Newsletter

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Rural Funds Management

Managing good assets with good people

About Rural Funds Management

Rural Funds Management Limited (RFM) is one of the oldest and most experienced agricultural fund managers in Australia. Established in 1997, RFM employs over 230 staff in fund and asset management activities and manages approximately $2.3 billion of agricultural assets. The company operates from a head office in Canberra and has additional offices in Sydney and regional Queensland.

RFM has a depth of experience accumulated over 27 years owning, developing and operating Australian farmland, agricultural infrastructure and other assets. Sector experience includes almonds, poultry, macadamias, cattle, cropping, viticulture and water. Assets are located throughout New South Wales, Queensland, South Australia, Western Australia and Victoria.

RFM is the responsible entity for Rural Funds Group (RFF), an ASX-listed real estate investment trust that owns a $1.9 billion portfolio of diversified agricultural assets including almond and macadamia orchards, premium vineyards, water entitlements, cattle and cropping assets.

RFM's company culture is informed by a precision-based approach to asset management and its longstanding motto of "Managing good assets with good people".

Scan the QR code to learn more.

Cover image: Beerwah macadamia orchard with Mt Beerwah in background, Sunshine Coast hinterland, Queensland, April 2024.
Image on top: Steers at Kaiuroo, central Queensland, January 2024.

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Interest rates, inflation and growing RFF's earnings

David Bryant, Managing Director

Beerwah macadamia orchard, Sunshine Coast hinterland, Queensland, June 2024.

Since April 2023, Rural Funds Group (ASX: RFF) securities have been trading at around $2, a discount of about one-third compared to the net assets owned by the fund. There are two major causes for this: higher interest rates and stagnant growth in net income. This article examines these two issues and what may happen to change things.

Interest rates and inflation

Higher interest rates have two important consequences. Firstly, higher rates increase the interest bill on RFF's debt, with the interest expense increasing by $3.26m over the past year. Secondly, higher interest rates at the margin reduce the attractiveness of the income that RFF distributes each year. In January 2022, the cash rate was 0.1%, while RFF's distribution yield was an attractive 3.9% on a share price of around $3. Now, the cash rate is 4.35%, while RFF's yield is relatively less attractive at 5.8%. For this reason, investors at the margin are investing in cash or fixed interest rather than income-producing stocks, like RFF.

Mungbeans under pivot irrigation at Lynora Downs, central Queensland, March 2024.

As we all know, the reason for higher interest rates is higher inflation. Where did it come from, and will it go away?

Figure 1 plots Australian inflation from 1901 to the present. This chart shows that our economy has experienced many periods of high inflation in the past, such as the periods following the two World Wars and the nearly two decades of inflation during the 1970s and 1980s. The first two decades of this century recorded very low inflation until the recent surge that began in 2021, during the COVID-19 pandemic.

The causes of this recent inflation were, in large part, a function of dislocations associated with the pandemic and government spending in response. As with previous inflationary periods, this global shock caused a rapid increase in commodity prices.

During the early phase of the pandemic, commodity prices dropped as the world ground to a halt. From December 2019 to April 2020, agricultural goods dropped 7%, metals 17% and energy 62%.[1] Commodity prices then began to rise as the world reopened, with the COVID-19 turning point occurring in November 2021 when the Moderna and then Pfizer vaccines were found to be 95% effective.[2] From this point, the strong recovery in global demand caused commodity prices to rise past pre-pandemic highs. During 2021, global demand for goods and services leapt due to a relaxation of lockdowns and the massive pandemic spending

Figure 1: Annual percentage change in Australia's consumer price index (CPI)

