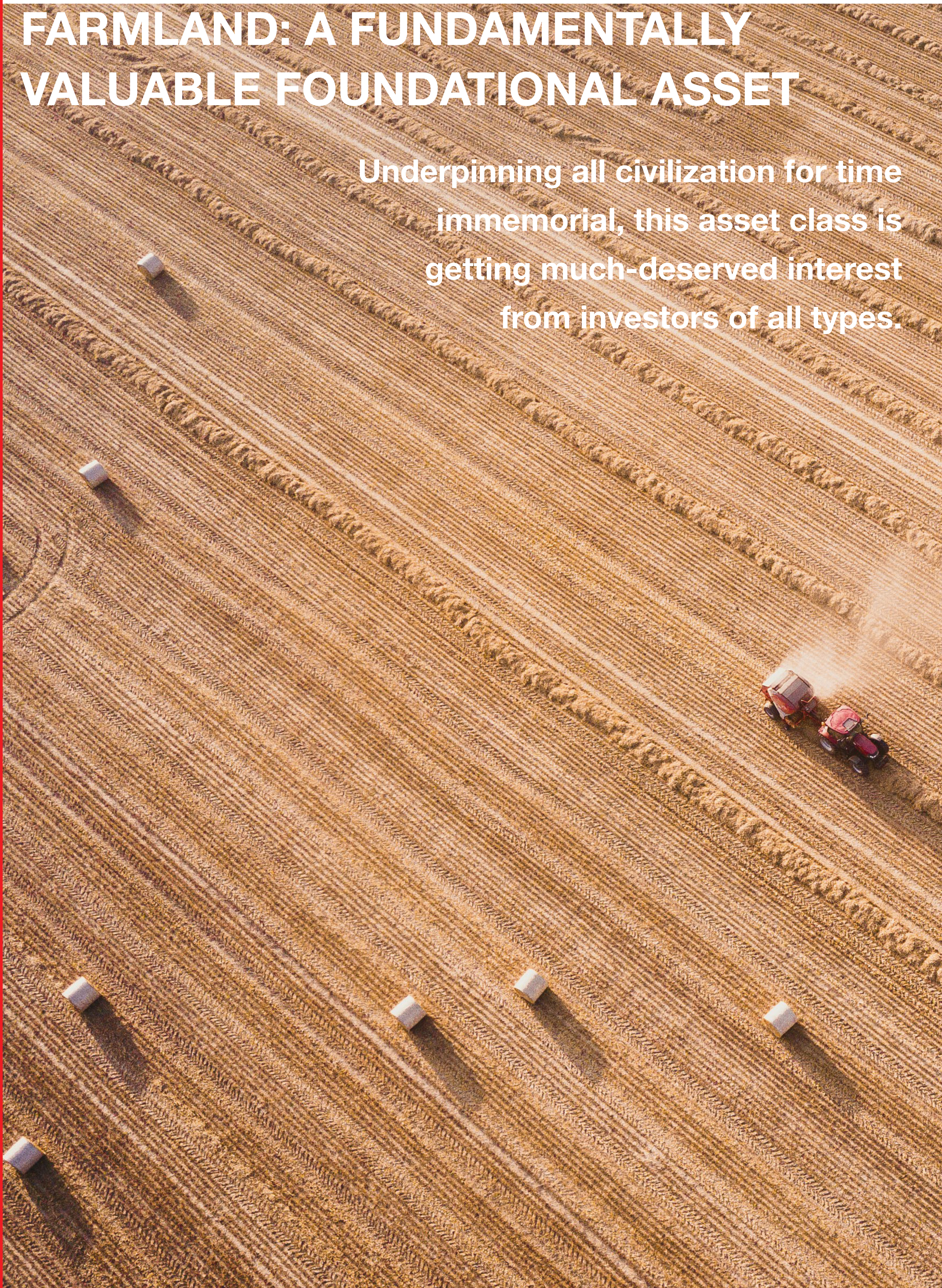
CANADIAN ASSOCIATION OF ALTERNATIVE STRATEGIES & ASSETS

FARMLAND: A FUNDAMENTALLY VALUABLE FOUNDATIONAL ASSET

Underpinning all civilization for time immemorial, this asset class is getting much-deserved interest from investors of all types.



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About CAASA & This Paper

Inclusive, Active, and Pan-Alternative

The Canadian Association of Alternative Strategies & Assets (CAASA) was created in response to industry requests for a national group to represent the Canadian alternative investment participants, including investors, asset managers, and service providers. CAASA is inclusive in that it welcomes participation from all companies active in the space (400+ members in 2024) who might want to participate in committees and working groups — or simply attend member events — without their employer being a member of the association.

