HOUSE STANDING COMMITTEE ON AGRICULTURE AND WATER RESOURCES

SUPERANNUATION FUND INVESTMENT IN AGRICULTURE

SUBMISSION BY PRIME SUPER

DATE: 21 JUNE 2018

TERMS OF REFERENCE:

The Committee inquire into and report on whether:

- there are any regulatory requirements imposed on superannuation funds by ASIC, APRA and any other relevant regulators, which are acting as a barrier to superannuation fund investment in Australian agriculture;
- the information required by the superannuation funds in order to invest in Australian agriculture is readily available, and if not, what statistical performance reporting of the agricultural sector is necessary; and
- there are any other practical barriers to superannuation fund investment in Australian agriculture.

Prime Super's origins are through enterprise bargaining agreements for those working under primary industry industrial awards. The Fund has a long and strong relationship with all the state farming bodies as well as the national peak farming body, the National Farmers Federation, and the union that represents workers in this sector, The Australian Workers Union. The Board of Prime Super over the years has included a number of Directors that have direct and extensive experience in farms and farming, and understand investing in agriculture.

Prime Super's Experience

Prime Super invested directly into agriculture for many years, and the outcome was less than satisfactory. There were many reasons for the poor investment outcome:

- climatic events (the drought during the 2000's) had a significant impact on the business, from the cost of running the business and the reduced quantity of crop;
- the crop was export quality and so the value of sales was significantly impacted by fluctuations in the Australian dollar, which was trading at above parity against the USD for a number of years;
- it was not possible to obtain sufficient scale for true diversification across geographic and climatic zones.

There has been a lot of talk about investing directly into agriculture over recent years and many funds have made forays into direct investment into agriculture. There have also been a number of vehicles established that provide opportunities for investing into a large pool of underlying agricultural businesses. There are also many government ministers and others citing great investing opportunities in agriculture, as well as the benefits that can be derived by becoming the food bowl for Asia.

In our view superannuation investment into agriculture is not necessarily a natural move, at this stage.

The Principles of Superannuation

A superannuation fund has a core obligations to invest the contributions and accumulated earnings from members in such a way as to provide the best outcome for members at the time they retire. By pooling across a large group of members and investing across a broad range of asset classes it is possible to construct a portfolio that will deliver an investment return that meets the best interests of the bulk of members across the majority of time periods.

As a superannuation fund invests for a large pool of members there is a need to:

- be able to provide liquidity to those members that are nearing retirement, to allow them to withdraw all or part of their superannuation account;
- be able to provide liquidity for those that are in retirement, through the payment of an income stream;
- meet ongoing benefit payments to those members that transfer to other funds or are in receipt of death or disability payments; and
- provide the best outcome for all members over every economic cycles.

The above apply every year, as in every year there are a number of new members joining the Fund and beginning their long term investment in superannuation as well as a number of members that have reached retirement age and are therefore withdrawing their account to fund their retirement.

Whilst superannuation is a long term investment it is also necessary to deliver a strong short term return each and every year.

Both the Government and APRA are regularly quoted on the need to remove the bottom quartile of underperforming funds. Any one year of underperformance contributes to the risk of longer term under performance, therefore the investment focus of superannuation funds is always on delivering a strong return over the short term, which then roles out to provide strong long term performance. An asset class that provides a risk to short term performance is therefore one to be avoided.

Superannuation Investing in General

The first question to consider is what does a superannuation fund invest in? Superannuation funds invest in a range of different invests, such as:

- cash;
- debt instruments, via fixed income products such as bonds, or direct;
- property, either directly or through pooled vehicles (both listed and unlisted); and
- equities (both domestic and international).

There are a broad range of other investments, but in essence they are merely a combination of the above, or a slight variation. For example, infrastructure is either a debt or equity investment into a vehicle that has infrastructure characteristics. Other investments such as ETF (Exchange Traded Funds) and the now out of favour Collateralised Loan Obligations (CLO) are merely overlays that are a variation on the theme.