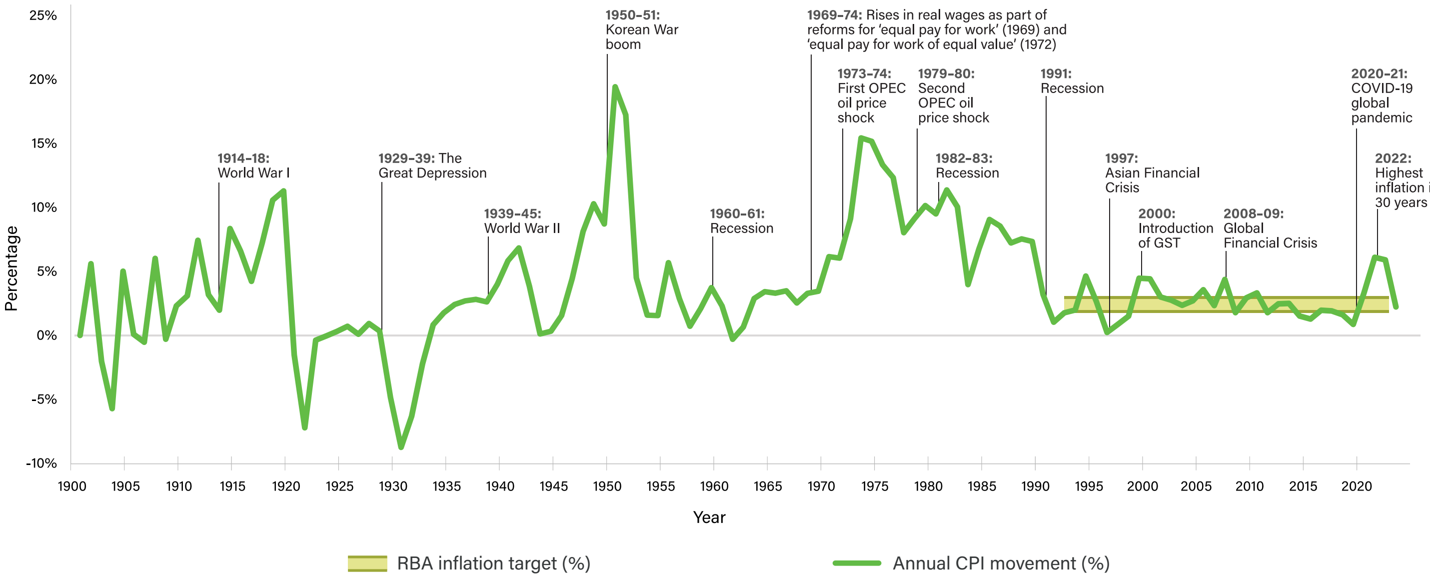
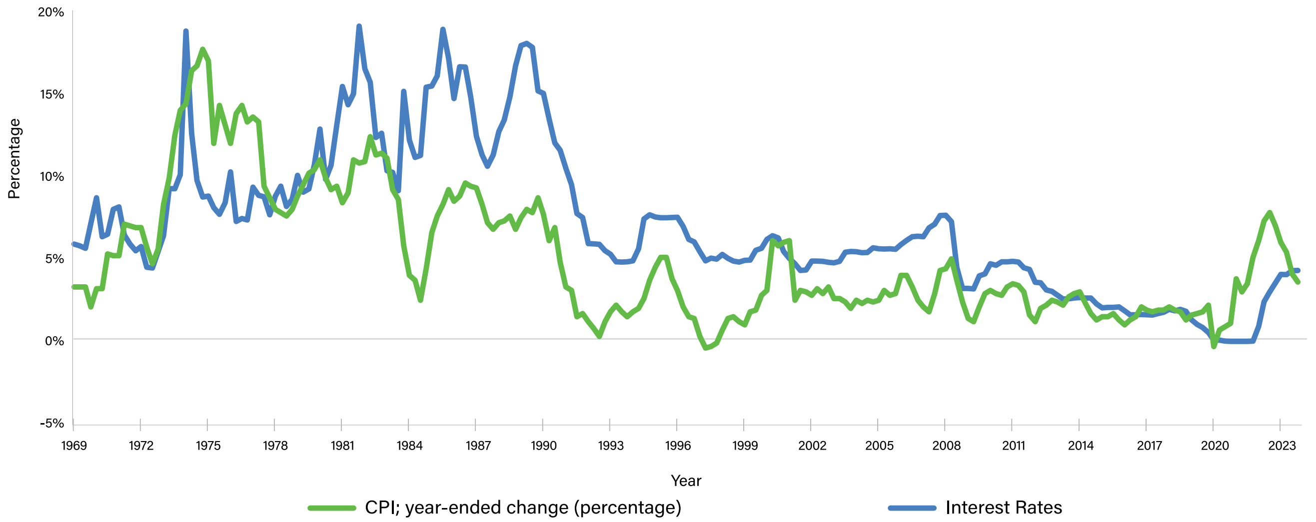


