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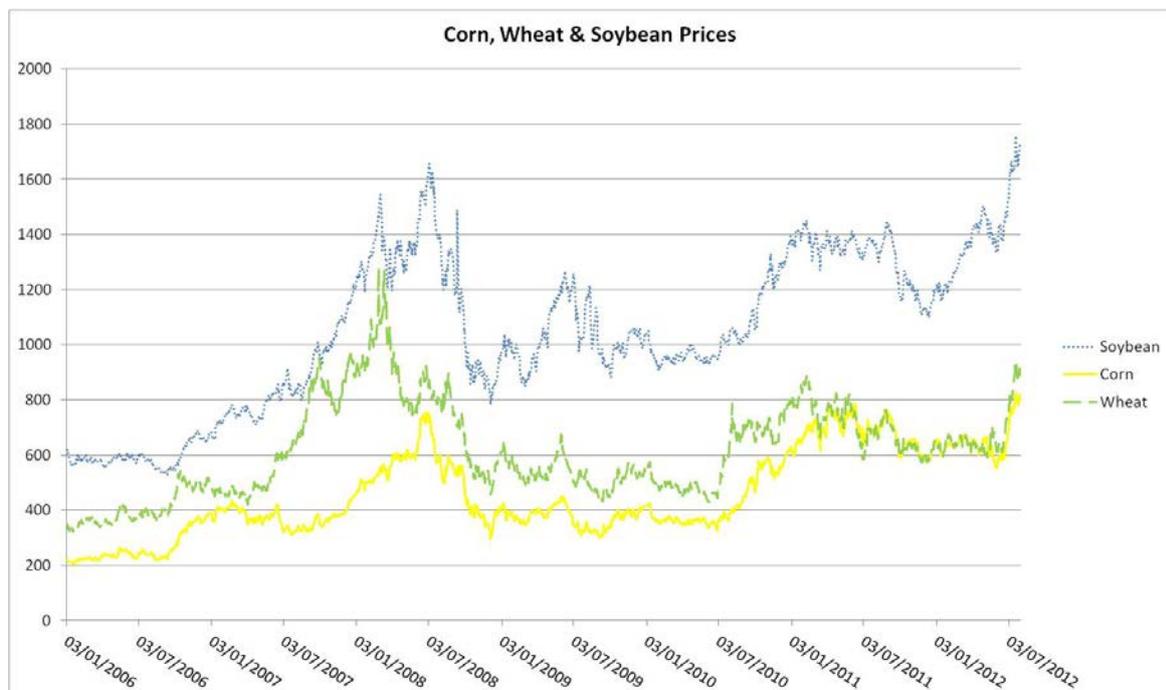
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## Agricultural Update

Grain prices continue to move higher, driven by the factors we set out in our October 2006 GBD report. Simply: low global stocks of grain, declining productivity gains for farmers and increasing global demand. In the past 6 years these drivers have not eased, and in fact the signs are that this trend is intensifying.

The current spike in corn, wheat and soybean prices over the summer, Chart 1, are a result of the worst drought in the US for over 50 years (the US is the world's largest exporter of both corn and soybean) combined with global stocks which were already dangerously low.