Investment is made into the economies of countries through a range of products (such as equities, property, bonds and cash), to get a balance of investments products that will outperform the economic growth expectations of that economy whilst not taking too much risk. So by investing in Australian equities, bonds and cash a superannuation fund aims to generate a return that is greater than just the return generated by the Australian economy as a whole over the medium to long term.

Investing is obviously a lot more complicated than this, for example the performance of specific companies listed on the stock exchange is driven by many other factors outside the control of the specific control of one company, as well as factors that the company can control. These factors can include social and environmental factors, market sector influences, domestic and international economic influences etc. These factors and others are driving the variation in performance between different countries, different market sectors within countries and different companies within market sectors.

Superannuation funds do not typically invest in private businesses, whether it be through debt or equity investment, for the main reason that it is not possible to get a "real value" of the business from an equity or debt point of view. A "real value" is only evident at the time of sale, and in periods of stress on markets this value can be significantly different to the carrying value as there is no ready pool of buyers for the business. In contrast, the listed environment provides a ready buyer at the right price, therefore it is almost always possible to exit an investment.

Another core principle of investing is that an asset only has a value if it generates an income stream. It is possible for an asset to have a value if it is currently producing no income, but this will solely be on the basis that it will produce an income stream at some stage in the future. There are some exceptions, such as gold, but in general investing is about what income stream an asset will produce.

When Prime Super invests in equities in Australia we invest a portion of the entire Fund into a number of different managers all with slightly different styles of investing (index, quant, growth, value, small cap etc.). The aim is to generate a return from the allocation to equities that out performs the return generated by the stock market as a whole.

Agriculture as an Asset Class

Given the investment principles discussed above, how does agriculture stack up as an investment class?

An investment in agriculture is no different to any other investment that a superannuation fund makes, it is an investment in either property or an investment in a business (equity or debt), and the intention is that the investment would generate a return that exceeds a benchmark for that sector. The other key consideration is the exit strategy: how is the asset disposed of when it is necessary to do so.

As with any investment, the key considerations that are made on investing into agriculture are:

- What are the returns expectations;
- How volatile are those returns;
- What are the risks in not meeting the return expectations;

- How liquid is the investment; and
- Government involvement.

Return expectations from the agricultural sector and volatility

A report produced by Industry Super Australia ("ISA") in June 2017 entitled "Driving Super Fund Investment in Agriculture" noted that there is a meaningful difference in the return generated from large scale and small scale agricultural businesses, and that over the period from 1980 to 2016 the income and capital return generated from large scale agricultural industries was 9.7% per annum. This is a reasonably strong return over an extended period of time.

However, when looking at the figures in more detail it is clear that the returns are volatile. Volatile returns are a concern for superannuation funds. Large variations in returns between the highs and lows, even if it averages out to be reasonable can have a significant negative impact on superfund performance.

The ISA report notes the income and total returns as follows:

	All Industries Income and Capital Return	**All Industries Income Return**
1980-1989	14.6%	5.5%
1990-1999	8.0%	7.6%
2000-2009	9.9%	4.8%
2010-2016	3.6%	3.2%
Long Term (1980-2016)	9.7%	5.7%

The long term return is driven by returns generated in the period from 1980-1989. The total return for the twenty seven year period from 1990 to 2016 is therefore less than 8% p.a., and the total return for the last seven years has only been 3.6% p.a.. Ironically the ISA report notes that volatility has reduced over the period reported, which is due to very flat and low returns being generated.

