REVISITING FARMLAND: GOLD WITH A COUPON?

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In last week's "Behind the Markets" podcast, we revisited a discussion on farmland investing that we had a few months back. Since that episode aired, the two public farm real estate investment trusts (REITs) have faced market pressure, caused by both specific concerns over the individual REIT operating models and anxiety over macro conditions and global trade-war concerns. With all that in mind, and taking advantage of Brandon Zick of Ceres Partners being back on the Wharton campus, where we record our podcasts, we spoke with Zick about his current thoughts on farmland based on his experience as a private investor in this area.

Zick's Background

Zick was the first hire at Ceres Partners in 2010, after he met Perry Vieth , its founder and CIO. Vieth started the fund to move some of his assets out of "fiat paper" money and into "hard assets" that could grow with inflation over time. Zick has been running the day-to-day portfolio and doing farm analysis. When he started at the firm, it managed 6,000 acres, and today it manages 113,000 acres of land and $725 million of investor capital.

Zick has some estimates that farmland is not very institutionalized; only 2% of the farmland is owned in traditional institutional channels, and it trades at a rate of only 1% per year, with more land turnover every year. He thus thinks this creates a more inefficient market with good valuation characteristics but makes it difficult to source the land.

Zick described the payoff to farmland as "gold with a coupon" that delivers strong inflation-hedged returns. The coupon is the rent stream—for a broad "noninvestable" index, it shows income of around 3.5% per year, and Zick's firm is targeting returns that are a bit higher. These returns are dictated by the productivity of farms, so he thinks there are ties to inflation in this income stream. There is also a beta to the farmland itself—one can receive the coupon of rental payments from leasing the land plus the growth in land investments, which historically has been 6% per year from some of the indexes over time.

Zick described the present as being a prime time to invest in farmland because it has been at the bottom of its cycle for the last three to four years in commodity markets—with tariff concerns exacerbating the issue. He sees a dearth of supply in many of the markets, and there's the general principle that high prices cure high prices through higher supply, and low prices cure low prices. He sees demand as robust and supply constrained.

Are Tariffs an Issue?

Zick commented that a large part of the U.S. agriculture market is driven by exports, so any disruption to global trade is not good for the U.S. Zick raised an interesting point regarding when the tariffs were announced in mid-May. Many U.S. farmers didn't have crops in the ground, and many already would have hedged out their production—so they aren't fully feeling the hurt from the recent drop in prices. This will become a bigger problem if the prices are still this low in February. But overall, Zick thinks most of the bad news is priced into the agricultural commodity markets and that many of the agricultural commodities might be good contrarian investments at the moment.

Buy Signal

Zick targets a 5% "rental" return to all the land he buys, and if he wanted to make capital expenditures he's looking for 10% cash on hand.

Public vs. Private Markets in Farmland

When investing in farmland, people are looking for income returns with low volatility of underlying asset returns that are providing inflation protection. Given the low-volatility nature of this asset class, the vehicles to get exposure should have lower volatility. The public equity markets have ebbs and flows with daily liquidity and more correlation with the public markets. Zick described the REIT structure as a currency to fund land growth—and when you have strong markets, this is helpful, but during painful declines in the market, it is more difficult, especially if the management team believes the public market is selling at a discount to intrinsic value.

This was an interesting conversation on an asset class that can play a unique role for portfolios intended for inflation protection. To hear the whole conversation, please listen below.

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DEFINITIONS

Real estate investment trust (REIT) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages. Returns predominantly relate to changes in property values and income from rental payments.

Inflation : Characterized by rising price levels.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Low Volatility : Characterized by lower standard deviation of price over time. This term is also associated with the Low Volatility Factor, which associates lower volatility stocks with better risk-adjusted returns vs the market over time.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.