**Chart 1**

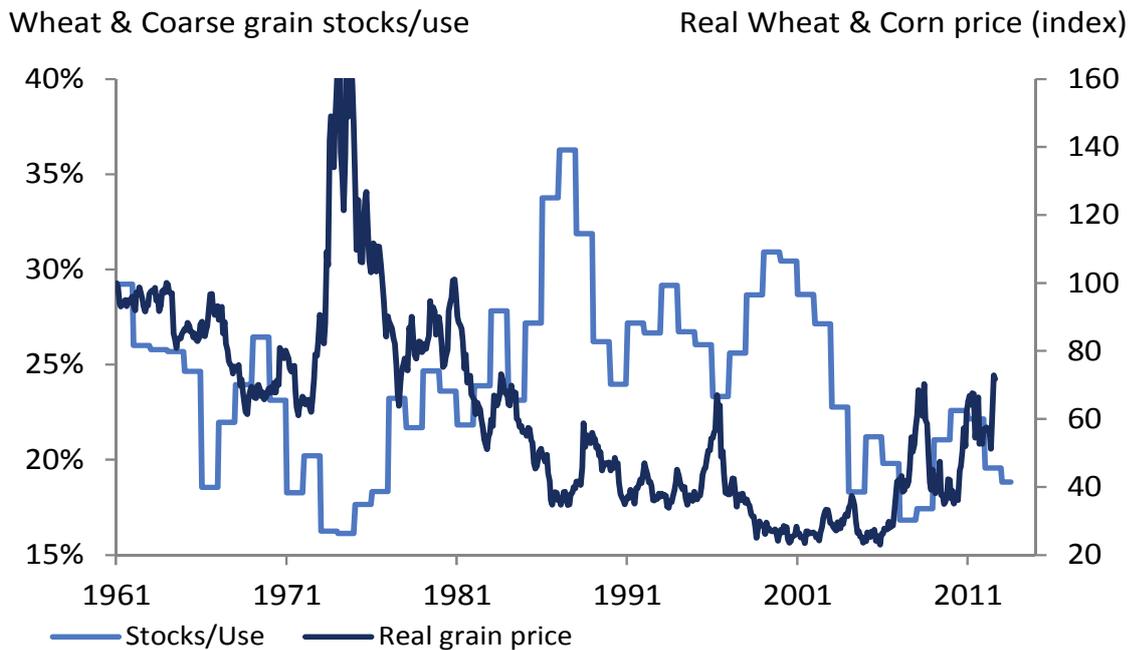


Source: Bloomberg

Chart 2 shows how global stocks of wheat and coarse grains (mainly corn) have declined since 2000 with no meaningful recovery (Stocks / Use). This is extremely worrying when many believe that the supply side is easy to fix and the return of food deflation is only a matter of time. “Don’t worry, next year farmers will simply plant more”.

Having spent the past 7 years at farm level in Brazil, Argentina, the U.S., Europe, Russia and certain parts of Africa, the reality is that the easy increases were brought on stream after the 2007 / 08 period of higher prices, and it will take 10 years plus in my opinion to meaningfully address the supply side. The main shortage is of infrastructure; suitable land, logistics, financing and actual farmers.

**Chart 2**



Source: Pareto / USDA

When these historic low stocks are mapped against real prices of wheat and corn, Chart 2, and one fully appreciates how difficult it is to increase the supply side, it seems realistic to predict that prices could easily double from here.

In addition, the United States Department of Agriculture, USDA, is the global benchmark for demand and supply figures for the global grain markets, and their reports on global stocks are widely read and used. (The stocks / use figures in Chart 2 are from the USDA). Many people in the agricultural industry however, view these figures with a certain amount of scepticism, and the fact that the USDA has a poor track record for predicting broad price moves doesn't help. One of the main problems the USDA has is that when forecasting global stocks, the bulk of these inventories tend to be in countries with limited transparency, China, India and Russia, and also in countries that are food importers and might be inclined to exaggerate their stocks. China for example routinely talks about its ample supply of corn, yet it has slowly begun to import corn in the past few years and the corn price in China is often at a large premium to international markets.

Looking at the facts, it seems quite possible that the global grain stocks are in fact much lower than the current reported levels, and any stocks that are held by importing countries, will not be released to the global market to ease the rising prices. (In 2008 many countries responded to higher prices with export restrictions)

On the demand side we have a global population that is currently adding between 75 million and 80 million people each year, with the rate of growth expected to increase until circa 2030. Between 2000 and 2012, an extra billion mouths were added to the world's population, as it increased from 6 to 7 billion.

The emerging / emerged markets as a whole have been the main driver. They account for 87% of the world's population and their demographic trends will only intensify in the medium term. For example the population of Nigeria is currently estimated at 162m, (half that of the U.S.) with 50% of this being people under the age of 18.

China, however, has the potential to make the largest impact on the grain markets due to its population size and its shortage of water and suitable farmland. It has 22% of the world's population and only 7% of the world's land and water.