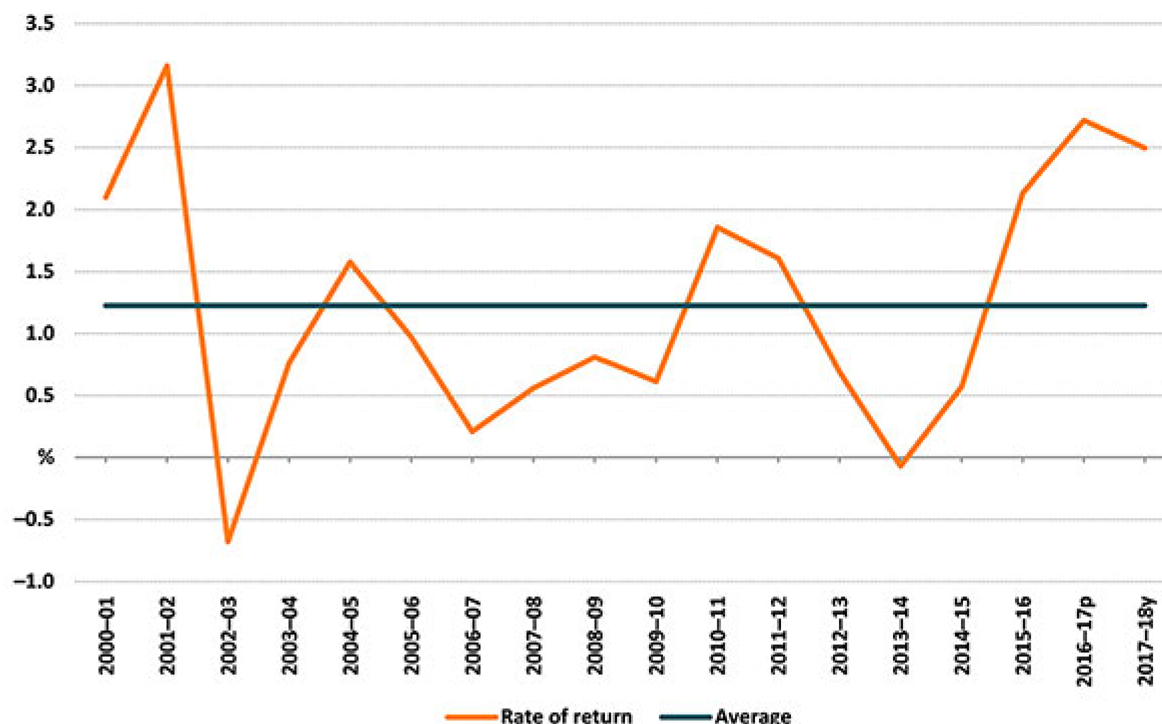
There have been a number of investment vehicles established over time that seek to pool top quartile farming businesses together to deliver a return over the long term. The Industry Super Australia report entitled "Driving Super Fund Investment in Agriculture" lists a number of ventures:

- Stanbroke;
- Prudential Agriculture Fund;
- DIRT & Warrakiri Asset Management;
- Warrakiri Dairy;
- Macquarie Agriculture; and
- Sustainable Agriculture Fund.

The stated returns for these investments do not appear to be out of line with the industry wide data quoted.

This data is backed up by data reported by ABARES (Australian Bureau of Agricultural and Resource Economics and Sciences). Farm surveys and analysis data released on 17 May 2018 note the following:

Figure 8 Rate of return, beef farms, Australia, 2000–01 to 2017–18
average per farm



Source: http://agriculture.gov.au/abares/research-topics/surveys/beef#detailed-farm-financial-performance-findings

Income returns since June 2000 for broad acre farming have been:

- Beef 1.2% (see above graph);
- Grain 2.4%
- Lamb 2.4%; and
- Dairy 2.2%

Capital returns are on top of these income returns. The overall picture is clear, returns from the agriculture sector have been low for a number of years.

Risks in not meeting return expectations

There are many risks in investing in agriculture that are over and above those of investing broadly into listed equities:

- Environmental factors are significant. The extended drought throughout the 2000's had a significant impact on the sector and the returns generated, this is seen in the data presented in the ISA report. The economy as a whole can be impacted by environmental factors, and this will flow through to the value of listed stocks, but the agricultural sector will be the sector that is fundamentally impacted, and so will have the biggest negative adjustment;

- Other risks are also paramount, with international trade and prices being a key driver in domestic profitability; and
- Diversification of investment approach is also a key risk. Given the number of factors that influence the success of an agricultural business it is important to have broad diversification to offset any of these risks. This therefore includes multi industry focus (broad acre, dairy, horticulture etc.) as well as broad geographic and climatic diversification. Only through this diversification is it possible to offset the specific risks associated with an agricultural business.

Liquidity of agricultural investing

Liquidity is probably the key risk associated with investing in agriculture.