Figure 2: Historical interest rates vs change in CPI

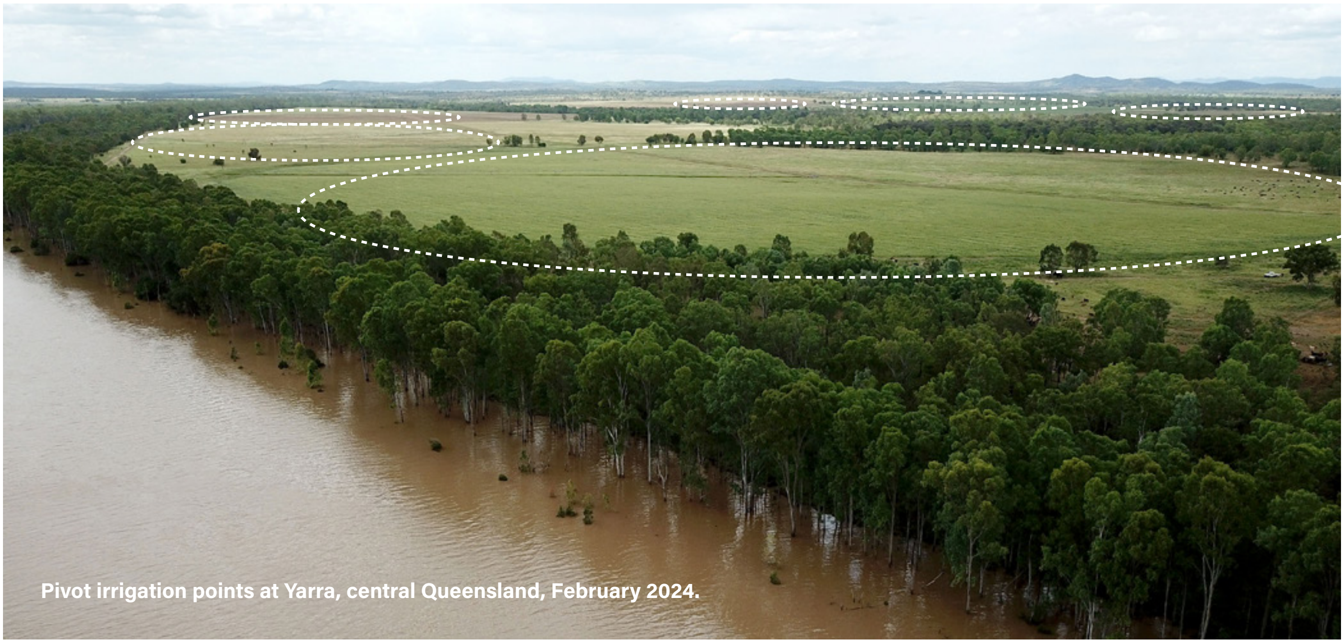


of higher-income countries.[3] Global economic growth surged to 5.5%, the strongest post-recession rise in 80 years.[4] Consequently, during the two years to December 2021, agricultural goods rose 28%, metals 55% and energy 45%. This rapid increase in commodity prices was a key early cause of the rise in inflation.

There are only four precedents where commodity prices increased by similar rates: the recoveries following two World Wars, the 1973 oil embargo following the Yom Kippur War, the 1979 energy crisis following the Iranian revolution, and the onset of the Iran–Iraq War. Peak inflation levels following these events were 11.3% in 1920, 23.9% in 1951, 17.7% in 1975 and 12.4% in 1982. In the event that the December 2022 inflation rate of 7.8% proves to be the peak, the post-COVID-19 inflation was relatively mild and possibly well-managed.

Factors other than increased commodity prices also contributed to inflation. The pandemic itself caused problems and changed behaviours. Interruption to production caused shortages of goods ranging from steel to computer chips, which in turn contributed to reduced production of many goods, such as cars. Constrained supply was exacerbated by changed demand as locked-down consumers reduced their consumption of services and increased their consumption of durable goods by 32%.[5]

Eighteen months on from the likely inflation peak, the RBA has forecast inflation to fall to around 2.5% by mid-2026.[6] Goods price inflation has fallen relatively quickly, though services inflation remains elevated due to strong demand for services, a tight labour market and low productivity growth. If inflation does fall as projected, some easing of interest rates will be possible, with the RBA forecasting the cash rate to decline from the current 4.35% to 3.25% by mid-2026.[7]



Pivot irrigation points at Yarra, central Queensland, February 2024.

Figure 3: Portfolio assets generating low rates of return

Sector	Properties	FY23 revenue ($m)	Value at 30 June 2023 ($m)	Rental yield (%)
Cattle	Yarra[8] and Cerberus[8]	(1.3)	49.6	(2.6)
Macadamias	Beerwah[8] and Bauple[8]	(1.5)	58.0	(2.7)
Macadamias	Swan Ridge[8] and Moore Park[8]	(0.2)	11.6	(1.5)
Water	High security entitlements	3.0	76.6	4.0
Total		**-**	**195.7**	**-**

The prospects for interest rates falling even lower are not good. **Figure 2** presents Australian inflation and interest rates for the past 55 years. Throughout this period, it is clear that interest rates were mostly maintained at levels higher than the corresponding inflation rate because that is how inflation is kept under control. The only significant period where interest rates were lower than inflation was from 2017 to 2023, when rates were initially set lower in an attempt to stimulate the economy and lift inflation back to within the 2% to 3% target. Then, with the onset of COVID-19, rates were dropped to all-time lows to provide further stimulus to our locked-down economy. From 2022, we re-entered a phase of contractionary interest rate settings as the RBA holds rates higher than inflation – to get inflation lower.

Once inflation is contained within the RBA target range, history would suggest that it is more likely that rates will be held above this level to restrain the economy – as opposed to rates being held below the range to stimulate the economy. For this reason, interest rates greater than 3% will be most likely.

Growing earnings

Given that interest rate reductions will most likely be slight, so too will be the benefits. For this reason, it is important to analyse what can be done to get RFF's earnings or, more specifically, adjusted funds from operations (AFFO) growing once more. AFFO are profits produced by RFF after deducting the non-cash profits, such as the capital growth on the farms and water entitlements that it owns.

The most significant way that RFF will increase AFFO is through the rental indexation mechanisms contained in its leases. The mechanisms vary between leases, but generally speaking, leases contain indexation of around 2.5% per annum with periodic reviews to market value or simple indexation at the rate of the CPI.

