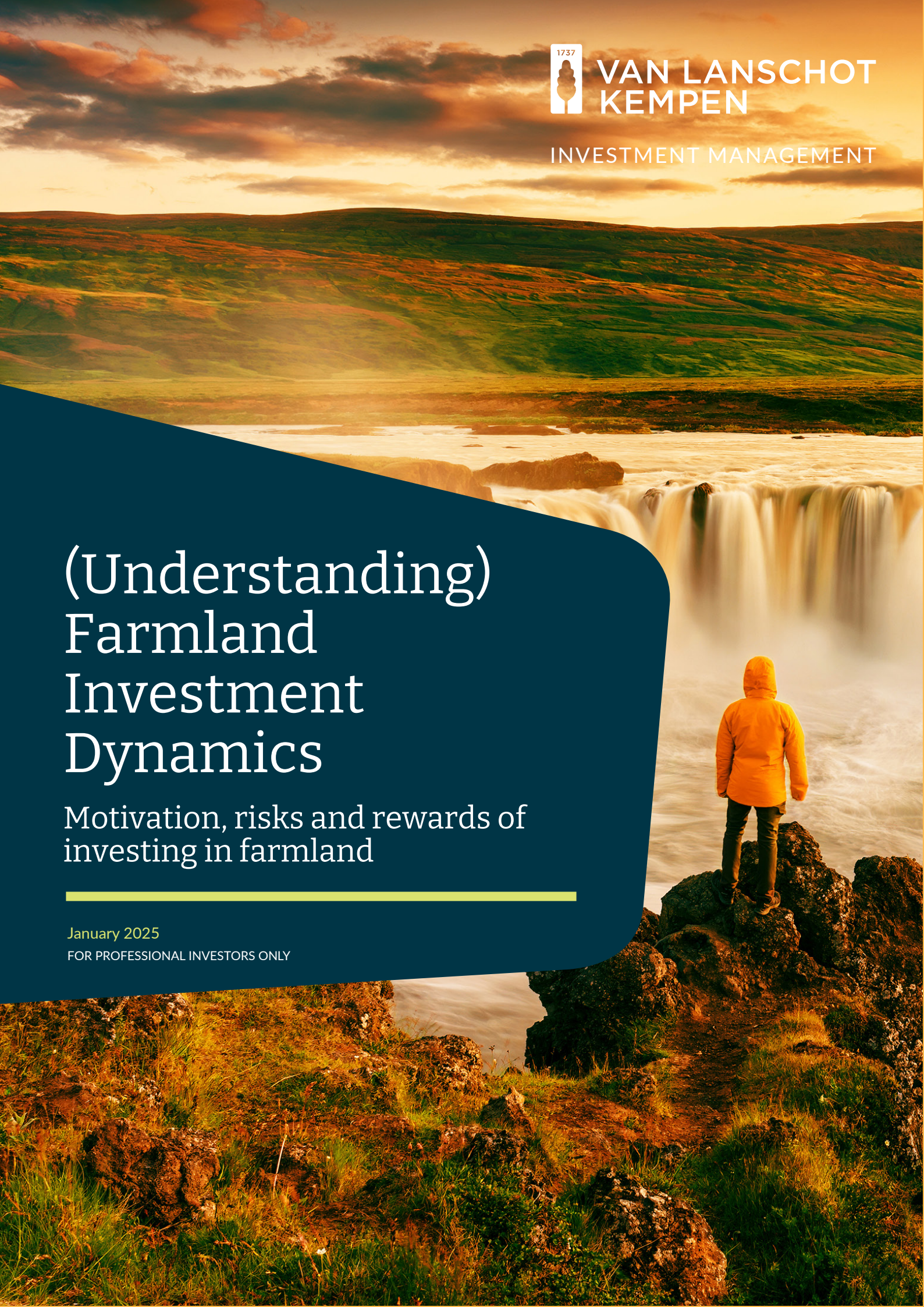

VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

(Understanding) Farmland Investment Dynamics

Motivation, risks and rewards of investing in farmland

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FOR PROFESSIONAL INVESTORS ONLY

In his short story 'How Much Land Does a Man Need?' Leo Tolstoy explores the dangers of unchecked ambition and the importance of prioritising the good of the people in a tale about land ownership. The same question is indeed still relevant today - how much land does mankind actually need? According to McKinsey Research, by 2030 an additional 70 to 80 million hectares of arable land will be required, leading to increased competition for suitable land.

