

Macquarie Agricultural Funds Management

A Member of the Macquarie Group

Level 22, 20 Bond St Telephone (02) 8232 6220
Sydney NSW 2000 Facsimile (02) 8232 5741



1 July 2009

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

By email: corporations.joint@aph.gov.au

Dear Madam/Sir,

Inquiry into agribusiness managed investment schemes (MIS)

Please find enclosed our submission to the Parliamentary Inquiry into agribusiness managed investment schemes. This submission addresses issues contained in your letter dated 3 June 2009.

Should you have any questions regarding this submission, please contact myself on 02 8232 4096.

Yours sincerely



Anthony Abraham
Chief Executive Officer
Macquarie Agricultural Funds Management

July | 09

Parliamentary inquiry into agribusiness managed investment schemes

Submission by:
Macquarie Agricultural Funds Management

About Macquarie Agricultural Funds Management

Macquarie Agricultural Funds Management (MAFM) is an operating business within the Macquarie group of companies. The Macquarie Group is a large, diversified financial services organisation with over 12,700 employees in more than 70 offices in 26 countries and approximately \$243 billion of assets under management¹. Macquarie Group Limited is listed in Australia (ASX: MQG) and is regulated by APRA, the Australian banking regulator, as a non-operating holding company and ultimate parent of Macquarie Bank Limited, an authorised deposit taking institution.

Macquarie Agricultural Funds Management manages over 150 staff and is responsible for managing over 3 million hectares of agricultural land in Australia. As at 30 June 2009, Macquarie Agricultural Funds Management Ltd had over \$1 billion of agricultural funds committed / under management.

Since 2003, Macquarie has provided Australian retail investors with access to 11 agribusiness managed investment schemes (agribusiness MIS, Projects); seven forestry projects and four almonds projects. Macquarie manages over 17,700 hectares of forestry plantations across Australia and approximately 800 hectares of almonds orchard on behalf of its investors. This submission seeks to provide comment on the Terms of Reference issued by the Parliamentary Joint Committee on Corporation and Financial services in relation to its inquiry into agribusiness managed investment schemes, and to outline a set of principles that MAFM wishes to put forward for consideration in order to promote a sustainable and successful agribusiness MIS industry in Australia.

¹ As at 31 March 2009

Executive Summary

Macquarie Agricultural Funds Management (MAFM) is making this submission (**Submission**) in response to the terms of reference issued by the Parliamentary Joint Committee on Corporations and Financial Services regarding its inquiry into agribusiness managed investment schemes (**agribusiness MIS**). The Submission addresses a number of the Inquiry's terms of reference, having regard to the recent collapse of two of Australia's largest agribusiness MIS providers and offers a set of key principles that MAFM believes may benefit the agribusiness MIS industry for consideration by the Committee.

It is noted, that the Submission represents views and information related specifically to the current Australian agribusiness MIS industry, and is specific to agribusiness MIS which have been made available to Australian retail investors (**Projects**). It is not intended that the discussion and the principles contained in the Submission extend outside the Australian agribusiness MIS industry, or that they should apply to agribusiness MIS other than the abovementioned, for example other types of agricultural investment products offered to wholesale or institutional investors.

The recent high profile collapse of Australia's two largest agribusiness MIS providers has highlighted a number of key issues, including:

- The financial position of the product provider and its relevance to agribusiness MIS;
- Inadequacies in the underlying scheme structure of some agribusiness MIS; and
- The amount of commissions payable to advisers to sell agricultural MIS

Whilst MAFM considers that the above issues do not pose any threats to existing Macquarie agribusiness MIS, the Submission seeks to address these issues insofar as they are relevant to the broader agricultural MIS industry.

The Australian agricultural MIS industry should address such issues, and ensure that the industry is operated within a framework that provides Australian rural communities and investors with sustainable projects and transparent investment opportunities.