Following the sale of some high-yield but low-growth assets in 2020, the AFFO generated on RFF's assets declined in 2021 and has been relatively static since then. Funds from these asset sales were recycled into the acquisition of lower-yielding but higher-growth assets, particularly macadamia orchard and cotton farm developments. The bulk of these developments are now well advanced, and long-term leases have been signed.

There are still a number of assets in the portfolio that generate low rates of return, which are presented in **Figure 3**. The first item in the table is two cattle farms in central Queensland, one of which carries large water entitlements that have enabled the development of 244 ha of irrigation fields. These developments and other improvements have increased the productivity of these farms so that they can now be leased for cattle and cotton farming.

The second and third lines in Figure 3 are mature macadamia orchards that are not currently leased. These farms, in aggregate, lost money during the last financial year because they are not leased, and macadamia prices have dropped. Prices have begun to recover but are still 35% below their ten-year average of around $5 per kilogram.[9] Leasing these assets may take longer than a year, but given current pricing, AFFO yields from these farms are forecast to be around 2% in the coming year. This is still unsatisfactory; however, it is expected that productivity improvements and further price recovery will resolve this.

The final item in the table is high-security water entitlements acquired by the fund for $34.4m in December 2016. The income generated on these entitlements is achieved by renting the water to farmers, generally on an annual basis. Rents on these entitlements have been lower recently due to the succession of wet seasons in South Eastern Australia. During dry seasons the inverse occurs, so higher yields can be expected on this asset in future.

Selling some or all of these underperforming assets is another way of increasing AFFO, although doing so may incur capital gains taxes. Despite this, assets may be sold if they cannot achieve returns consistent with the rest of the portfolio.

RFF has also recently listed for sale its two cattle farms located near the Gulf of Carpentaria, Mutton Hole and Oakland Park. These are considered to be non-core assets because the leases will expire next year and because they are specialist breeder farms, which are not required by RFF's other cattle lessees. The farms were purchased in 2016 for $9.5m, and it is expected their sale, if completed, will produce a sizeable capital gain.

The recent sale of a 50% share of two cotton properties, Mayneland and Bamba Plains, was a transaction designed to attract a well-capitalised long-term lessee.

Conclusion

COVID-19 caused an unanticipated change in the global economy that triggered the return of high inflation. Higher interest rates will most likely bring inflation back to the target range, but inflationary pressures will most probably require rates to remain above 3% for the foreseeable future.

RFF has a portfolio of assets largely delivering acceptable rental yields. Rents have indexation mechanisms, which combine with the capital growth in assets to provide an excellent inflation hedge and good long-term total returns. A number of assets are undergoing development and will be added to this pool, while assets that cannot deliver satisfactory returns may be sold.


Harvest of cotton crop grown on a pivot irrigation field, Mayneland, central Queensland, June 2024.

Notes:

1. United States International Trade Commission (2021) The 2021 Commodity Price Surge: Causes and Impacts on Trade Flows, https://www.usitc.gov/research_and_analysis/tradeshifts/2021/special_topic, see chart.
2. David J. Sencer CDC Museum (2020) CDC Museum COVID-19 Timeline, 16 November 2020, https://www.cdc.gov/museum/timeline/covid19.html#Mid-2020
3. United States International Trade Commission (2021) The 2021 Commodity Price Surge: Causes and Impacts on Trade Flows, https://www.usitc.gov/research_and_analysis/tradeshifts/2021/special_topic, see chart.
4. Ibid. See under title: *Recovery of Global Demand*.
5. McKinsey Global Institute (2021) Shortages of everyday products have become the new normal. Why they won't end soon. https://www.mckinsey.com/mgi/overview/in-the-news/shortages-of-everyday-products-have-become-the-new-normal-why-they-wont-end-soon
6. Reserve Bank of Australia (2023) Statement on Monetary Policy – February 2024 Outlook, https://www.rba.gov.au/publications/smp/2024/feb/outlook.html, see graph 3.8
7. Ibid, section 3.4.
8. FY23 revenue and Rental yield includes AFFO contribution from farming operations from owner-occupied properties.
9. Nut-in-shell average price per kilogram at 10% moisture.

Cropping co-investment and lease arrangements

Australia's advantages in cropping, such as expansive growing areas, fertile soil types and suitable climate characteristics, make it particularly attractive to investors.

Rural Funds Management Limited (RFM) recently announced that Rural Funds Group (ASX: RFF) has leased two cropping properties located in central Queensland. The leases include an offshore institutional investor. As part of the leases, the investor will also acquire a 50% share of the properties.

The co-investment model provides both the investor and RFF with exposure to potential capital growth in property values and an alignment of interests. This article will provide details of the transaction and the benefits to RFF investors.

Lateral irrigation which spans 1km, Baamba Plains, central Queensland, June 2024.

