RFM DISCUSSION PAPER #1:

A comparison of institutional ownership in the Australian commercial property and agricultural sectors.

Aerial photo of Mooral Almond orchard, Hillston, NSW, February 2012

RFF MARKET PERSPECTIVES

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The Australian commercial property sector is well serviced with fund managers and investment funds designed to meet the needs of tenants and investors. In contrast the agricultural sector, though of comparable scale, has only one fund designed for this purpose: the Rural Funds Group (RFF).

A calculation of the total value of Australia's investment grade commercial property indicates that this asset class has a total value of around $280 billion. This figure was derived from national data relating to floor area multiplied by market values per square metre. Investment grade properties in this case, were properties valued greater than $10 million. **Figure 1** sets out this data and demonstrates that the level of institutional ownership is on average 70%, with the balance owned privately. Interestingly, retail property is 95% institutionally owned, while industrial property has a lower level of investor ownership (47%), though this figure is changing rapidly with the expansion in number and scale of Real Estate Investment Trusts (REITs) focusing on this segment.

While the application of an investment grade threshold skews the data to a certain extent, these statistics relating to commercial property are interesting for two reasons.

Firstly, if 70% of these properties are owned by investors, it means that at least 70% of these assets are leased by tenants. Therefore, leasing commercial property is a very common practice among Australian businesses. Reasons why businesses lease premises, rather than own them include the flexibility that leasing provides as business space requirements expand or contract.

Leasing, rather than ownership also allows a business to more efficiently use its scarce capital. Rather than tying

Figure 1: Summary of the Australian property investment market[1]

	Property investment market size total value AU$b	Institutionally owned property total value AU$b	Market coverage by institutional investors
Core Property Sector			
Office Investment Market	111	63	56%
Retail Investment Market	112	106	94%
Industrial Investment Market	55	26	47%
Total	**280**	**195**	**70%**

1 Higgins Dr D.M., Australian Commercial Property Investment Market: Styles, Performance and Funding, Australian Centre for Financial Studies, Melbourne, 2013

up equity in a building that could be rented for say 10%, many business owners choose to invest the money into expanding their business operations, where they may hope to make a return of 20%.

Academic research on the performance of listed companies, verifies that leasing is good for business.[2] A study of 2,343 listed UK companies over a 13 year period, revealed that companies lease property to reduce their debt, to finance growth prospects, and to conserve liquidity, namely cash. Companies that leased real estate were found to generate higher returns than those that did not, with the optimal ratio of leasing being 65% of a company's total property requirement.

The second reason why the data in **Figure 1** is interesting is that it demonstrates a large commercial property funds management sector. The middle column shows that $195 billion of Australia's investment grade commercial property is managed by property fund managers. Of this amount, $89 billion is owned by REITs whose securities are traded on the ASX, $90 billion is owned by wholesale funds typically targeting large superannuation funds, and the remaining $16 billion is owned by property syndicates, that would tend to be owned by retail investors and their self-managed super funds.

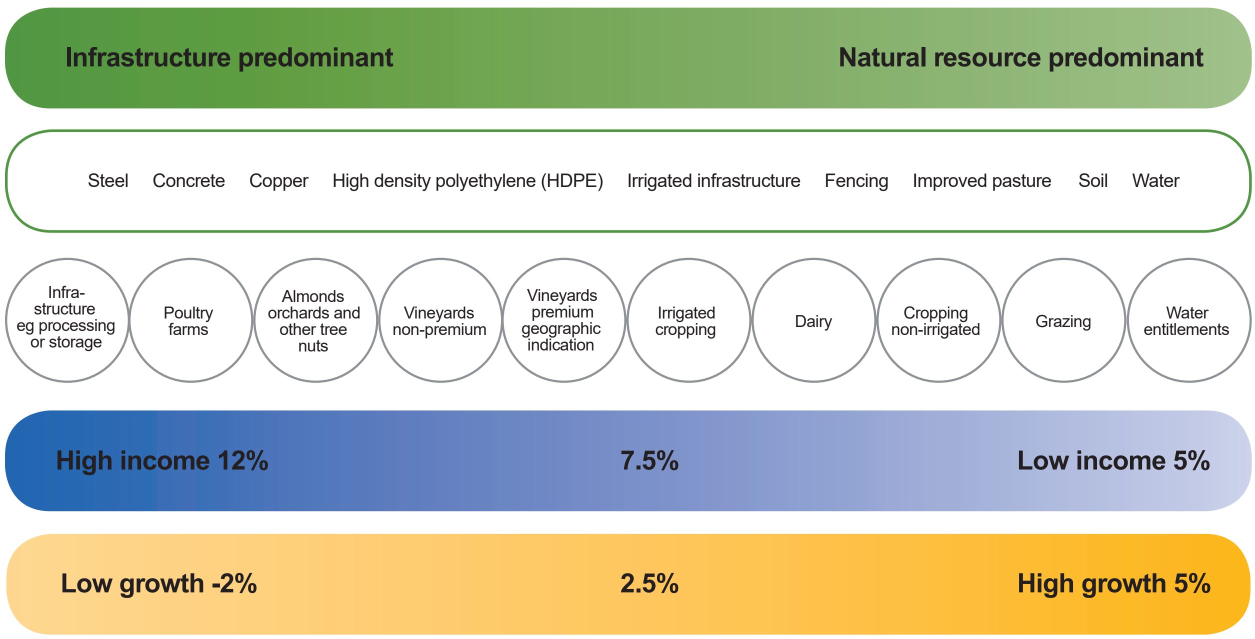
From this statistical snap shot of Australia's commercial property, a picture emerges of a funds management sector that has grown to meet the needs of business. The success of this sector could not have occurred unless it delivered a product that both improved the bottom line and flexibility of businesses, while simultaneously delivering investment returns that satisfied the expectations of investors. In this respect a property fund manager is straddling two markets: the rental market for tenants, and the equity market for owners.