To achieve this, MAFM believes the following key principles should be considered:

- Agribusiness MIS providers should be required to annually certify to the regulator that they have financial capacity to support the financial obligations created by each agribusiness MIS.
- Agribusiness MIS structures should provide investors with land rights providing ongoing access to the land utilized for the agribusiness MIS for the life of the project. These rights should be capable of surviving in the event of a failure or a replacement of the Responsible Entity.
- Commission structures and the way in which commissions are disclosed should be reformed.
- Product providers should be required to disclose their past performance results with respect to previous agribusiness MIS. Furthermore, where appropriate, ongoing inventory assessments should be a requirement for each agribusiness MIS project to provide investors with a guide as to the ongoing performance of their project.

1. The relevance of agricultural MIS to the Australian agriculture industry

There is currently limited opportunity for investment into direct farm gate agricultural production. This is especially so for retail investors. The Australian agricultural MIS industry has thus provided Australian retail investors with an effective vehicle to directly participate in large scale commercial farm gate production through a relatively modest initial contribution and as a result, has injected millions of dollars into rural Australian communities. Traditionally, such access to participate in large scale commercial production has been available only to private individuals capable of funding the significant investment commitments required to establish these ventures. The survival and long term sustainability of the agricultural MIS industry is therefore vital to attract the investment required for the establishment of some of the world's best commercial farming operations in rural Australia.

Prior to the introduction of agribusiness MIS, many of the current agribusiness MIS providers did not emerge from a history of providing investment services or a funds management background. This is despite the fact that agribusiness managed investment schemes, by definition are regulated funds and financial products.

Many of the underlying farming operations behind Australian agribusiness MIS offerings are quite capable of producing profitable returns. However, the profitability of a project alone does not, guarantee a successful Product. Rather, an application of robust funds management disciplines and techniques is required to convert a profitable project into a successful Product providing positive returns to investors. A strong funds management based approach to establishing agribusiness MIS is essential.

The Australian agribusiness MIS industry should be operated within a framework that provides Australian rural communities and investors with sustainable projects and transparent investment opportunities. To achieve this, agribusiness MIS needs to be developed within a framework that is based upon sound agricultural practices and sound funds management and investment principles, rather than a sales oriented approach.

2. Key principles to promote a sustainable agribusiness MIS industry

Below is a summary of key principles that MAFM seeks to raise for consideration in order to promote a sustainable and successful agribusiness industry.

2.1 Demonstrating adequate financial capacity

- Agribusiness MIS providers should be required to annually certify to the regulator that they have the financial capacity to support the financial obligations created by agribusiness MIS, including how they (or related parties on which a scheme is reliant) will be funding or provisioning for the costs associated with all obligations in respect of that scheme.

2.2 Revised project structures

- Agribusiness MIS structures should provide investors with land rights providing ongoing access to the land utilized for the agribusiness MIS for the life of the project. These rights should be capable of surviving in the event of a failed or replacement responsible entity (RE).
- This can be achieved either through a structure that is capable of:
 - i. Meeting annual and ongoing land funding costs; or
 - ii. Providing investors with ownership (or the economic equivalent of ownership) of the land

2.4 Reform commission structures

- Commission structures for agribusiness managed investments should be amended to establish a maximum limit to the overall level of commissions (both hard and soft dollar commissions) payable to advisers.
- As part of the certification requirement under 2.1 above, agribusiness MIS providers should be required to report the overall level of commissions (both hard-dollar and soft-dollar), including all other financial incentives and marketing expenses attributable to agribusiness MIS sales each year.

2.5 Past performance of schemes

- Product providers should be required to disclose their past performance results with respect to previously completed agribusiness MIS.
- For current projects, ongoing inventory assessments should be a requirement for each agribusiness MIS to provide investors with a guide as to the ongoing performance of their project.

