play bull and bear markets, potato land may be the way to go. "The potato industry is dramatically cyclical," says Wise. "It's rags to riches, with few stopping points in between. You could have years where you have 100 percent returns and years with 20 percent losses."

Opportunistic and Value Added. In commercial real estate and private equity, opportunistic and value-added investors seek annualized returns of 20 percent or more from distress sales and asset repositioning. Analogous investments exist in agriculture.

Many cranberry producers fell into distress following a major price correction in 1999. Cranberry prices have recovered somewhat but remain depressed to this day. "We love to buy in markets like that," Conrad says. HAIG purchased its first cranberry property in 1999 and continued to pick up cranberry bogs in distress sales through 2005, becoming one of the top three cranberry growers in the United States.

Wise capitalized on distress and fixer-upper opportunities in the early 1990s, but says they are not as common today. But there have been plenty of opportunities to convert row-crop land to permanent crops. He likes to buy bare land; put in the irrigation system; plant almond, wine grape, or citrus trees; and oversee production.

"We like to build from the ground up," Wise says. "We're using the latest in technology and plant varieties, the latest in strategic planning and management, and as a result, we're building an orchard or a vineyard that is much more productive than one that's been around for 10–15 years."

Wise has done about three dozen such repositioning projects, and his goal is a 12–15 percent return. HAIG is also active in repositioning, switching land to almond, pistachio, walnut, or wine grape production.

Redevelopment. Wise has seen institutional investors buy farmland and redevelop it for residential and commercial use. He has sold significant amounts of land in large tracts, particularly in the last five years, to national homebuilders for residential subdivision. "We've been able to sell those properties at a value considerably above the agricultural value of the holdings," he says. One of his portfolio properties is a 4,000-acre citrus and potato farm in Florida that is currently being master-planned by a national homebuilder for a new city with its own infrastructure, city center, and golf course, plus thousands of homes.

But it's not a casual matter to flip agricultural land for redevelopment. Complexities abound. Rutledge is advising a farm family that owns over 200 acres in the distant Chicago suburbs now ripe for development. "People don't understand how long and drawn out the development process is and what risks go with this," he says. The family's first move was to option the land to a developer who sat on the opportunity for a couple of years before walking away. Then the family

engaged a planner to optimize the value of the land by assessing which portions were suitable for various uses. Parcels were sold to Wal-Mart, Lowe's (the home improvement chain), and Kohl's department stores. Another 15–20 small lots fronting the main highway were made available to restaurants, shops, and bank branches, but it took about five years for the first business of any kind to open. Then there was the municipality to contend with. It required contributions for local parks and schools and specified such details as what bushes to plant and what lights to install.

"There's going to be a lot of money made here, but I can't begin to tell you the millions of dollars that have been spent on legal fees, engineering, surveying, soil testing, zoning work, and planning," Rutledge says. And the returns? "You ought go in budgeting for a minimum of 20 percent annually, recognizing that you're not going to get that," Rutledge says. The farm family will make out better than the average investor because the family bought the land years ago at an agricultural price and didn't have to pay interest to carry it.

Still, the allure is there. Go on the internet and you will find investment firms advertising how land worth US$5,000 an acre in 1976 is valued at US$400,000 today and how buying land for redevelopment can generate superior returns. Farmland values within 150 miles of expanding cities have increased dramatically, in part because of tax provisions deferring capital gains on like-kind exchanges. Section 1031 of the U.S. tax code gives sellers only a limited time to roll over gains into similar properties or face current taxation. "When you're in that position, sometimes you pay foolish premiums because of the time pressures," Rutledge says. "I have seen the 1031 market drive farmland values significantly higher in this part of the country."

For HAIG, redevelopment is the icing on the cake. "It's not what we set out to do," Conrad says. "It's hard for a manager on a national basis to acquire properties ahead of the local crowd. Locals always know the game better than you do." But "with the passage of time—10 or 15 years—inevitably, you have certain properties where you have higher and better use pressures and, all of a sudden, your property's more valuable to grow houses than it is to grow almonds. That does happen, and our clients do benefit from it."

For institutional managers not already in the game, entering by way of a redevelopment fund is one option. Rutledge cites a series of funds from Avanti Investment Advisors dedicated to land investment and development. Avanti has put over US$750 million to work for endowments, foundations, and pensions in 20 expanding markets in the southern and western United States.

Wise agrees it makes sense for institutional investors to enter through a fund. He has tried to start funds several times only to have the initial investor in every case decide not to wait for other investors to climb on board and instead fully fund the project itself (once to the tune of US$75 million).

Calling a Top?

There have been double-digit returns in farmland investing in recent years, but it's not the first time institutional money has entered a rising market. In the mid-1970s, U.S. farmland values were in what some called a speculative bubble. Values had tripled since 1967. The price increase alone of US$233 an acre in Iowa in 1975 was more than an acre was worth there 15 years before. Pensions and their external managers bought farmland in New Jersey, Texas, Arkansas, and Mississippi to rake in capital appreciation during the surge.

The ethanol/biofuel craze is one factor driving farmland values higher today. In the western corn belt (portions of Iowa, Nebraska, Minnesota, and South Dakota), 60–80 ethanol plants are under construction. "It's a tidal wave," he says. "We're moving to new commodity price levels. The number of plants under construction is going to create a new set of dynamics relative to those historic crops."

For this reason and others, a surge of capital, institutional and otherwise, has reached farmland. While opportunities remain in row crops (corn, wheat, soybeans), Wise is sitting on as much as US$30 million in client permanent–crop capital because he can't find enough assets to buy at a reasonable price. In his view, too much money has been chasing too few deals, and he's not willing to pay up for properties today—only to suffer subpar returns tomorrow.

Jump in? Stay out? The question is different for investors already in the game. Almonds have had a good run in recent years, but given reports of operators switching land to almond production, almond prices may be under pressure in a couple of years. While Conrad shuns market timing generally, he does use market cycles to add to positions when prices are low and to prune weaker properties from the portfolio when values are high. "Almonds have been performing very well, and we have liquidated some of our [properties]," he says. He views the coming shift in almond prices as a buying opportunity. To everything, there is a season.

Christopher Wright authors an investment newsletter and is based in the Washington, DC, USA, area.