In general superannuation funds do not typically invest directly in private or unlisted investment vehicles as it is difficult to exit those companies. It can be difficult to establish a real "market value", particularly when the business is in trading difficulties and there is no ready market to purchase the shares. It is more usual that investment occur through pooled venture capital or private equity funds where risk can be spread across a broad range of companies, with the aim that the successful opportunities outweigh the unsuccessful opportunities. The exit strategy of most of these vehicles is through the ultimate public listing of the underlying companies, which provide liquidity to the investors.

In the case where a superannuation fund purchases a single agricultural business the exit strategy is difficult (as it would be with an investment in any one business). The risks associated with investing directly in any single business are too high to justify the return that may be generated, and the risks that occur at the time of exiting the investment.

Agriculture does not have an established path for the growth of a business through to an ultimate public listing (like through private equity funds). This is a key limitation for the sector, there are some listed agriculture companies, but not many. The limitations that exist include:

- The need for large scale multi industry multi geographic exposures in one entity;
- The high risk of climatic and economic impacts on the return; and
- The volatility of those returns due to the above factors.

Government involvement

A further risk that is little discussed is government involvement in large agricultural businesses. As we have recently seen with the attempts to sell S. Kidman & Co Pty Ltd and Cubbie Station, where very large agricultural land owners are looking to sell, there is government and public interest in who the ultimate purchaser is. Where the ultimate purchaser is an offshore entity there is the risk that the Government may prevent the sale. In any situation where a third party can limit the range of potential purchaser there is an impact on the value of that business, and an impact on the ability to create a liquidity event. Both of these issues are significant impediments to superannuation investment.

Debt or Equity Investment

Investment in agriculture can be through either debt or equity investment, but at the end of the day the ultimate risk is the same. Debt ranks more highly in the capital structure, but the relative arguments to invest in agriculture as opposed to more broadly in the economy remain the same.

Direct Property Investments

There have been a number of vehicles created in recent years for direct investment into a pooled agriculture investment vehicle. Some of those have separated the operating business from the property business, so that it is possible to simply invest in agricultural property as a stand alone investment class.

This approach is based on the premise that the land can be pulled out, so that capital can be provided back to the operator (the farmer) so that they can better manage their business. Why is this any different to the farmer mortgaging their business to a bank to gain access to capital – fundamentally it is the same thing. The long term outcome is bad, mainly because as an investor in property a superannuation fund will want a higher return than what a bank would want through providing debt to the farmer. In tough times (such as in a drought) the investor still wants a high property return, so the outcome will be the same as what we have seen over generations, that is farmers being kicked off the land, and investors losing money.

Secondly, this approach takes the view that agricultural property has the same nature as a block of land in a city, that is, it can be repurposed easily. This is not the case for farming land. Yes it is possible to repurpose farming land from broad based agriculture to something more high intensity like horticulture, but there is significant cost involved, and the environment and climate are significant drivers in the real flexibility of the land. This is very different to city based investing, where higher values can be achieved through rezoning to more high density occupation.

Thirdly, there are some models where the farmer sells the entire business to an investment Fund and remains as the manager of the business, not the owner. This changes the alignment between the farmer and the business, as a business owner they “reap” the benefits of hard work and windfalls when the economic and environmental climate is right and so work to get those super profits. As a business manager the incentive is not the same.

WHY DON’T SUPER FUNDS REPLACE THE BANKS?

A question often asked is why don’t superannuation funds replace the banks and provide debt facilities to farmers?

This question is driven more by a general dislike of banks than by an understanding of superannuation. Yes there is a large pool of money in superannuation funds that is available to invest, and through certain structures it is possible to lend money to businesses, which includes farming businesses.

The first point to raise is if debt financing of farming businesses is moved from the banks to superannuation funds, then during the next economic downturn it will be the superannuation

funds that are evicting farmers from their properties and selling the business to recover capital. All that has occurred is that the “bad guy” has been moved from the banks to the superannuation funds.