3. Scheme structures and business models

3.1 The relevance of the corporate strength of the Provider

The recent collapses of Australia's two largest agribusiness MIS providers (and their subsidiary companies that acted as responsible entities for agribusiness MIS) (**Providers**) have highlighted that a sole or dominant reliance on agribusiness MIS sales to fund not only profitability, but also operational requirements (including the financing and leasing of assets held), has the potential to lead to financial difficulty. A corporate failure of the Provider may therefore cascade into a failure of each individual agribusiness project that it was responsible for creating.

3.2 Increasing sales leads to increasing financial commitment

Whilst an increase in agribusiness MIS sales is typically positive for current year profitability, it creates a number of future and ongoing financial obligations for the Provider that must be met either out of current year revenue or from future income streams. These financial obligations can include:

- Funding costs associated with servicing the rights to use land for the project – either from land held on balance sheet or through a lease arrangement (see below); and
- Ongoing and future capital expenditure commitments often required for the ongoing development of a project.

In almost all cases, investors have no ownership of (nor economic entitlement to) the underlying land used by the project, but rather they are granted rights to use the land by the Provider to access the land (e.g. through property agreements or subleases). The ability to maintain the integrity of these land-use rights is critical to ensure the project can continue successfully for the term. The land is generally sourced for agribusiness MIS by the Provider either by:

- Owning land directly on balance sheet (freehold approach); or
- Entering into a long term leasing arrangement with a third party owner for the life of the project (leasehold approach); or
- Sale and leaseback arrangements where land held on balance sheet is sold to a third party and leased back for the project term (sale and leaseback approach).

The level of ongoing funding costs associated with maintaining land access therefore depends on the level of interest borrowing costs under a freehold approach, or on the annual rental expenses payable under a leasehold approach. In both circumstances, agribusiness MIS structures are reliant upon the Provider (or a related entity – e.g. parent company) in meeting these costs to ensure the ongoing viability of the scheme.

Under a sale and leaseback approach, land previously held on balance sheet (by the Provider or a related entity) is sold to a third party (or multiple third parties). Whilst this method is effective in reducing corporate balance sheet debt, it does little to reduce the annual funding cost of land as the cost of meeting rental payments is typically commensurate to the cost of funding debt. In addition, the change of land ownership and the new rights granted under the new leasing arrangement, has the potential to introduce new risks to the underlying structure of the project that were not originally contemplated by an investor when they originally entered into the project.

3.3 Reducing corporate risk through appropriate scheme structures

An alternative to reduce investor counterparty risk on the Provider, is to address this issue through scheme structures, establishing agribusiness MIS that provide for the following key elements:

1. That initial and ongoing operating costs associated with the operational management of the Project can be met; and
2. That investors have, or have the means to maintain, a right to access the land for the life of the Project.

3.3.1 Meeting ongoing operating costs

Most forestry Projects require investors to make an upfront contribution and no further ongoing commitments, and rely on the Provider to meet the ongoing maintenance costs associated with a typical forestry Project. To ensure that sufficient funds exist for the Provider to meet these ongoing costs as and when they fall due, a Provider should make appropriate financial provisions at the outset.

In the case of horticultural MIS, the ongoing operating expenses associated with these types of Projects are more intensive than that of forestry. To deal with this, many horticultural MIS projects are structured so that ongoing fees are charged annually to investors over the life of the Project, which are then used by the RE to meet these operating costs. The ability for the RE to charge investors ongoing fees is made easier by the fact that horticultural Projects have the ability to provide annual income from harvest revenues. These revenues can then be used to offset annual operating costs. Given that the quantum of these costs however are substantially higher than the ongoing costs associated with forestry, there is a greater reliance on the RE in being able to meet these ongoing costs on behalf of investors.

To address the risk of corporate failure of the Provider, each Provider should be able to certify to its capability (and the financial capability of any related entity on which the underlying scheme is also reliant) to meet the ongoing financial commitments created through new and existing agribusiness MIS sales. Providers should be required to provide an annual certification to the regulator that the financial provisions made for these costs are continuously being maintained and that the level of these financial provisions is adequate.

