COMMENTARY

April 13, 2017

Dear clients and colleagues,

Real estate, real assets, infrastructure—investors are constantly searching for better risk-adjusted returns.

But what are real assets and what are hard assets? According to Investopedia, real assets are physical assets that have value due to their substance and properties. Real assets include precious metals, commodities, real estate, agricultural land, machinery and oil. So why is owning shares in companies like Nestlé or Microsoft any different than owning "real assets"?

Nestlé has delivered an annual return of 10.7% since 1990, offers a dividend of 3% and has a beta of 0.82. It has over €75 billion, or around €25 per share, in tangible assets (raw materials, inventory, property plant and equipment, etc.). We are not counting the brands. However, owning shares of Nestlé is not considered as owning a real asset.

In the last few years many large pension funds have made an important asset mix shift to hold less liquid asset classes, such as private equity, unlisted real estate and infrastructure, up from 5% in 1995 to around 25% today.

In the past, these asset classes offered the potential to capture an illiquidity discount as they were sold at a discount to the more liquid asset classes. This discount would eventually disappear over time or when the assets were sold or when the issuer went public. The theory was that a large investor with a long-term horizon, limited short-term liquidity needs and higher risk tolerance could profit from these strategies.

In the last few years, with record low interest rates and high volatility, many pension funds have moved to illiquid assets, branding them "real assets". They don't do this to capture the discount or to accept higher risk, but in the hope of generating higher returns and benefiting from the different accounting rules applied to illiquid investments.

Direct real estate, private equity and infrastructure assets are not listed and have a limited secondary market. These assets are more correlated to liquid markets than many believe. Given their illiquidity, they should sell at a discount.

The effect of this change in asset mix and the flow of money into illiquid assets has been that these assets now sell at a premium to their closely related liquid investments. The weight of capital chasing assets is so great it is also reducing returns on these so-called real assets.

Are we preparing the next crisis? Only time will tell.

Our portfolio has many companies that possess assets that would qualify as "real assets", and we also have the liquidity—a win-win.

A few examples: Ormat Industries (ORA US) which owns and operates 713 MW of geothermal power. Advance Residence (3269 JP) is the owner of more than 20,000 apartments in central Tokyo. We recently profiled Rayonier (RYN US), the second largest timberland REIT in the US, which owns approximately 2.7 million acres of timberland.

Farmland is becoming another sought after “real asset”. Last October, we profiled Limoneira (LMNR US), one of the largest growers and marketers of lemons in the US. Over the last 40 years, Farmland has outperformed most asset classes with lower volatility.

Asset/Index	Annual Average Return	Standard Deviation	Coefficient of Variation	Correlation
	1970 - 2015			
US Average Farm (all)	10.54%	6.41%	0.608	1
S&P 500	6.74%	16.74%	2.484	-0.262
NASDAQ	9.71%	25.53%	2.631	-0.145
TCM 10-Year	6.67%	2.88%	0.432	0.077
AAA	7.79%	2.50%	0.321	0.003
Mort30F	8.35%	3.06%	0.366	0.033
Gold	7.40%	23.04%	3.112	0.298
All REITs	9.09%	20.34%	2.237	-0.146
CPI	4.00%	2.86%	0.714	0.641

Source: Professor Bruce Sherrick, TIAA Center for Farmland Research, University of Illinois

This week we will profile Farmland Partners (FPI US - $10.95).
http://www.farmlandpartners.com/

Business description

Headquartered in Denver, Colorado, Farmland Partners is the largest public farmland REIT. The company owns 151,000 acres of farmland with a value approaching US$1B.

Farmland Partners owns farmland in 17 states. It leases land to over 100 tenants who collectively farm over 500,000 acres spanning all major crop types: row crops, specialty crops and permanent crops.

Industry overview

Global food demand is projected to increase 45% by 2050 while global cropland is only planned to increase by 4.3%. According to USDA, in 2012, 3.2 million farmers operated 2.1 million farms in the US covering 915 million acres. 98% of US farms are run by families with the average age of the principal operator at 58 years and rising. Over 700,000 farmers are over 65 years old.

Competitive Advantage

Farmland Partners is the lowest cost manager of farmland assets in the US. It is also the buyer of choice for farmers.

Imagine an older farmer who has three children and one child wants to continue to farm the family land. How can he give an inheritance to all his children and fund his own retirement without burdening the child who will operate farm with a big mortgage.

By offering a choice of cash or shares when purchasing a property, and with the yield on shares approaching 5%, FPI provides a farmer many options while allowing him and his children to continue to farm if they choose.

Growth Strategy

Farmland will continue to make acquisitions with primary row crops being the largest part of the portfolio (goal of 75%). The company will invest in its land (irrigation, storage) to increase rent.

Opportunistically, the company will seek higher business uses such as solar, wind and real estate development.

Management

The CEO is a former farmer and investment banker and rolled his farm into the REIT.

Management and directors own 6.5% of the company

Risks

Risks are mitigated by the company's geographic and crop diversification. The company has over 100 tenants and most pay rent upfront in cash (80%). Many states give landlords first security interest on crops and crop insurance provides a minimum payment floor.

A risk, as it is to many REITs, would be an increase in interest rates, but this would most likely lead to rent increases, therefore mitigating this risk.

ESG

The company is a member of the Global Harvest Initiative that works to improve food security and emphasize agriculture's role in conserving natural resources and adapting to and mitigating climate change.

The company's social and governance practices are in line with industry practices.

Market Data

Market Cap: US$350M, Net debt: US$260M, Dividend Yield: 4.7%.

Have a great weekend.

The Global Alpha team