RFF's cotton investment strategy

Cotton is an annual crop that grows over the summer months. Once it has been harvested, other crops, such as mungbeans and chickpeas, may be grown in the same area. Because of this, the terms 'cropping' or 'cotton' are often used interchangeably. However, cotton – being usually the most profitable of the crops grown – is the focus of the production system.

RFM has over 25 years of experience developing and operating cotton properties. In 1998, RFM first acquired and commenced operating an irrigated cotton property in the Riverina region of New South Wales. RFM has managed cotton crops most years since.

RFF first invested in the cotton sector in 2016 with the purchase of Lynora Downs, a 4,963-hectare cotton property situated on the Comet River in central Queensland. Lynora Downs added commodity and climatic diversification to the portfolio, as the majority of the portfolio at the time consisted of assets located in southern Australia.

Lynora Downs is leased by a joint venture between RFM and Queensland Cotton. RFM staff have operated the farm since 2016, providing useful experience specifically in central Queensland cotton growing.

After the acquisition of Lynora Downs, two additional cotton properties were added to the portfolio achieving further scale in the sector: Mayneland, a 2,942 ha property acquired in September 2018 for $18.0m, and Baamba Plains, a 4,130 ha property acquired in November 2021 for $32.0m. Both of these properties are on the same river as Lynora Downs, the Comet River (see **Figure 1**).

Rural Funds Group's overall strategy is to generate capital growth and income for investors through developing and leasing agricultural assets. RFF deploys two development strategies: converting properties to a higher and better use (such as developing sugar cane properties into macadamia orchards) and implementing productivity improvements (such as increasing the carrying capacity on cattle properties).

Baamba Plains and Mayneland are also good examples of RFM developing assets to improve productivity. The approach with these acquisitions is similar to Lynora Downs: maximising underutilised water allocations on additional irrigated cropping areas to improve the farms' productivity.

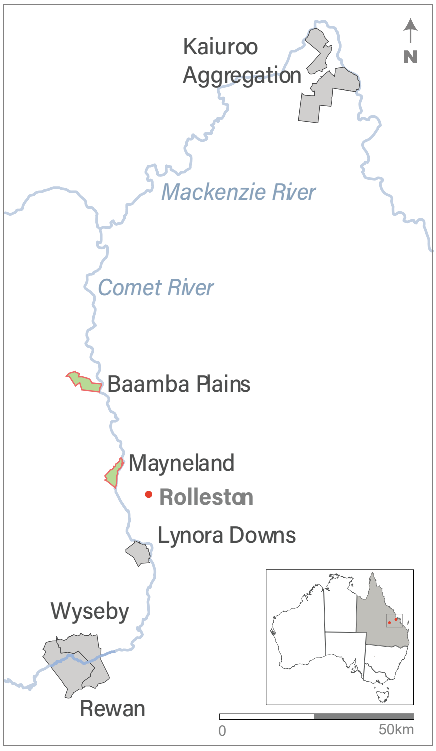
In the case of Mayneland, additional water storages for an additional 4,970 ML of water entitlements were developed. Access to this water enabled an increase in the irrigated cropping area from 485 ha to approximately 1,000 ha. The irrigation systems included the replacement or installation of 10 new centre pivot irrigation systems.

Pivot irrigation systems are beneficial due to their ability to use water efficiently and optimise yield. Water is supplied to the pivot via an underground pipeline where the irrigation system, propelled by electric motors, rotates around a pivot. A series of sprinklers are fitted to the system to water the crop. The application rate can be adjusted in line with the crop's water requirements. In the case of RFF cropping properties, pivots cover areas of up to 80 ha each. These systems can apply up to 15 mm of water within a 24-hour period.

Similar developments were undertaken on Baamba Plains. Two new water storages were developed with combined storage capacity of approximately 7,980 ML. The irrigation area was increased from 386 ha to over 900 ha with the installation of three new lateral irrigation systems. These lateral systems span approximately one kilometre wide and can cover a distance of approximately two kilometres over a 24-hour period. Depending on weather conditions and crop requirements, these lateral irrigation systems also allow water application of up to 15 mm per 24-hour period, providing enough for optimal growth and yield.

The development of water storages is essential to utilise water from owned water entitlements. To provide some sense of their dimensions, the combined additional storage at Mayneland and Baamba Plains represent *over five thousand* Olympic-size swimming pools.

Figure 1: Area map of Baamba Plains and Mayneland



Heavy-duty machinery, such as scrapers and graders were used to construct the storages. This work included the removal of approximately 2.8 million cubic metres of soil. The soil was then used to construct the storage walls up to approximately eight metres high, which further increased the storage capacity. Higher walls allow more water to be stored on a smaller footprint to reduce evaporation.

By developing water storages and increasing the irrigated areas, water allocations are now being better utilised and both properties can provide a more reliable production of annual crops. The improvements across the two properties have significantly increased the annual average planted area.

Benefits of the lease and co-investment transaction

As highlighted in the June 2023 Newsletter, a core focus for RFM has been to lease assets once developed and to reduce the level of debt.