The second aspect is that superannuation funds are chasing a higher rate of return from debt financing. Superannuation funds currently provide debt financing into the capital structure of large corporates and infrastructure businesses. Most superannuation debt financing is provided at the mezzanine or secondary level of debt, where there is a higher return with a corresponding higher level of risk. The primary layer of debt is provided by banks.

So where banks seek a return of between 4-6%, superannuation funds are chasing returns of between 6-9% from this type of investment. Being further down the capital structure, and therefore at a slightly higher risk of loss a superannuation fund seeks a higher return to compensate for that risk.

If superannuation funds are to compete with or replace banks then the outcome is either:

- The superannuation funds replacing banks and generating a lower return on this capital. This is not a good outcome for super fund members and it doesn’t change anything structurally or improve anything for farmers;
- Debt is provided at a higher rate via the super funds which has a negative outcome for farmers.

Comparison Investment Example

Consider the hypothetical example of two businesses with the same turnover and profit, one is agricultural, one is a suburban business. The exact products made and distributions strategies are not relevant.

Both investment opportunities would be considered on the same investment basis:

- What is the cashflow of the business;
- How sustainable is the cashflow;
- What is the profitability of the business;
- How certain is the income stream;
- What expense risks does the business face;
- What is the value of the business, which determines the purchase price;
- What is the return that will be generated over the lifetime of the investment;
- What is the exit strategy?

Whether the business is in the agricultural sector or not is irrelevant, the above considerations apply to all direct investments. For a superannuation fund to invest directly in a private business the key concern is how to exit the investment in times of stress.

All unlisted businesses have the same risks, and liquidity is the key risk. It is difficult for superannuation funds to invest into small business because of this liquidity risk, this is not an issue that is confined to agricultural businesses.

RECENT SUPERANNUATION DEVELOPMENTS

The Productivity Commission's Draft Report: Superannuation: Assessing Efficiency and Competitiveness dated April 2018 raises a number of matters that will have an impact on the ability of a superannuation fund to invest directly into Agriculture.

The key recommendation to be considered in this context are:

> *DRAFT RECOMMENDATION 2* ***'BEST IN SHOW' SHORTLIST FOR NEW MEMBERS***
>
> *A single shortlist of up to 10 superannuation products should be presented to all members who are new to the workforce (or do not have a superannuation account), from which they can choose a product. Clear and comparable information on the key features of each shortlisted product should also be presented. Members should not be prevented from choosing any other fund (including an SMSF).*
>
> *Any member who fails to make a choice within 60 days should be defaulted to one of the products on the shortlist, selected via sequential allocation.*
>
> *The ATO should embed the shortlist and accompanying information into the centralised online service.*
>
> *DRAFT RECOMMENDATION 3* ***INDEPENDENT EXPERT PANEL FOR 'BEST IN SHOW' SELECTION***
>
> *The Australian Government should establish an independent expert panel to run a competitive process for listing superannuation products on the online shortlist. This panel should select from products submitted by funds that meet a clear set of criteria (established beforehand by the panel) and are judged to deliver the best outcomes for members, with a high weighting placed on investment strategy and performance.*
>
> *The panel should have flexibility to select up to 10 products, with the exact number at the discretion of the panel based on the merit of each product and what is most tractable for members, while maintaining a competitive dynamic between funds for inclusion.*
>
> *The panel should be comprised of independent experts who are appointed through a robust selection process and held accountable to Government through adequate reporting and oversight.*
>
> *The process should be repeated, and the panel reconstituted, every four years.*
>
> *DRAFT RECOMMENDATION 4* ***MYSUPER AUTHORISATION***
>
> *The Australian Government should legislate to allow APRA to apply the MySuper outcomes test.*
> *Authorisation rules for MySuper should be further strengthened to require funds to:*
>
> - *obtain independent verification — to an audit-level standard — of their outcomes test assessment, comparison against other products in the market, and*

determination of whether members' best interests are being promoted, at least every three years

- *report to APRA annually on how many of their MySuper members switched to a higher-fee choice product within the same fund.*

Funds that fail to meet these conditions — or persistently underperform (for five or more years) an investment benchmark tailored to their asset allocation by a material margin, as determined by APRA — should have their MySuper authorisation revoked.