CAASA is very active, organizing numerous conferences, webinars, socials, and podcasts throughout the year. Pan-alternative, for CAASA, encompasses all alternative strategies and assets including hedge funds/alternative trading strategies, private and public real estate (funds and direct), private lending, private equity, infrastructure, development and project finance, digital assets/crypto-assets, weather derivatives and cat bonds, and all aspects of diligence, trading, structuring, dealing, and monitoring alternatives in a stand-alone portfolio and as part of a larger investment strategy.

As with all our papers, we use an external writer to draft it from interviews with participating members and it represents, in the end, our views and not necessarily that of every participating member.

For more information, please visit www.caasa.ca.

Introduction - Why farmland?

When it comes to investment in real estate, there's an old adage: "buy land - they aren't making any more of it." Investors of every size and at every level of sophistication have taken this adage to heart, allocating capital to real estate for its stability, its predictable cash flow, and its capital appreciation. It's one of the most accessible and intuitive of all of the alts, as it fulfills a core human need - shelter.

This is the fundamental source of its value, and also the reason why it is a true diversifier. Humans will continue to need a roof over their heads irrespective of the direction of public markets.

But there is another type of real estate that fulfills a basic human need - farmland. And it's a Canadian strength.

Canada is an agricultural powerhouse. Our Prairie region is one of the world's breadbaskets, producing much of the world's supply of cereal grains. It is the largest supplier of dried lentils to India. Ontario, while also a grain producer, is best known for its extremely diverse array of vegetable and fruit crops. Canada also produces world-class meat - and in the modern agricultural sector, livestock is largely fed by grain grown on farms.

The demand for farmland is intuitive. But there's another source of value that is tied to this land - the farming operations themselves.

While the average farm remains a family farm, modern farmers are a far cry from the smallholding subsistence farmer that exists in popular imagination. Today, farmers are businesspeople and highly skilled professionals, and agriculture is a highly capital-intensive, sophisticated industry, with new technologies like precision agriculture allowing ever-more yield to be extracted from the land. But it remains a volatile industry, with weather, soil and market conditions having a huge impact on an individual farmer's balance sheet. This volatility presents interesting opportunities for lenders who are willing to give farmers the flexibility they need to get their operations back to profitability.

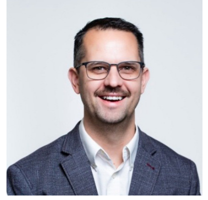
A core part of any portfolio

People need to eat - and farmers, and farmland, feed people. The population is increasing and getting wealthier, both of which increases demand for food. There is a fundamental value that comes from farmland that will help it maintain its value irrespective of the direction of the public markets. In this sense, it is an investment that behaves much like infrastructure - humanity will continue to need electricity, bridges and railroads whether or not the market is up or down.

It is also an investment that, to a degree, self-hedges. Demand for cereal grains is driven in part by human consumption and in part by livestock consumption. As prices for cereal grains drop, the cost of livestock inputs decreases, causing livestock producers to increase the size of their herds and in turn bolster demand for grain, in a self-perpetuating cycle.

But in addition to this fundamental value, and this tendency to self-hedge, there is a good reason to believe that the value of farmland will appreciate. The adage that they aren't making any more land might be true, but when it comes to high-quality farmland with direct access to water, the amount of land that can be cultivated is actually decreasing. The reason is simple: cities were founded to be near good farmland and freshwater, and as cities expand, that farmland is built over, never to be returned to its original use.

Altogether, these factors paint a picture of an investment with a fundamental value, with strong capital appreciation, with low volatility, that can be held for the long-term - a core asset for a portfolio due to predictable and sustainable demand for the food it produces.



"The case for farmland is the stability. If you look at the 30-year history of farmland, in comparison to other real estate, or even other tangible assets like gold or even the TSX, farmland has only one state - with returns above zero. Everything else kind of goes below zero, or you get peaks and valleys. But farmland is steady, in that it keeps appreciating at a nominal rate consistently. It's not going to be your biggest winner every year, but it's going to be consistent, and it'll be pretty stable."

Andy Wiebe
Founder
TerraGen Technology Group

Farmland in an inflationary environment

In the present environment, where, despite markets pricing in rate cuts, inflation and the rising cost of living stubbornly persist, investors would be wise to understand how their investments perform in inflationary environments. Farmland is quite an effective inflation hedge, regularly outperforming the Consumer Price Index, with low correlation to the public markets.