The lease of Baamba Plains and Mayneland, to a company managed by The Rohatyn Group (TRG) on behalf of a joint venture between TRG and a global institutional investor, provides several benefits.

The lease arrangements ensure that RFF is insulated from the operating risks associated with the properties, such as risks associated with production volumes, commodity prices and severe weather events.

The leases are on triple-net lease terms, which means the lessee pays all property expenses, including land taxes, insurance and maintenance. These expenses are in addition to the cost of rent and utilities. This arrangement provides RFF with a more consistent and predictable income stream.

The lease is for 10 years with an option to extend for a further 10 years. The lease includes annual indexation linked to CPI, within a 1.5% to 2.5% range. A profit share mechanism is also included in the lease, where RFF can capture rental income from best-practice farm management and higher yields.

RFM will continue to provide TRG with farm management services. The continuity of operational management on the property is expected to help maintain property productivity by retaining the considerable knowledge that RFM has built up on the properties and associated commodities.

One way to reduce gearing and demonstrate that RFF's assets have maintained their values is to sell assets at a price close to their valuation.

The cotton property transactions with TRG include a sale of 50% of the assets. The proceeds from the partial sale will be used to reduce debt, which will in turn reduce the gearing within the fund.

As RFF will retain a 50% interest in the properties, it will continue to benefit from any future valuation increases.

While lease terms are in place across RFF's portfolio that align the interests of lessees and RFF as the lessor, the co-ownership model provides other synergies including sharing capital growth.

TRG on behalf of a joint venture between TRG and a global institutional investor, also leases 3,000 ha of macadamia orchards from RFF. This new cropping lease demonstrates RFF's ability to continue to attract high-quality lessees on long-term leases.

Conclusion

The lease and co-investment of Baamba Plains and Mayneland, provides several benefits to RFF. It mitigates operational risks and secures a consistent income stream through triple-net lease terms, which include annual indexation and profit-sharing mechanisms.

The partial sale of these properties enables RFF to reduce debt, while retaining a 50% interest ensures RFF can benefit from potential future valuation increases.

This latest transaction affirms RFF's commitment to reducing leverage, enhancing asset value, and securing long-term growth and income for investors.

Harvest of cotton crop grown on a pivot irrigation field at Mayneland, central Queensland, June 2024.

Cotton sector attributes

Australia is the world's third-largest cotton exporter.

Cotton demand is correlated to global population growth.

25+yrs

RFM has over 25 years of experience in cotton operations.

Cotton produced by Australian growers is of high quality compared to other regions globally and typically receives a price premium.

Australia has invested significantly into cotton through ongoing research at the CSIRO, resulting in cotton varietals that have greater insect resistance, produce higher quality cotton lint and have improved yields.

Australia has an advantage in cotton growing with expansive suitable growing areas and soil types, favourable climatic conditions and advanced production techniques with specifically developed plant varieties.

Developing sustainable macadamia orchards

RFM is developing macadamia orchards in Queensland's Fitzroy and Maryborough regions that aim to provide long-term sustainable production. Central to the developments are key orchard principles that focus on sustainable water management and soil health enhancements. These practices, as outlined in this article, are designed to improve environmental outcomes, conserve water and maximise yield.

Orchard design and irrigation

Sustainable macadamia orchard design benefits both environmental health and long-term productivity through innovative irrigation and landscape management.

A critical component of RFF's orchard design is the incorporation of dual irrigation systems, which not only supply water directly to the trees but also allow for the irrigation of grass within the interrow using supplementary micro sprinklers.

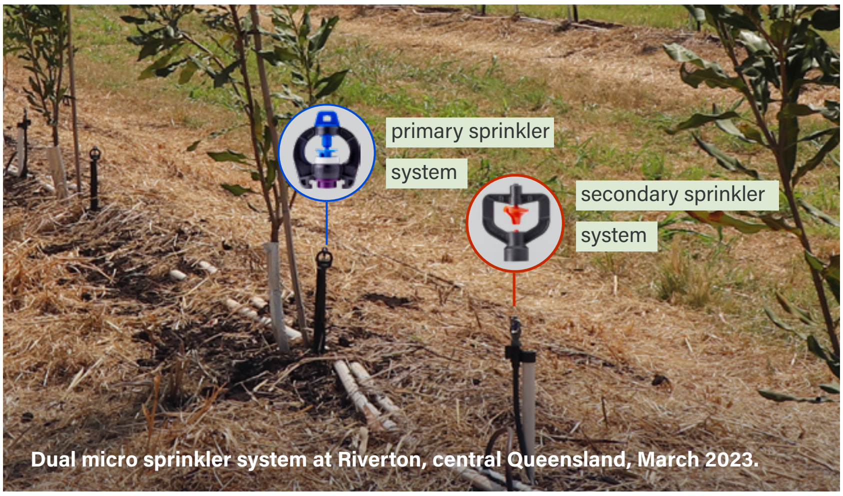
Newly planted trees at the Riverton macadamia orchard, central Queensland, June 2023.