After implementation, the Australian Government should commission an independent review, every five years, of the effectiveness of the MySuper authorisation rules (including the outcomes test) at meeting their objectives.

Draft Recommendation four contains a key driver in superannuation thinking for the future. It is clearly stated that a superannuation fund is seen to be an underperforming Fund if the underperformance occurs for a period of five or more years. Any short term underperformance, that is, over one to two years will have a material impact on the ability of the Fund to deliver an above average investment return over a five year period.

Returns in the agricultural sector are low and are volatile. Based on the above release by the Productivity Commission direct investment into agricultural opportunities will be difficult.

Draft Recommendations two and three relate to the opportunity to obtain new membership through default arrangement, a key avenue for membership growth for all superannuation funds. The Productivity Commission has recommended that a short list of funds be nominated on a 'best in show' list, which means the opportunity to attract new default membership will be limited to potentially just ten funds. In addition, this "best in show list' is only reviewed every four years.

The outcome of the above recommendation is that superannuation funds will need to construct an asset allocation that delivers an investment performance that will enable the Fund to be considered as a potential fund to be included in the 'best in show' list. Direct investment in agriculture is a volatile investment class, it will therefore be unlikely that it will be included in any fund's asset allocation.

Whilst the recommendations from the Productivity Commission are nothing more than recommendations (at this stage) they do set the tone for superannuation funds for the future, which will be a focus on short term investment performance and a reluctance to invest in an asset class that may deliver volatile investment returns.

Specific Responses to the Questions Raised in the Terms of Reference

Whether there are any regulatory requirements imposed on superannuation funds by ASIC, APRA and any other relevant regulators, which are acting as a barrier to superannuation fund investment in Australian agriculture

There are no specific regulatory requirements imposed on superannuation funds that would prevent them investing into agriculture.

Whether the information required by the superannuation funds in order to invest in Australian agriculture is readily available, and if not, what statistical performance reporting of the agricultural sector is necessary

There is sufficient information that is available for superannuation funds to understand Australian agriculture from an investment point of view.

Whether there are any other practical barriers to superannuation fund investment in Australian agriculture

The problem is not agriculture as a stand-alone investment class. Most superannuation funds do not invest directly into any private businesses so it is not an issue that is related to agriculture.

The key practical barrier is one of creating an environment for agricultural businesses to grow and succeed and become listed entities. This commences with a significant focus on infrastructure to allow agricultural business to be world competitive.

What Is The Solution?

Australia has a lot of very successful farming businesses and this will continue to be so into future. We have the ability to generate significant economic output from the agricultural sector. The key thing that is lacking is an investment in infrastructure to make the agricultural market more efficient economically and globally.

This is where Government can play a vital part in setting out a future plan to make the agricultural sector more efficient, and allow successful business to get their product(s) to market more quickly and at a lower cost, through an established development plan that considers such things as:

- Better road linkages from the farm gate to market, such as bypasses around regional centres;
- Better rail linkages from local centres to port and around the country;
- Better port and airport facilities to enable direct transport to off shore markets;
- Lower cost of transport through improvements to the above;
- Better water management infrastructure;
- Better IT connectivity and availability to fully enable uptake of future technologies;
- Less duplication and regulatory red tape, especially between States, Territories and the Federal Government; and
- Other key infrastructure spends, such as cheaper and more reliable sources of energy.

The above can be financed through super funds, where clear government backing and initiatives are in place. Through the government investing in infrastructure that can make agricultural businesses more efficient and more effective it will be possible to create the opportunity for these business to develop into large economically viable businesses that can be floated on the stock exchange.

The second stage of the process is where there are a number of successful venture capital type agricultural businesses that can be invested in via a pooled arrangement, with the successful businesses being floated onto the stock exchange.

Superannuation funds have a role to play in investing in the infrastructure that gets this process started, not in just buying the farm. Over time we will see the creation of bigger and stronger businesses that will be successful as listed entities, and will be held by all superannuation funds through their listed portfolios.

Agriculture is no different to any other sector of the Australian economy, the opportunity needs to be created for a small business to become a successful large business. The money for investing is available to invest in all stages of the evolution of the industry.