

# Liquidity vs Profitability

## An investigation of the major issues pertaining to the survival of investments in South African agribusinesses and farmlands

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An investigation of the major issue pertaining to the survival of investments in South African agribusinesses and farmlands are fraught with conflicting signals.

On the one hand, investing in farmland has generally proven to be profitable, but on the other hand, the evidence is not as ubiquitous when the investment is looked at from a cash flow perspective. Some will argue that the appreciating nature of land value and its long-term capital gains are incompatible with the capital recovery terms sought by investors and lenders (1). If these are the facts about investing in land, why do people continue to buy land and what makes it worthwhile for them.

To solve this apparent paradox, it is important to split the farm business into two separate entities that are often, but not necessarily, linked: the property business and the farming business (2). Success in the property business is measured by changes in asset values over time and is driven by smart purchase and sale decisions. Success in the farming business is the result of effective and efficient sustainable operation of the resource base.

### Farmland market liquidity

The economic value of agricultural land has always been recognised, but in the course of the last decades it has also become an important component of many investment funds and individual portfolios. This increased attention gave way for a more effective and developed market made up of local farmers and outside investors. An example of this effectiveness in the market is offering larger properties in small tracts, in order to let different types of bidders compete on equal footing. This growing liquidity in the farmland market enables investors to diversify a farmland portfolio by region, crop, quality and other criteria with increasing ease.

### Investing in farmland, the problem

The problem inherent in land investments lies in the measurement of performance when property and farming businesses are combined. When measuring aggregate business performance, the success of one business (e.g. capital gain in the property business) can cause the other business to fail (e.g. reduced return on assets, net operating profits after tax/capital value, in the farming business), while both could be performing well. Another problem is that, albeit efficient markets, land investments are illiquid and new investment opportunities are potentially limited.

### Analysing the agricultural pay-offs

The overall profitability of a farm investment is the sum of the profitability in its farming and property businesses. The former is generally a more volatile investment, as yields are very dependent on climate, and income is reliant on ever-changing demands and volatile prices. The return on the latter is considered to be dependent on fewer outside factors. Trade-offs between these two forms of income can be achieved in different proportions, from a fixed income investment to profit sharing.

Historically, the property business entity has outperformed the farming business entity, although returns have been three times more volatile than farming returns. Even to a level that for most farms it is impossible to maintain a positive cashflow at any debt level without outside income. The inability of farmland to generate sufficient cash flow to fully service the cost of capital investment required for its purchase is the normal competitive situation, so this has to be considered as the given situation.

This is in line with the saying "asset rich and cash poor" that is commonly used in farming and that indicates the widespread problem of liquidity (i.e. cash flow surplus) in the farming business. This liquidity problem has made it nearly impossible for lenders to justify funding to farmers. Oltmans therefore concludes that the problem inherent in land investments is one of liquidity rather than income or profitability, and that land as a growth asset is more suited to equity financing than debt financing.

### How to determine "fair" returns to every player?

The return on asset (RoA) calculation based on annual operating profits is not a fair measure for comparison, as it does not take into account risk, capital gain or time value of money. Unfortunately there are a number of operator agreements that have been altered in the landowners' favor because of an undue emphasis being placed on RoA.

The measures of success used by the property business and the farming business differ so to ensure "fairness". It may be more relevant to aim to meet the expectations of each party without attempting equivalence in returns.

### The solution

The solution for land investments therefore lies with alternative equity arrangements. One example is 'passive' equity money. 'Passive' equity investors would invest in the land and lease it back to the farming business. This would also remove the largest liability for the farmer, being the land purchase. 'Passive' equity money would thus receive no or little return on a short-term basis but would benefit from any improvement in asset value at the end of the 10-15 year investment. In other words: 'passive' equity investors need to look for long-term growth rather than short-term income investments.

Investing in farmland should thus be split up in two different possibilities: investing in the property business or investing in the farming business. For the property business investors, their returns include farming 'rent' and what they believe the property business will deliver over time, as well as capital appreciation on the land. Their returns are less variable than farming business investors, resulting in lower risk and higher dependability. The high variability in returns for farming business investors requires a greater emphasis to be placed on liquidity as a measure of success and for a range of risk management strategies to be in place to reduce the probability of deficit outcomes.

(1) Oltmans

(2) N.M. Shadbolt and J.W.M. Gardner (2003) Farm Investments: Alternative ownership structures that address the liquidity versus profitability conundrum

## Few risks pertaining to farmland investment

As with any investment, there are risks associated with owning farmland. Both land values and rental rates will fluctuate in the future. Commodity markets and government policies can influence farmland values and rental rates. There are, however, several factors that make an investment in farmland favourable when compared to other real estate investments.

Because farmland produces internationally traded commodities, it is much less dependent on the local economy than other forms of real estate.

Farm operations are highly scalable, in order to rent an additional 300 acres, for example, most farmers would not have to hire additional employees or purchase additional machinery. This makes the market for rentable farmland very competitive.

Unlike stocks or bonds, there is no underlying company to go bankrupt or miss analyst expectations on an earnings report.

Office buildings and retail space will physically depreciate, there will be repairs that need to be paid for and eventually the buildings will become obsolete, properly managed farmland will not.

## Different types of rent structure?

- Fixed annual lease: all the risk is on the operator.
- Variable lease: based on the value of the crop produced in a given year spread the risk between the investor and the operator.
- Hybrid lease: Fixed base payment and percentage of the value of the crop above the base payment.

## Conclusion

The Old Mutual African Agricultural Fund (OMAAF) acquires farmland and agricultural assets and lease it back to a large-scale agri-operator in exchange of a fixed annual lease fee. Hereby dividing the farming enterprise and property and focusing solely on the property business for stable income from rent and capital gain.

In practice, this changes little for the involvement of the Fund in the farms in its portfolio, for it has implemented a monitoring system which guarantees sustainable farming practices and proper investment decisions. This can be hardly be qualified as the "passive" investor as mentioned earlier, but still benefits from the characteristics of the asset value appreciation.

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