An analysis of these two markets and how they relate to agriculture reveals a very different picture – and an opportunity.

Australian agriculture utilises 405 million hectares of land, which is 53% of the country's total land area. The industry is relatively fragmented with 120,000 businesses reporting that farming is their principle business. RFM has estimated that the total value of the land and improvements of these businesses is just over $200 billion.[3]

Added to this are substantial processing and infrastructure assets, typically owned by food processors and agricultural commodity marketers, whose total assets add tens of billions to the value of the agricultural property sector.

Figure 2: Spectrum of investment opportunities



2 Lasfer, M., Why do companies lease real estate assets?, Cass Business School, London, 2005

3 While the Australian Bureau of Statistics (ABS) publishes data on the numbers and types of agricultural enterprises, there is little data available on the actual capital value of the industry. RFM has attempted to calculate this figure through a range of techniques such as obtaining data on the size of the national beef herd and multiplying this by the typical price paid for sufficient land to carry one cow. The same technique was used for sheep, with adjustments made in both cases for the lower feed requirements of non-breeding livestock. In the case of cropping, RFM analysed grain production, the area planted and applied a land value adjusted for productivity. Similar techniques were repeated for the major agricultural industries covering nearly 80% of the total farm population.

4 The term broadacre describes less intensive enterprises such as livestock grazing and cropping. These contrast with intensive enterprises such as vineyards, almond orchards and poultry farms.

RFF has become Australia's first agricultural REIT to serve Australian farm businesses and meet the expectation of its owner: the RFF unitholders.

The threshold for investment grade agricultural assets is probably lower at around $5 million. This is because a property of this value is economically viable on a standalone basis, and could be efficiently managed and leased out by a fund manager. Possibly one third of Australia's farms would qualify as investment grade based on this criterion, while almost all processing assets tend to exceed this value threshold. Therefore the total value of investment grade assets in Australian agriculture is of the order of $150 billion, making it a larger sector than either the office, retail or industrial property sectors detailed in **Figure 1**.

Despite the scale of the agricultural sector, it is estimated that only 4% of agricultural property in Australia is leased compared to around 40% for the US and many European countries. Why is Australia's leasing rate so low, and why has there been no equivalent emergence of property fund managers facilitating property leasing?

The main reason is the relatively low lease rentals paid by broadacre[4] farm enterprises.

Broadacre farms can be leased at a rental yield of 5% of the capital value of the farm. This compares with an office building in the centre of our cities that would lease on a yield of 6-7%, and industrial warehouses on the fringe of our cities that lease for around 9%. On the surface then, leasing commercial property would appear more attractive.

However higher lease rentals on commercial property may be due to the depreciation occurring on the structure or building that makes up the majority of a commercial property asset value. As the building ages, obsolescence will one day necessitate either the demolition or major upgrade of the building, and this comes at a cost that should be considered throughout the lifecycle of the asset. In contrast to commercial property, broadacre farms have much lower levels of depreciating infrastructure installed on them. In fact modern cropping properties often have no fences, no buildings and just a few dirt access roads.

As a consequence the asset is an almost pure natural resource with no wasting infrastructure detracting from long term returns.

While broadacre lease rentals may not be diminished by depreciation, the fact remains that the net yield generated by these assets is too low to compete with the investment yields historically generated by fund managers of commercial property. The Rural Funds Group (RFF) has addressed this dilemma by accumulating a mix of agricultural assets, that include the natural resources of land and water, but also substantial infrastructure capable of generating higher yields. As a consequence of this asset mix, RFF is able to distribute investment yields that exceed the majority of REITs.

RFF then is uniquely placed. Just as commercial property fund managers have provided a service that assists Australian business, while meeting the expectations of their investors, RFF has become Australia's first agricultural REIT to serve Australian farm businesses and meet the expectation of its owner: the RFF unitholders.