This is in part because, as the adage goes, they aren't making any more land. Like gold, it is a safe haven. But unlike gold, there is a strong fundamental value proposition.

This is also in part because the increasing cost of food means increasing returns for farmers, who then have the ability to expand their operations by renting land which may be owned by a farmland investment fund.

"Farmland serves as a safe haven asset because, unlike other types of investments, it's finite - they're not making any more of it. This makes it similar to gold. However, some could argue that these assets lack intrinsic value. Farmland offers a unique proposition, it has a fixed, and even decreasing supply, coupled with a cash flow stream from rents that help support its value. And historically, farmland prices tend to strongly correlate with the expansion of the money supply."

Gabriel Millard
Managing Partner – Equity Capital Markets
Avenue Living Asset Management

“From a portfolio perspective, the diversification benefit you can get from farmland is tremendous, because it really isn’t very correlated with anything else. As an institutional investor, you’re always looking for things to add to your portfolio that will make it more robust. … Farmland really does have a lack of correlation with everything else, and has returns that are comparatively more stable than many other asset classes. And they’ve done pretty well in inflationary environments, too.”

Derek Brodersen
Board Chair
AGinvest Farmland Properties Canada

An alignment of interests

Many of the qualities that make farmland an attractive investment are also present in residential real estate: low correlation with the public markets, strong fundamentals, especially in the context of ever-increasing demand, and an intuitive value proposition.

But there are a few things that make farmland distinctly attractive.

The first is the alignment of interests between landlord and tenant. Under a typical landlord-tenant relationship, the landlord’s interests and tenant’s interests are at odds - the tenant has little incentive to keep up the property, and the landlord can make more money when the tenant leaves due to mark-to-market.

In farmland, however, landlord and tenant incentives are aligned. In order to produce maximum yield, farmland must be cared for - its nutrient balance and pH must be carefully stewarded through soil care and crop rotation, and not exhausted. Farming can be a business with very low margins. If a farmer is paying money to rent land to expand their operation, they are highly incentivized to treat that land as well as possible, in order to maximize the return on their investment.

The second factor is the major economies of scale that accrue to large-scale farming operations. Capital goods like tractors, seeders and automated irrigation systems are substantial investments, and a farmer who is not using those investments to their full potential is highly incentivized to expand their operation. Due to increasing land prices, expansion often means renting farmland - either from an institution or from a neighbouring farm family - generating demand which can accrue to farmland investors.

A potential drawback of farmland investment, as with all real estate investment, is illiquidity: it is difficult to purchase farmland and liquidate it on-demand. Investors looking to allocate to farmland should therefore be prepared to buy and hold - and if they do, they will find that their asset appreciates steadily, and reliably, every year. There are, however, new technological platforms looking to solve for this issue, leveraging proprietary blockchain technology to ‘tokenize’ individual investments, and letting investors trade those investments on a secondary market. While this concept is still in its infancy, it could provide investors with some welcome liquidity and flexibility.

Investors looking to allocate to farmland should allocate to it like they would to other alternatives - with a separate sleeve in their portfolio. It is a unique enough asset class that it deserves its own allocation, without being treated as a subset of real estate.

“The owner of farmland and the tenant renting that land are aligned like no other form of owner-tenant relationship. In order to maximize their crop yield and hence, profit, tenants must manage the soil in an optimal and sustainable way. It would be rare to find this landlord-tenant symbiosis in any other real estate class. In addition, there are no structures that need upgrading or repair, and no electrical or plumbing invoices to pay. Properly treated, farmland does not depreciate in accounting terms nor in its capacity to provide food now and in the future.”

Leif Snethun
Chief Executive Officer
Avenue Living Agricultural Land Trust & Tract Farmland Partners

"We really try to be farmer focused. We create a custom plan with every farmer that we work with based on where they're at in the farm lifecycle. Maybe there's succession planning as part of it, or maybe they are on a piece of land on the outskirts of a city that could be redeveloped. We create a case-by-case solution with each farmer and with the end goal of the investor. We help the farmland stay in the control of the family as long as possible, as long as that makes sense for the family. We're small enough and nimble enough that we can make those on the ground decisions and custom plans with each farm as needed."

Andy Wiebe
Founder
TerraGen Technology Group

Agricultural Credit

The equity side of agricultural investment has obvious advantages to a portfolio, from diversification to stability, the credit side also deserves attention.

While farming is now a sophisticated, capital-intensive industry, one thing remains true from the past: it is highly volatile, and a single bad year can damage a farmer's prospects. Banks lend to farmers, but for various reasons - whether a farmer who inherits a farm does not yet have a track record of success, or whether a bad year has damaged already thin margins - many farmers do not qualify for financing from traditional financial institutions.