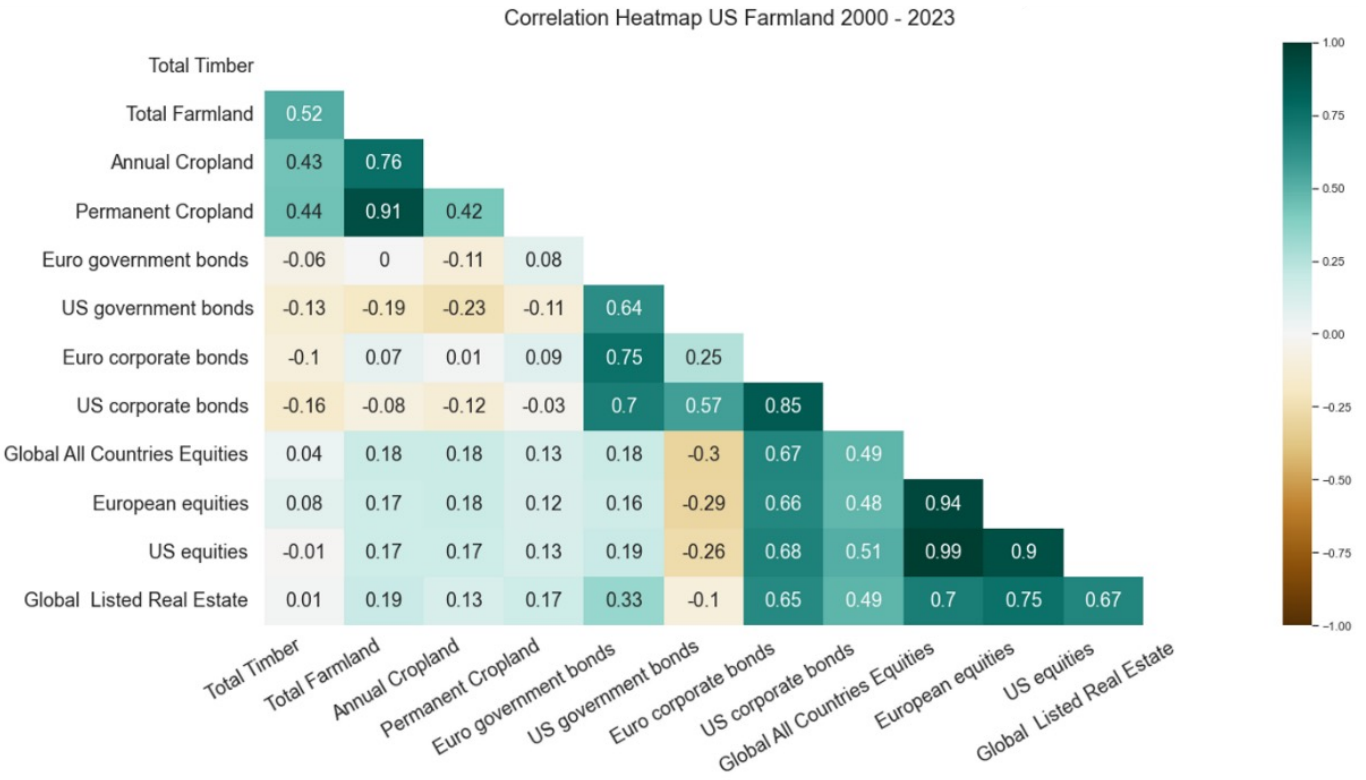
In this paper, against the backdrop of Tolstoy's prose, we will discuss the motivation, risks and rewards of investing in farmland. With the global demand for food, livestock and power sources fuelling the desire for land, Tolstoy's story reminds us to find a balance between the demand for land and the protection of natural capital, which is a crucial challenge for a sustainable future.

In Tolstoy's narrative, it is greed that drives the main character to acquire increasing amounts of land. However, in today's context, investors will have very different reasons for investing in land. Let us first examine a few incentives at play.

Low correlation with other asset classes

Farmland is a real asset whose yield (the agricultural products) has a positive correlation with the price development for these products on the world market. Therefore, correlations with traditional asset classes are low and are expected to remain low. The heatmap below show the correlations between farmland and global markets. This significant diversification benefit is explained by the nature of the asset class as described above. It is good to bear in mind that this is not only due to the very stable underlying 'real' assets, but also to the vulnerability to other risk factors such as weather, climate, disease and pests.