Maintaining soil cover with grass mitigates erosion and run-off because plant roots secure the soil, keeping it in place during heavy rainfall. In addition, the presence of grass increases soil organic carbon, enhancing water retention capacity and reducing irrigation requirements while improving rainfall water absorption. It also improves plant diversity to encourage beneficial insects.

This approach, in line with RFM's Hort360 Reef Certification and other relevant environmental approvals, not only safeguards marine environments but also enhances harvest efficiency, yield quality and nutrient utilisation.

The secondary micro sprinklers also provide flexibility for irrigation schedules to manage heatwave events that can adversely impact tree health and yield. The integration of dual irrigation systems allows for precision management with increased control over water application, effectively mitigating the potential effects of water-stress on crop productivity.

In addition to advanced irrigation techniques, the design of the orchards incorporates elements to achieve sustainable production, such as diversion banks, block layout and grassed drains.



Dual micro sprinkler system at Riverton, central Queensland, March 2023.

Diversion banks positioned upslope from the orchards prevent the ingress of water into orchard blocks.

The direction and length of the rows, as part of the block layout, contributes to reducing sediment loss and maintaining soil integrity by limiting water volumes and velocities during rain events.

Grassed drainage structures strategically placed throughout the orchards also play an important role in controlling water movement effectively. They manage accumulated water away from blocks in appropriate volumes, velocities and locations to minimise risks of soil erosion and sediment loss.

Overall, the implementation of these elements and secondary sprinkler systems represents a holistic approach to sustainable water management and soil conservation. These systems not only mitigate erosion risks and conserve water, but also contribute to enhanced soil health and agricultural productivity.

Orchard technology

The use of technology within the orchards aims to optimise resource efficiency. Sap flow meters, soil moisture probes and weather instruments capture real-time digital data that can be combined with tree growth data and leaf samples. This data enables precision agricultural management practices, including nutrient efficiency and water use efficiency.

Integrating advanced monitoring technologies like these can further

Macadamia orchard under development at Rookwood Farms, central Queensland, February 2024.

refine orchard management practices to ensure optimal use of resources and long-term sustainability in macadamia cultivation.

Environmental, economic and community benefits

Macadamia developments specifically in the Fitzroy region are underway on properties previously used for cattle grazing (Rookwood Farms and Riverton). They are located near the Rookwood Weir on the Fitzroy River, approximately 65 km west of Rockhampton (see **Figure 1**).

The availability of water is an integral factor in the productivity of the orchards. The nearby Fitzroy River has average stream flows of 5,000 GL per annum. Completed in November 2023, the weir provides up to 86 GL of water for agricultural, urban and industrial use. RFF owns approximately 22 GL to support macadamia developments and cattle operations in the area.

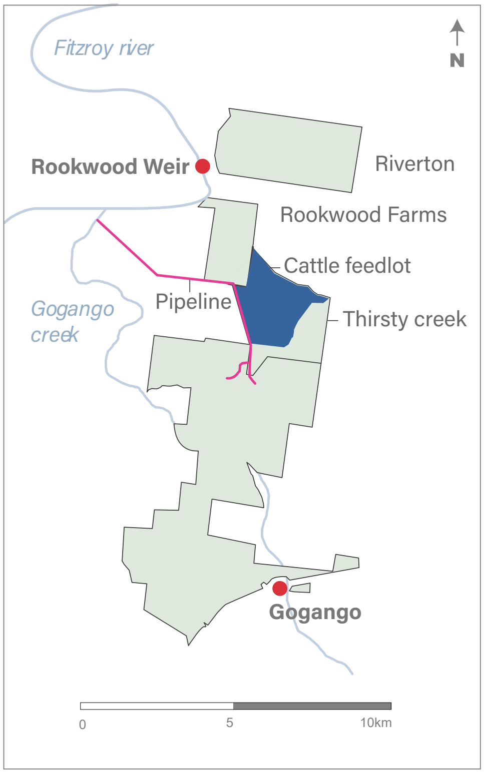
Converting Riverton and Rookwood Farms to higher and better use will significantly increase the agricultural production value per megalitre of water used. Once established, the macadamia orchards are projected to provide approximately three times higher agricultural production value compared to the central Queensland average, per megalitre. This reflects the higher value of macadamias relative to other commodities currently produced in the region.

Macadamia production in central Queensland is also generating employment, despite the mechanisation of many aspects of macadamia production and relatively low labour requirements. Once the orchards are in a steady state of production, the macadamia developments will generate further employment including flow-on jobs in other businesses which benefit from growth in the local economy.

Transforming these parcels of land into fully vegetated spaces with trees and interrow grasses helps reduce the impact of water flow, enhances water infiltration, and curbs sediment run-off onto the Great Barrier Reef. Parts of the land acquired for the developments had been grazed consistently, resulting in compacted soil, diminished ground cover, and heightened susceptibility to sediment erosion.