Dylan Grice at Societe Generale [Dylan.grice@sgcib.com](mailto:Dylan.grice@sgcib.com) wrote a great piece in September 2010 in which he looks at the energy shock in the 1970's that caused oil prices to increase from \$3 to \$35, and compares it to China and its demand for food today. Yes the 1970's oil spike was initially driven by OPEC's embargo, but he goes on to show how the permanent peaking in the U.S. oil production from 1970, pushed the U.S. dependency ratio (imports as a percentage of consumption) from 20% to 40% in barely 3 years. The permanent nature of this shift reflected the permanent rise in real oil prices. Dylan goes on to point out that China is rapidly seeing its dependency on food imports increase, in a similar way to that of the US in the oil markets in the 1970s.

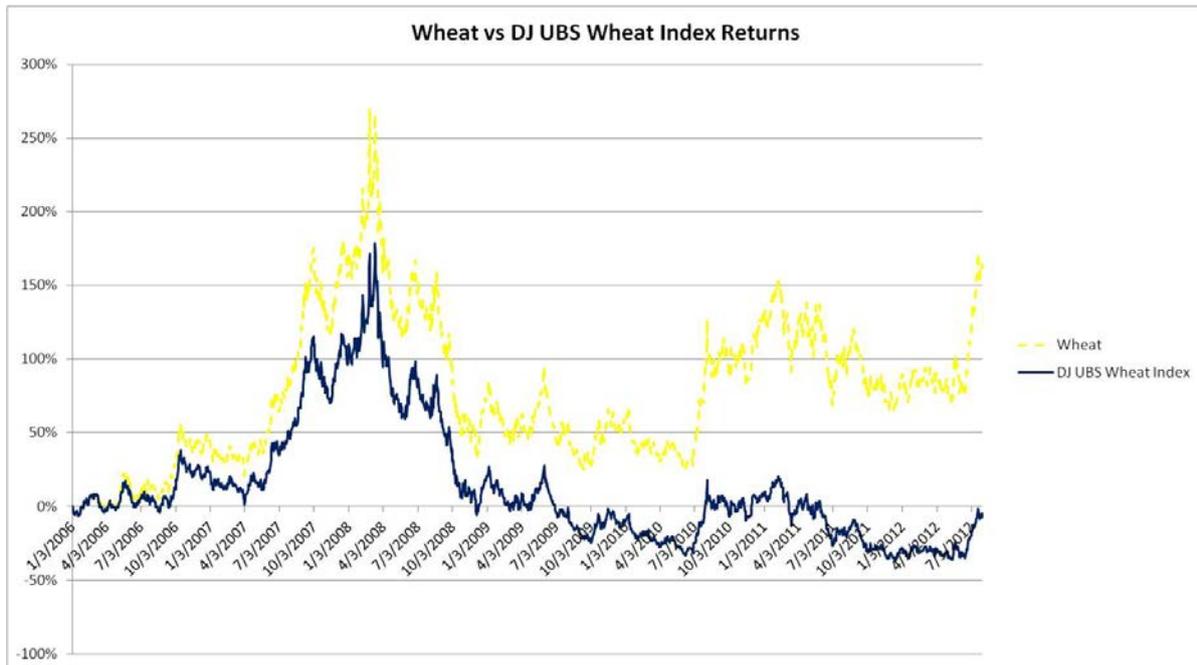
Today China is by far the largest importer of soybean (used mainly for animal feed) and its imports have been growing at a compounded annual growth rate of 17% for the past 10 years. Currently it accounts for 64% of all global soybean trade with the EU-27 in second with 11%.

In conclusion, it seems logical that grain prices will over the medium term continue their rise to much higher levels. The challenge for investors is how to profit from this.

The simplest way is to buy grain futures, however short term timing is crucial due to the cost of buying and holding. (I recently spoke with the head of one of the largest grain trading companies in the world. He said that with all their information flow, they rarely made money on directional trading, the large majority of their profits came from essentially day trading, matching buy and sell orders)

Most grain futures curves, for the majority of time, are in contango, ie the price curve is upward sloping, so the future is higher than the spot price, and there is a negative (funding) cost to buy and hold futures. As time passes, the price of your future naturally falls to settle at the lower spot price. This can easily be seen in Chart 3 where we compare the performance of the spot price of wheat with the Dow Jones UBS Wheat Index, which is based on the futures price.