Figure 1. Correlation Heatmap U.S. Farmland 2000 – 2023



Source: NCREIF quarterly data from 2000 to 2023

Inflation Hedge

From a conceptual point of view, inflation should correlate positively with returns from agricultural land. An increase in the general prices of all goods and services in a country weakens the purchasing power of each unit of the national currency. Higher commodity prices can lead to higher expectations of future farm income and therefore increase the value of farmland as well. Also, inflation can lower real interest rates, thereby lowering the interest rate at which landowners discount future farm incomes and effectively increasing the present value of farmland.

Farmland appears to be an attractive investment again: it is a real asset that performs well in an inflationary environment, tends to provide stable returns over long periods and has a low correlation with other assets.

Sustainable returns through regenerative farming

Following the financial crisis of 2008, investors generally began to look towards farmland to enhance and diversify their returns. However, with the end of the bull run in 2014, this interest somewhat waned. More recently, we have observed investors returning to this sector for sustainability reasons. The global food sector is responsible for over 26% of global greenhouse gas (GHG) emissions[1], whilst land has the capability to sequester carbon. Nature has been undervalued for a very long time, and investors are slowly beginning to recognise this.

In farmland, the natural capital trend is primarily focused on regenerative farming, which places a significant emphasis on soil health, aiming for the soil to sustain itself. This approach moves away from the 'Green Revolution' system that focused on a limited number of crops and increasing yields per hectare with higher input costs.

Regenerative farming offers numerous benefits: it helps to mitigate climate change by sequestering carbon in the soil and improving crop resilience to climate shocks. Additionally, it enhances soil fertility through increased biomass production, thereby preventing soil degradation. This method also promotes biodiversity by supporting diverse crop rotations and reducing pesticide usage. Furthermore, regenerative farming improves water use efficiency, reducing the stress on freshwater reserves.

The financial crisis illustrated that although farmland has some similarities to real estate, its behaviour is distinct. The decline in real estate prices did not lead to a widespread corresponding decrease in farmland value. Farmland investments tend to perform well in recessions due to their low volatility and uncorrelated nature with equity markets. This can make farmland a strong alternative for investors seeking stability and long-term returns.

In summary, the renewed interest in farmland investment is driven by its potential for sustainable returns and its role in addressing environmental challenges. As investors increasingly recognise the value of nature, regenerative farming practices are likely to gain more traction, contributing to a more resilient and sustainable agricultural sector.

[1] Our world in Data, 2019

Drivers of farmland returns

Despite the moral lessons that Tolstoy is keen to teach us, investors do find the potential returns generated by farmland to be of interest as well.

Historical returns

Of the relatively few datasets available, compared to other asset classes, we believe the best dataset for farmland is the NCREIF index, which includes data from 1990 onwards for the major agricultural regions[2]. The index's returns are broken down into income and appraisal returns, and further categorized by annual and permanent crops[3].

The NCREIF Farmland Total Return Index has shown remarkable growth over the past two decades. Over the last 15 years, the index has increased more than fivefold, and over the last 20 years, it has grown tenfold. This impressive performance is reflected in the total returns, which have averaged 7.3% p.a. over the past 10 years and 12.3% p.a. over the past 20 years. In 2023, the index captured an annual total return of 4.96%, ending the year with a new record value of $16.6 billion, made up of c. 62% annual cropland and c. 38% permanent cropland.

[2] NCREIF. While the index has its weaknesses, such as its exclusive focus on the U.S. and its reliance on annual valuations, it has nevertheless become the primary source of metrics for tracking and analysing farmland investment performance. [3] Annual crops are those that need to be replanted every year (e.g. corn and soybeans), while permanent crops are those that have a multi-year life span (e.g. almonds and oranges). Most vegetables, cereals and oilseeds are annuals, while most fruits are perennials, i.e. permanent crops.

Significant potential despite natural volatility

Several significant events have influenced farmland values and returns over the years. For instance, the drought in the United States from 2001 to 2002 severely impacted agricultural production in the western and southern regions, particularly in California, Nevada, and Arizona. This drought led to crop failures, reduced water supplies, and economic losses. Consequently, the decreased crop yields and water scarcity drove up the prices of agricultural products, while the value of farmland declined due to reduced productivity and uncertainty about water supply[4].

The period from 2010 to 2014 saw a bull market for agricultural commodities, driven by increased demand from emerging markets such as China and India, and the production of biofuels. Extreme weather conditions during this time also contributed to tighter supply and higher prices. More recently, from 2021 to 2023, another bull market occurred, influenced by COVID-19-related supply chain disruptions and increased food demand. Geopolitical tensions, such as the Russia-Ukraine war, and extreme weather conditions further contributed to supply constraints and price increases.

