

# RFM DISCUSSION PAPER #4:

## The attributes of natural resource and infrastructure intensive assets.

*Droughtmaster cattle grazing on Rewan Station, RFF's blue-ribbon cattle property located adjacent to Carnarvon Gorge in central Queensland.*

## TORTOISE & HARE

David Bryant, RFM Managing Director

**You will only get two things when you buy a listed security such as the Rural Funds Group (RFF): the distributions and the price on the day you sell. Interestingly, the first thing (distributions) can to a large part determine the second thing (the value of your securities).**

This article considers three measures used to monitor the sustainability of distributions, then examines the attributes of RFF's assets on the sustainability of investment returns.

### Three key measurements

A primary measurement reported in RFF's financial results presentations is 'funds from operations' (FFO),<sup>1</sup> which is the net profit after tax, with an add back of non-cash items, such as depreciation and the changes in the valuation of assets. Put more simply, it is the actual cash available each year that can be used to fund distributions.

For the purposes of this article, the term FFO is interchangeable with 'cash'.

A second measurement is designed to test the sustainability of distributions and is called the 'payout ratio'. This is the amount of distributions paid relative to the amount of cash generated each year from RFF assets. If the payout ratio was greater than 100%, the fund would be paying investors more cash than it is generating – which cannot be sustained indefinitely. RFF's current payout ratio is 78%, one of the lowest among comparable real estate investment trusts (REITs).



*Farm 68 with twelve of RFF's poultry sheds, located outside Griffith NSW*

1. In the case of RFF, 'adjusted funds from operations' (AFFO) is used. These adjustments relate to the tax treatment of the entities within the Group. The adjustments have the effect of producing numbers that are consistent with FFO reported within the sector.

A third measurement in REIT investment analysis is the growth rate of distributions backed by the growth rate of cash generation. The quantum and sustainability of this growth has a substantial influence on the present-day value of a security. Consequently, if you can pick a stock that grows its cash generation and annual distributions, you will increase the two things from owning a listed security: more distributions and a likely higher price when you sell.

Because of these three measurements, most REIT managers aim to maintain a portfolio of assets that can sustainably generate cash to fund distributions and ideally fund an increase in these distributions over time. Let's now turn to the RFF portfolio and examine it through this lens.

### The RFF portfolio

Four years ago, RFM developed the diagram presented in Figure 1, to provide investors an understanding of the characteristics of assets in Australia's agricultural sector. The diagram creates a differentiation between assets with high levels of infrastructure compared to those assets which are more intrinsically a natural resource. It provides examples of the materials used in infrastructure at left, transitioning through to elements of assets that are a natural resource. It also aligns examples of assets arrayed from left to right, in an order consistent with this method of classification.

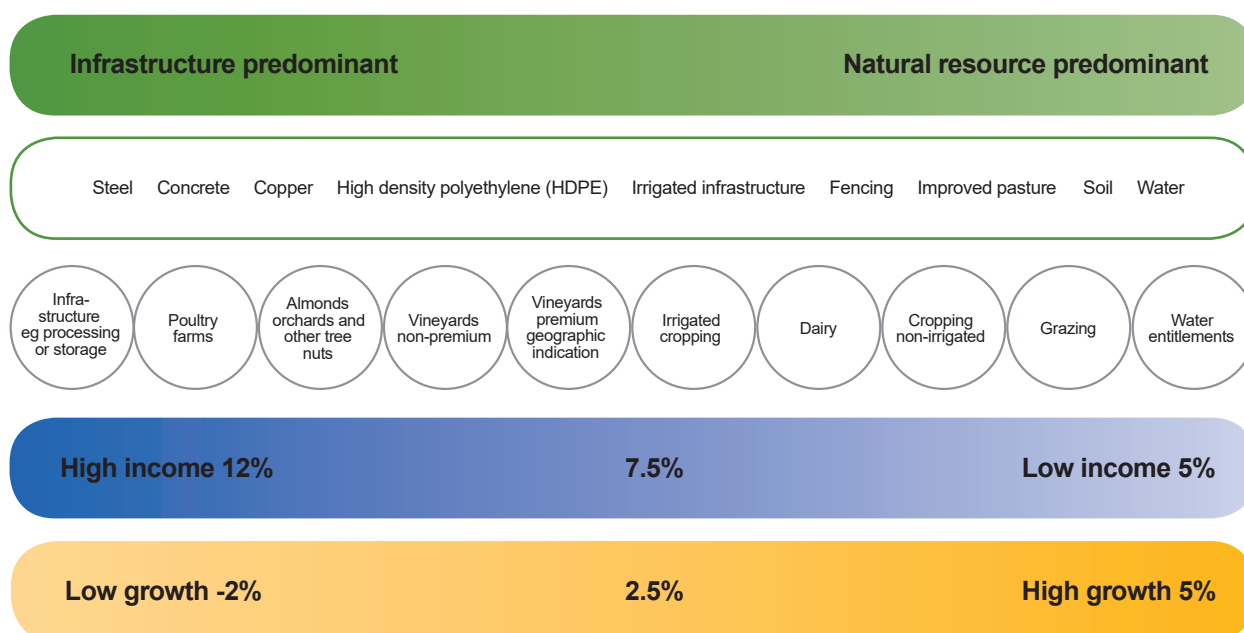
The final two rows of the diagram suggest income and capital growth rates for both ends of the spectrum. Assets to the left provide high rates of income, but negative capital growth, because they depreciate over the useful life of the infrastructure, while natural resource assets, on the right, generate lower rates of income, but higher rates of capital growth.