This may be achieved by making the annual certification to the regulator as a condition of the Australian Financial Services Licence. Providers should be required to certify that all future financial obligations of intended (new) and existing agricultural schemes have been appropriately considered and provisioned for, and that in meeting these financial obligations they are not wholly reliant on future or expected income that will be derived from additional agricultural MIS sales. If required, these provisions should be capable of being reviewed at appropriate intervals to assess their ongoing adequacy and to provide a clear point of audit. This will provide investors with the transparency to determine the degree of corporate risk, if any, associated with an agribusiness MIS and its Provider.

It is also important to ensure that appropriate protection measures are implemented with respect to these funds (be they provisions, or annual fee contributions from investors) to ensure that the funds are directed towards the expenditure for which they were intended and not to satisfy any other unrelated expenses of the RE. This can be achieved by placing these funds into a security deposit held for the benefit of investors, which is a feature that has been adopted by the Macquarie Forestry Investment 2009.

3.3.2 Maintaining a right to use the land

Agribusiness MIS structures should be required to provide investors with a right to access the relevant land for the life of the Project. This may be achieved in a number of ways:

1. *Providing a right to land use regardless of annual land funding costs being met*

To achieve this, these land access rights must be capable of continuing for the term of the Project, and must survive any default by the Provider in meeting its obligations to fund the land. This approach is reliant on the land owner (or its financiers as the case may be), to accept the risk of holding land and providing the Project with continued access for the term without an annual return. In most situations, this would be unlikely to occur, as it does not provide a commercial outcome.

2. Ensure the structure is capable of meeting ongoing land costs

In the case of horticultural Projects, the fee structure of the Project can be established to provide for sufficient funds to be received from investors each year to cover these costs.

However forestry Projects do not generally produce annual income to meet the annual costs associated with funding land use. Accordingly, the Provider should, out of its own resources, make provisions in its accounts or establish a security deposit to meet these obligations. These provisions may be established in order to survive any insolvency of the RE and to provide a means by which annual land funding obligations can still be met. The Macquarie Forestry Investment 2009 has been structured using a similar approach, whereby funds are placed in a security deposit with Macquarie Bank Limited, to meet a large proportion of the annual rental expenses payable for land use over the life of the project.

3. Enable investors in the project to also acquire the ownership (or the economic ownership) of the Land

An additional alternative is to ensure that the product is adequately capitalized to make an outright purchase of the land on behalf of investors in the Project. This model has been successfully adopted by previous Macquarie Forestry Investment structures by providing investors with the opportunity to invest in the underlying land through an investment in the Macquarie Timber Land Trusts. The adoption of a structure combining rights to both Trees and Land ownership, can provide investors with a right to continued access to the land for the term of the Project, and may reduce the counterparty risk on the Provider in this respect.

4. Commissions, fees and other remuneration paid

4.1 Commission structures

Adviser commissions for agribusiness MIS are generally calculated on the amount invested and paid upfront to advisers. In the case of many agribusiness MIS, these upfront commissions may range from anywhere between 5% and 12%, with the onus on advisers to comply with their AFSL and Corporations Act 2001 obligations to disclose these amounts to their clients. Whilst the total commission payments per annum over the life of the project may not be above those generally paid for alternative investment products (e.g. structured products, managed equities or property funds), the industry practice of high upfront commissions may lead to a conflict of interest for advisers that may not be adequately managed by disclosure alone.

One alternative to the current upfront commission structure may be to adopt a commission structure for agribusiness MIS that is aligned to performance of the Project and the returns to investors. This may align the interests of advisers and their clients and would also ensure there is an alignment between the point at which adviser commission is paid and the point at which returns are generated to the client.