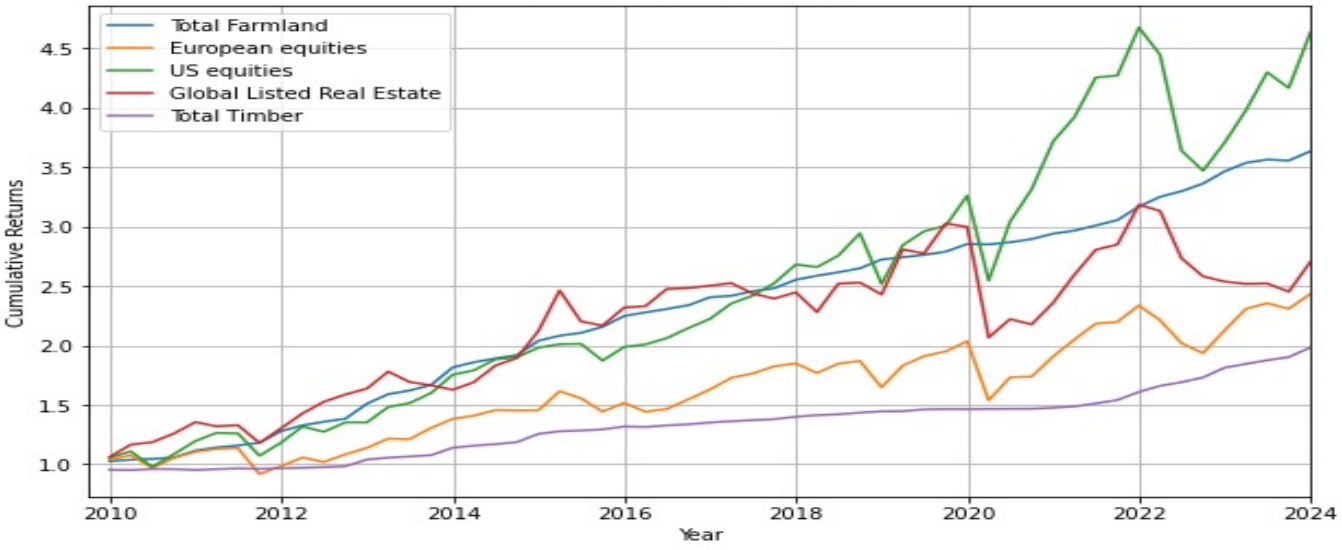
We are now observing a gradual decline in the bull market for row crops, with agricultural commodity prices decreasing while farm input costs remain high. This trend is already evident in the stock prices of farm input producers, and we anticipate that farmland values will also experience some short-term pressure. We see this temporary halt in the rising prices of row crop land as a potential good entry moment for new investors into the space.

These events highlight that despite the volatility, there is substantial potential for significant returns in the farmland market. This can make it an attractive investment for those looking to diversify their portfolios with agricultural assets.

Returns versus other asset classes

Farmland has not always been the best performing investment. Excessive subsidies led to overproduction in agriculture in the 1990s, resulting in lower prices and returns. Over the next decade, farmland outperformed its peers as stocks and bonds were hit hard by the two economic recessions of the 2000s. Thus, in the first ten years of the new millennium, farmland averaged a 14% annual return, while stocks averaged a slight annual loss. Since the comparison starts in 2000, this benefits farmland. This is slightly different if the sample starts after the dot-com bubble or the global financial crisis, as the index posted phenomenal returns in the years up to 2008, primarily due to the rise of the Californian almond sector.

Figure 2. NCREIF Farmland Cumulative Returns 2010-2023 versus other asset classes (2000 = 1)



Source: Bloomberg, MSCI, NCREIF and Van Lanschot Kempen. The value of your investment may fluctuate. Past performance provides no guarantee for the future.