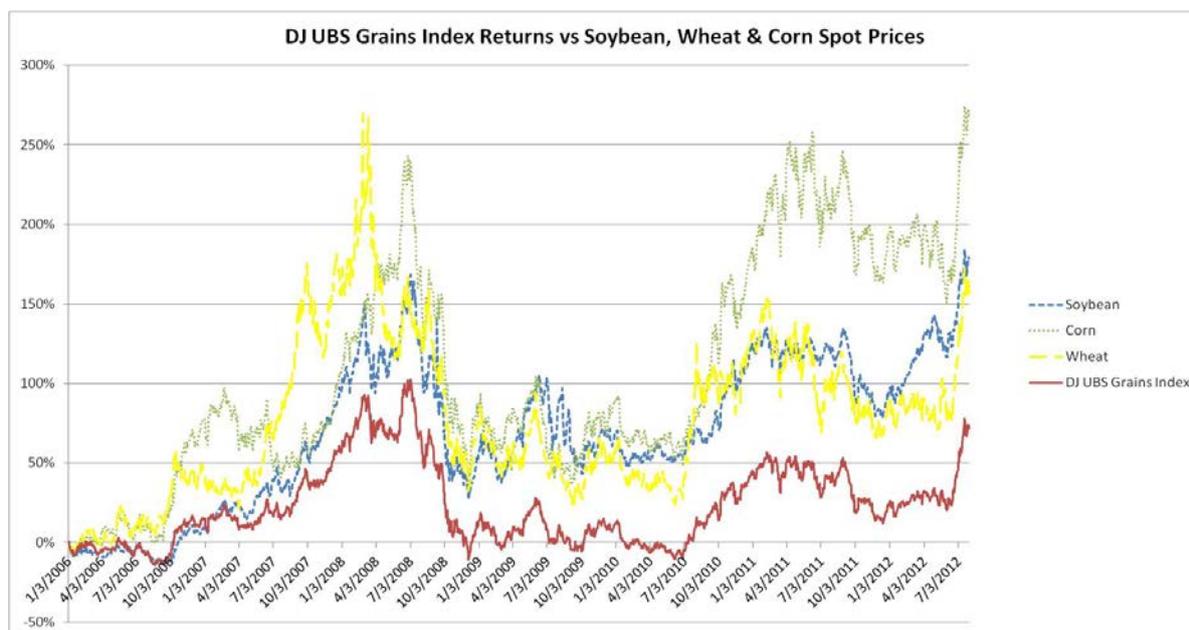
### Chart 3



Source: Bloomberg

Even though the price of wheat is 160% higher than in January 2006, an investor who bought the DJ UBS Wheat Index, used as the benchmark for many ETFs, would today only just be returning to breakeven. In Chart 4 we compare corn, wheat and soybean, versus the Dow Jones Grain Index, which is composed of the grain futures. Again there is a material difference in performance versus the spot prices.