The trees and soil also serve as effective carbon sinks, with a potential macadamia tree lifespan exceeding 50 years. As an example, under the lease to The Rohatyn Group (TRG), 3,000 ha of macadamia orchards are being developed. This equates to nearly one million trees that will contribute significantly to carbon sequestration during their lifespan. The roots of macadamia trees, which sequester soil carbon, combined with soil health improvements from introducing perennial pastures in the interrows, create a significant carbon sink.

Figure 1: map of Fitzroy macadamia development sites



Development of Rookwood Farms commenced in 2021 and included the installation of a nine-kilometre rising main pipeline from the Fitzroy River system to the property, the installation of pumping and irrigation infrastructure, and the establishment of water storages. Planting commenced in February 2024. Scan the QR code to learn more.

Conclusion

The macadamia developments in the Fitzroy region significantly change how those land and water resources are used – shifting from low-value cattle grazing to high-value macadamia orchards. This transition not only enhances water productivity and agricultural output, but also provides environmental and socio-economic benefits, making a lasting positive impact on the region.

Developments at Riverton (pictured) started with ground preparations and irrigation development in July 2021. Planting of trees began in December 2021, with the completion of the orchard expected in the 2025 financial year. Scan the QR code to learn more.

Cattle grazing on improved pasture at Yarra, central Queensland, February 2024.

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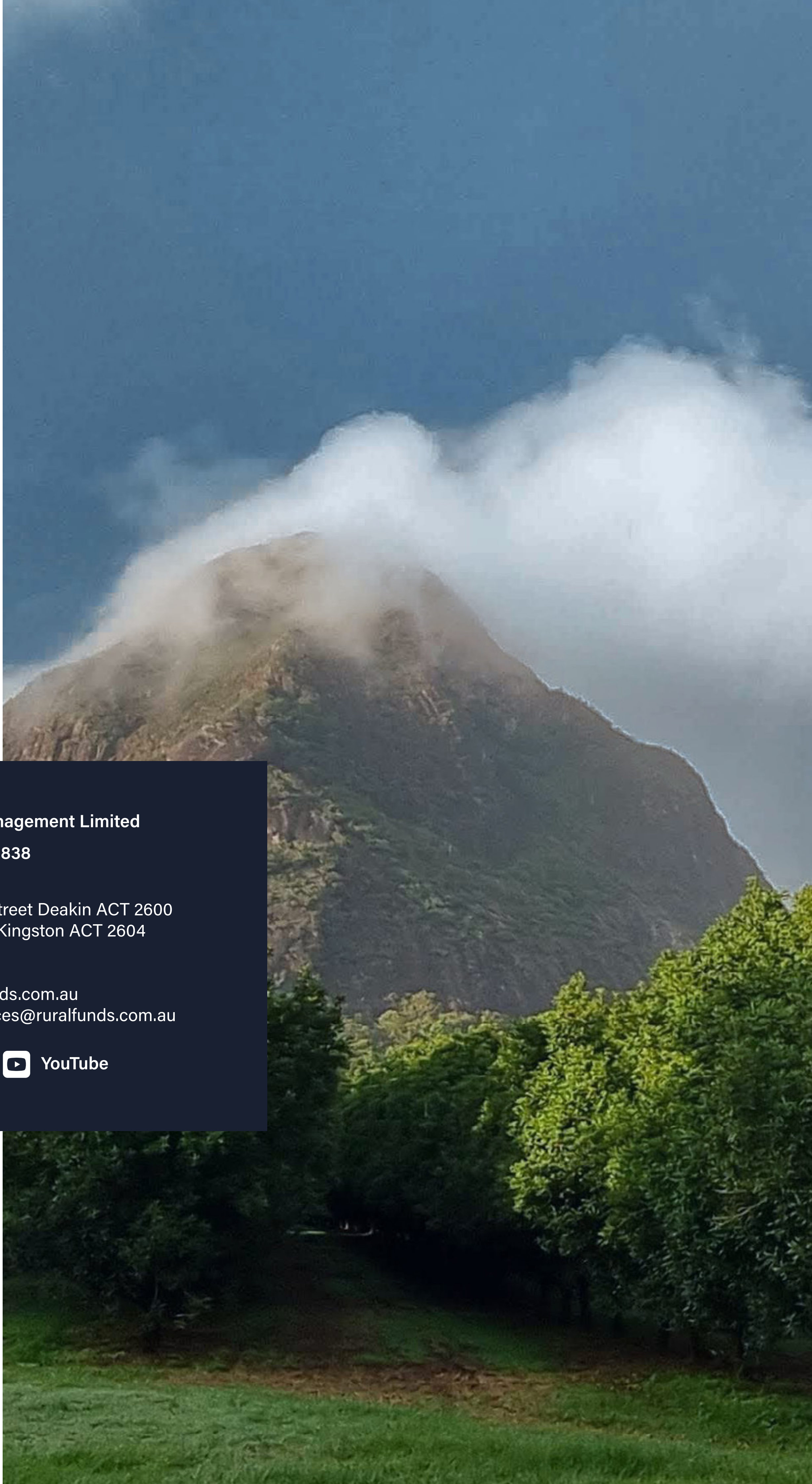

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