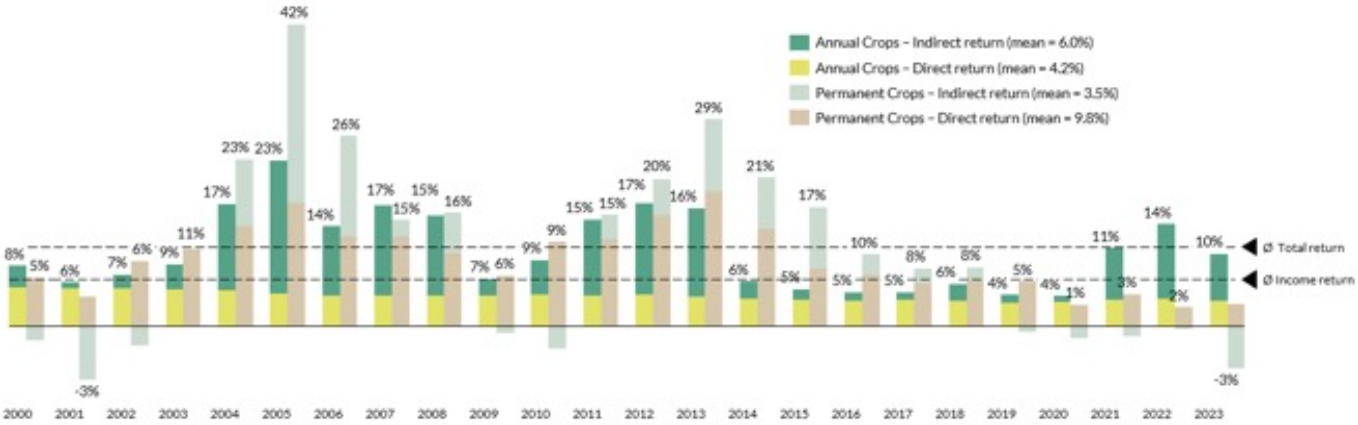
[4] NCREIF Total Return Index.

Opportunities and challenges

We can safely say that over the long-term we believe farmland will increase in value. However, emphasising the importance of a nuanced and well-informed approach for investors navigating farmland investments, it is important to remember that there are multiple drivers of farmland returns that are difficult to predict. Among them are appreciation in property values and tax incentives.

On a more geographic and geopolitical level, the availability and efficient management of water resources is crucial for ensuring optimal agricultural productivity and therefore optimal returns. Also, the emerging recognition of carbon and natural capital as valuable assets positively influences farmland valuations. Furthermore, crop choices and agricultural practices affect profitability and thus farming values. The interplay of these drivers underscores the complexity and dynamism in the realm of farmland investment.

Figure 3. NCREIF Farmland Returns 2000-2023



Source: NCREIF, 2024. The value of your investment may fluctuate. Past performance provides no guarantee for the future.

Permanent versus annual crops

Let us examine the latter aspect mentioned. The yield profiles of permanent and annual crops (also called row crops) are different. Permanent crops are considered to generate higher cash-on-cash returns over their life cycle compared to row crops due to their higher production value. However, investments in permanent crops undergo depreciation over time due to the limited life of permanent crops. This is not the case for properly maintained row crops.

Whilst both row crops and permanent crops have experienced a steady increase in value over the past two decades, fruit and nut crops are losing value over time, partially offsetting recent higher rates of appreciation in the permanent crop market. The result is that row crops historically generated less yield-based cash flow and more value growth, while permanent crops generated more yield-based cash flow and less value growth.

These yield profiles have an impact on risk. A larger share of returns tied to cash flow from product sales means that permanent crops' returns are more dependent on commodity price volatility and consumer preferences. These dynamics are reflected in the NCREIF Farmland Returns 2000-2023 graph (figure 3).

Conclusion

The renewed interest in farmland investment is not merely a fleeting trend, but a strategic move towards the objective of achieving sustainable and resilient returns. As the global community grapples with the pressing challenges of climate change and food security, regenerative farming emerges as a beacon of hope. This approach not only enhances soil health and biodiversity, but also plays a crucial role in carbon sequestration, thereby mitigating greenhouse gas emissions.

Investors are beginning to recognise the intrinsic value of nature, a sentiment eloquently captured by Leo Tolstoy in his literary works. Tolstoy, who found profound joy and wisdom in the simplicity of rural life, believed that true fulfilment comes from working in harmony with nature, underscoring the timeless value of nurturing the land.

By investing in farmland, one not only secures a stable and potentially lucrative asset, but could also contribute to the greater good of environmental stewardship. Just as Tolstoy advocated for personal responsibility and connection to the land, modern investors have the opportunity to foster sustainable practices that benefit both the planet and future generations. We believe that embracing farmland investment could not only be a wise financial decision, but also a commitment to a more sustainable and equitable world.

Authors:

Tim van den Pol
Portfolio Manager

Chris Windeatt
Director, Distribution

VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

Van Lanschot Kempen Investment Management NV
Beethovenstraat 300
1088 WZ Amsterdam
The Netherlands.

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