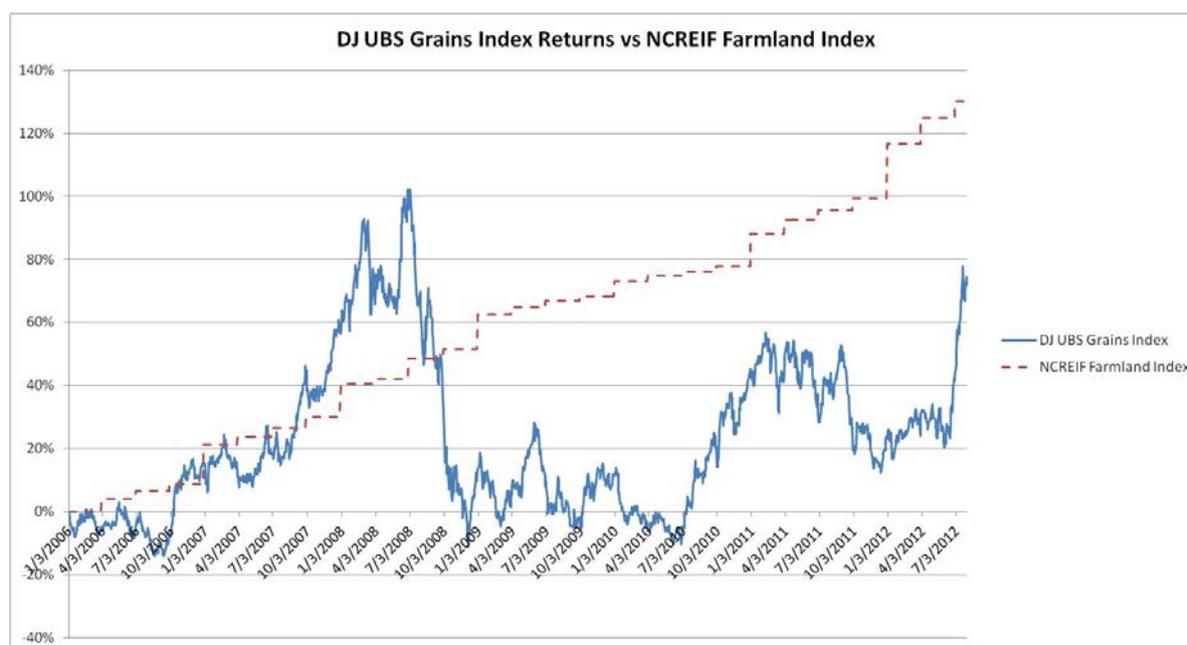
### Chart 4



Source: Bloomberg

In 2006 we decided the best way to capture rising grain prices was to buy farmland. Essentially we owned the grains with positive carry, ie we got paid to wait for the higher prices with annual profits from harvest, and the higher prices were then reflected in higher farmland values. Chart 5 shows the performance of US Farmland (NCREIF Farmland Index) v the DJ UBS Grains Index. The NCREIF Farmland Index is a broad measure for farmland in the U.S. and has been increasing at a compounded rate of 13% pa. We are using this as an illustration, due to the depth of data available in the U.S. and the transparency (the index is available on bloomberg)

## Chart 5



Source: Bloomberg

When looking globally for farmland, the key is to find cheap land which is profitable and where you have full legal title in a stable country. The key to profitable land is first having the agronomic capability, ie good quality soils and sufficient rainfall, evenly distributed throughout the growing season. (There might seem to be adequate rainfall on an annual basis, but if it falls over a 4 week period when the growing season for most crops is in excess of 18 weeks, profitable farming will be near impossible). Infrastructure is vital for profits and this is where many countries fail. Apart from financing and simply moving inputs and produce to and from farm, there is the severe lack of skilled farmers.

Brazil has many advantages in the production of agricultural commodities. Its climate and topography is ideal, with high quality soils and a high level of rainfall spread throughout the growing season, making it extremely productive. It has a long tradition of agricultural exports; for example it is the largest exporter in the world of animal protein (chicken and beef) and sugar, the 2<sup>nd</sup> in soybean (soon expected to be number 1) and the 4<sup>th</sup> largest in corn.

In addition, the Matopiba region of Brazil in the north east, (thousands of km away from the Amazon), offers the opportunity to transform cheap virgin savannah type land into highly productive farmland. Renato Rasmussen at Rabo Bank, [renato.rasmussen@rabobank.com](mailto:renato.rasmussen@rabobank.com) wrote a very informative piece in July titled “Matopiba”, covering in detail the development and opportunities in this region.

SLC Agricola, based in Brazil and listed on the stock market, is one of the largest and most profitable farming companies in the world. Current market cap US\$1.1bn. It was set up in 1977 and grew as a private company until its IPO in 2007 and follow-on share sale in 2008. The proceeds were used to acquire additional farmland in the Matopiba region. (Local financing for the acquisition of farmland is not available in Brazil).

In order to continue their profitable growth, SLC decided in 2011 to set up SLC LandCo to bring in additional capital. SLC Agricola contributed \$240m of existing productive farms to LandCo and investors would contribute \$239m of capital to buy cheap development farms in the Matopiba region and transform into highly productive farms. These farms would then be rented back to SLC Agricola at an arm’s length basis. LandCo shareholders would profit from the rental yield, and capital gains from the land transformation process. Expected returns of +20% IRR.

This is a simple win-win structure for both parties. For investors they minimise execution risk by partnering with one of the best operators in one of the best regions in the world for farming, and SLC obtains the capital it needs to grow its business

Last year, after selling the farming business I built up in Argentina since 2006, for US\$83m, I joined Valiance Asset Management in London. In May we entered an exclusive partnership with SLC Agricola to invest the \$239m. We currently have a limited opportunity to offer co-investment for third parties.