Like in other sectors, when banks refuse to lend, alternative lenders fill the gap. In the agricultural space, these lenders often bring agricultural expertise with them, to help operations who have seen sudden downturns bridge back to profitability and viability.

Unlike funds that purchase and rent out farmland, these assets are similar to other fixed income assets - their primary appeal is their strong cash flow, with capital appreciation being a secondary consideration.

But what differentiates private agricultural lenders from other private lenders - or from other fixed income securities in general - is the profile of the borrower.

The typical farmer is still a family farmer, whether they own or rent their land, or a mix of both. They are connected culturally to their land and their farms. They are therefore much more likely to do what is needed to ensure their debts are paid, reducing risk to the investor.

Investors looking to allocate to private agricultural lenders should understand that this is a fixed income investment, and allocate accordingly, out of the fixed income part of their portfolio. These securities have a distinct and complementary value proposition to farmland.

"Farmers, on occasion, have a bad year, it sneaks into their three-year average numbers which is what banks look at. And they get ushered out. Our job as a transitional lender is to get them through a year, or two, or three, in which they can repair their numbers and get back to mainstream banking."

Greg Kalil
Chief Executive Officer
Glengarry Farm Finance

"The multi-generational aspect of this asset class is worth mentioning. Most of these land holdings are third generation, butting on fourth generation ownership. There's this significant and understated tie to the land. These borrowers will do just about anything to keep that ownership. The mindset of these farm owners is: we own it for our lifetime. We've been given the opportunity to work this land and have the revenue from this land, it's our obligation to improve it and leave it in better shape for the next generation."

Shawn Bustin
Chief Credit Officer
Farm Lending Canada

Who is investing?

Farmland is an investment with significant upside. As operations expand and enjoy economies of scale and increased access to capital and expertise, productivity and returns will increase. So far, the typical investor in farmland, or a farmland fund, is a high net worth individual or a family office. (Bill Gates, one of the world's richest people, is the largest private landholder in the United States, due to his allocation to farmland.) There is increasing institutional investment in the space, but it is not yet the majority.

Part of the reason why is scale. Although the farmland market is vast, farmland does not come up for purchase very often, and so it is difficult for farmland funds to be able to accept the large capital allocations preferred by large players like pension funds.

But the value proposition is obvious, and with the long-term, stable, low-volatility value delivered by farmland being in keeping with the investment needs of many institutions, it is likely that institutional players will play a bigger role in the space in future.

Due diligence on a farmland asset manager

Farming is a highly specialized industry, with domain-specific knowledge required to ensure that yields are being maximized. Farmland investment, and farm lending, therefore requires highly specialized knowledge, to ensure that farmland quality is maintained, and that farmers who are offered loans are taking the proper steps to bring their operations back to profitability.

Many funds who offer exposure to farmland or agriculture boast that their founders, or allocators, are themselves farmers, or have farming backgrounds. In addition to regular due diligence, investors looking to allocate to farmland, should look to speak to the asset manager and ensure that the manager can speak knowledgeably about agriculture, and how they work with farmers to ensure that value is preserved and that returns are delivered

"I think, like any kind of due diligence process, when it comes to researching the manager, it's critically important to have somebody managing the fund that is intimately involved with, or understands, agriculture as a business. … I'm a fourth generation farmer myself, and I actively run my family's farm today. We have other partners that are the same."

Shawn Bustin
Chief Credit Officer
Farm Lending Canada

"Our lending team all come from farming. They're either farmers who are becoming lenders, or they are lenders with farming backgrounds. And there's really no substitute for that sort of intimate understanding of why a given farm is going to work or not."

Greg Kalil
Chief Executive Officer
Glengarry Farm Finance

A unique value proposition

Every human being needs to eat, and as the world's population increases, and especially as the world becomes wealthier, demand for calories will continue to rise.

The Canadian agricultural industry is well positioned to take advantage of this growth. Investors who allocate to Canadian farmland will receive a stable, long-term investment, and investors who allocate to private agricultural lenders will receive the strong cash flow of a fixed-income security, with a unique risk profile and will enjoy the benefits of an uncorrelated asset, reducing risk in a volatile time.

"Farmland is different from other alternatives. Because you have to think about how they are packaged and sold. Are they on an index? Or are they in any way tied to equities? Because if they're tied to equities, even just in how they're packaged, they start to act like an equity. … Farmland is pretty unique in the sense that it's just not publicly traded. It's very, very private"

Kent Willmore
CEO & President
AGinvest Farmland Properties Canada

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