Income generated from RFF's assets feed through to the cash metric (or FFO) discussed above, while indexation mechanisms contained in the leases over RFF's assets, feed through to cash growth. Capital growth may also feed through to cash growth, though by the indirect route of market reviews. This means that high rates of capital growth in assets are of no use, unless they can be monetised by a market review confirming an asset has increased in value, and that the lessee should pay more rent.

The preceding discussion is interesting because it proposes another dimension to the concept of diversification. It is clear that RFF owns assets operated in a diverse range of agricultural industries. Moreover, RFM has articulated a strategy of climatic diversification. This will provide RFF exposure to lessees operating in climatic zones with low correlation to its existing assets, and as a function of these different conditions, further diversification by industry. What **Figure 1** does is consider the diversity of financial characteristics of RFF's portfolio of assets. This is an important consideration for balancing immediate cash generation and cash growth.

RFF's asset base has been skewed towards infrastructure predominant assets such as poultry farms, almond orchards and vineyards – which is why it can provide a relatively high rate of distributions to investors. More recently, RFF has acquired assets with larger natural resource components, being approximately \$34m of high security water entitlements and three cattle properties acquired for \$42m, all within the past six months. This represents a measured shift in the balance of the portfolio's financial characteristics.

**Figure 1: Range of agricultural investments<sup>2</sup>**



*The spectrum diagram above was published by RFM in 2013 prior to RFF being listed on the ASX*

2. The income and growth figures presented in Figure 1 have been provided to differentiate the profile of income and growth that can be derived from different assets. They are based on RFM's experience and observations of agricultural lease transactions and historical rates of growth. They are neither forecasts nor projections of future returns. Past performance is not a guide to future performance.





*Poultry sheds owned by RFF in Griffith (left) are infrastructure intensive assets which are high income but depreciate as they age. Conversely, Rewan, a cattle station in central Queensland (right) is a natural resource predominant asset which may generate lower initial cash flows, but will consume little or no additional cash when leases are renewed*

In the investor presentation dated 4 November 2016, RFM advised that we expect RFF can sustain an annual distribution growth rate of 4% per annum. This growth is funded by growth in cash and buffered by RFF's low payout ratio. An implication of a shift towards lower yielding natural resource assets is that cash generated per unit may be diluted initially, as new equity is raised to fund acquisitions. This will not, however, affect the growth in your distributions for two reasons: the shift to natural resources is measured, and RFF's low payout ratio will buffer any divergence between growth in distributions and the cash growth needed to fund them.

A limitation to the cash metric (FFO) is it ignores future lumpy cash consuming events, such as the major reconstruction of an asset after it has become obsolete. For example, the oldest of RFF's poultry farms, currently valued at \$41.5m, will require reconstruction or disposal in eight years' time. Other examples within the REIT sector include office and commercial buildings that periodically need major refurbishment. Unsurprisingly, it is more infrastructure predominant assets that require these refurbishments. To overcome this limitation, RFM conducts a whole of life analysis of all RFF assets, and incorporates funding requirements for refurbishments into its long term modelling.

Natural resource predominant assets are much less exposed to lumpy cash consuming events because they have relatively little infrastructure that could become obsolete. What is apparent from this discussion is infrastructure assets generate higher initial cash flows, but will consume cash when a lease is renewed at some point in the future. In contrast, natural resource assets generate lower initial cash flows, but will consume little or no cash when leases are renewed. This means that over time, the natural resource tortoises may overtake the infrastructure hares.

Over the past two years, RFM has been investigating natural resource assets in northern Australia, visiting numerous properties and meeting with management, agricultural scientists and the people who value these assets. In that process we have observed much greater potential for productivity gains from modest additional capital investment.

Several examples of 'productivity capex' are outlined on page eight of this Newsletter, including the central Queensland cattle properties acquired by RFF in mid-2016. Capital improvements costing \$1m are being rolled out over the next eighteen months across the properties, which aim to lift the carrying capacity and daily weight gain of the cattle bred or fattened on them. On the fifth anniversary of the lease, the properties will be revalued for the purposes of a rent review where productivity gains may lead to a rental uplift due to improvements to the properties' cattle carrying capacity. Acquiring and improving more assets like this would be of great benefit to RFF.

RFM continues to analyse investment opportunities that can enhance RFF's portfolio, increase the scale of the Fund and therefore increase liquidity of its securities. These opportunities include assets with high infrastructure components, such as poultry farms or almond orchards, and more natural resource predominant assets such as cattle properties. In so doing, the priority remains building a balanced portfolio of assets that can generate the highest total returns over their lifecycle, to maximise the two things you will get from your investment in RFF: the distributions and the price on the day you sell.



*Cattle grazing on RFF's Rewan Station, with the forage legume Leucaena visible in the background and winter forage crops in the foreground*