4.2 Soft dollar benefits

In addition to the commissions payable to advisers, the Provider (or its related entities, as the case may be) may also enter into arrangements to provide “soft-dollar” or other financial benefits. Examples of soft dollar benefits include sponsorships, conferences, professional development, marketing costs, accommodation or travel. Many product disclosure statements disclose that soft-dollar benefits may be paid however there is not the same degree of transparency as compared to commissions, in respect of the actual quantum of these payments (in either dollar terms or as a percentage of the application fee). The onus is therefore on advisers to appropriately disclose the level of commissions and soft dollar benefits received to their clients.

Whilst much of the recent attention has been on the level of commissions payable by the industry, due and proper consideration must also be given to the level of soft dollar benefits and the practices engaged by Providers in providing other financial incentives to supporters of their products.

A review of the existing practices used by agribusiness MIS providers around soft dollar commissions and other financial incentives to advisers is warranted, and consideration should be given as to whether tighter restrictions should be placed on the ability of Providers or their related entities to supplement commissions through the use of soft dollar payments and other financial incentives.

In order to improve the transparency and regulation of commissions in the agribusiness MIS industry, it is suggested that there be an annual regulatory requirement on Providers to report on the overall level of commissions (including both hard and soft dollar benefits) and other financial incentives, including marketing expenses, consulting fees etc directly and indirectly (where relevant) attributable to agribusiness MIS sales each year. If required, the details of these payments and their breakdown should be subject to regulatory audit or review, and available for disclosure to prospective investors.

5. Past performance of schemes

5.1 Drivers of scheme performance

Agribusiness MIS are dependent upon a number of factors which can influence returns including, but not limited to:

- i. Climatic agricultural risks – for example, frosts, fire, drought and floods.
- ii. Managerial risks – for example, project selection, operational management of the project, and land site selection.
- iii. General forces influencing the underlying agricultural markets, such as demand and supply fundamentals for the project commodity, global economic financial conditions and in some instance exchange rate movements.

It is important to recognize that not all drivers influencing the performance of an agribusiness MIS are capable of being managed or controlled by investors (e.g. extended periods of drought, severe frosts etc). What is important is that factors capable of influencing returns that are within the control of the Provider are being appropriately managed (such as project site selection and project management).

5.2 Ensuring appropriate disclosure of past performance

All Providers should be required to disclose to investors the past performance of previous Projects. To date, independent research rating agencies have played the most important role with respect to providing a level of awareness with respect to the past performance of agribusiness MIS Providers.

As agricultural returns are a factor of both yield and price, it is contended that any disclosure of yield and price performance should allow investors to make a comparison between the original estimates or assumptions and the actual results achieved. It is also necessary that this comparison can be made separately on both yield and price performance. This is due largely to the fact that poor performance in yield may be offset by a higher than expected performance in price, resulting in overall performance levels being met.

As most horticulture Projects provide an annual crop (typically after three years from the date of investment), there is a degree of transparency available to investors to determine whether their Project is meeting its stated objectives. The Macquarie Almond Investment 2006, for example, has just recently reported to investors that it has achieved almond production yields from its 2009 crop that were in line with original PDS expectations.

Forestry MIS projects, by contrast, do not produce a commercial harvest until many years after the initial investment, thereby providing investors with little basis to ascertain how their investment is performing throughout its term. Whilst all harvest results should be appropriately disclosed and made available to both new and prospective investors, inventory assessments on

agribusiness MIS should be a requirement on all forestry Projects to overcome a situation where a Provider has no previous track record on harvesting results and has not sought to measure the interim performance of prior Projects.

Regular inventory assessments of tree growth for forestry plantations can be conducted to provide investors with an assessment of the ongoing growth performance of their plantation and should be conducted as a matter of good forestry practice. For example, each of the Macquarie Forestry Investments performs inventory assessments at tree age three, five, seven and nine, and reports the results of these to investors shortly after the results become available. Whilst inventory results cannot provide investors with certainty as to final yields, they do provide a reasonable basis upon which to assess progress and any issues arising prior to harvest, and the performance of the Provider.