Benefits and Pensions MONITOR EXCLUSIVE

# Ontario Farmland – The Undiscovered Alternative

By: **Anthony Faiella**

After four decades of benefiting from the decline in interest rates and the tailwind it provided the standard 60/40 portfolio, investors now face a new macro environment. The highest inflation in four decades and the resulting interest rate increases made 2022 the worst year for the 60/40 portfolio in a century.

### Enter Farmland

Since the 1950s, farming as an industry has benefited from improvements in mechanization, the implementation of new technologies, and productivity gains from modern biotechnology. These innovations have transformed farming into a scale business requiring farmers to increase the size of their operations to remain viable. While farming operations need to grow, farmland ownership remains fragmented. The result is that more than half of the farms are rented to larger farmers, even as families continue to live on their family farm. The ownership of farmland is largely in the hands of older farm families with the average age approaching 60. In Ontario, it is forecast that as much as half of the approximately $170 billion of farmland could see a change in ownership over the next decade. The fragmented ownership and the aging demographic of farmers make it an asset class ripe for consolidation and in need of capital.

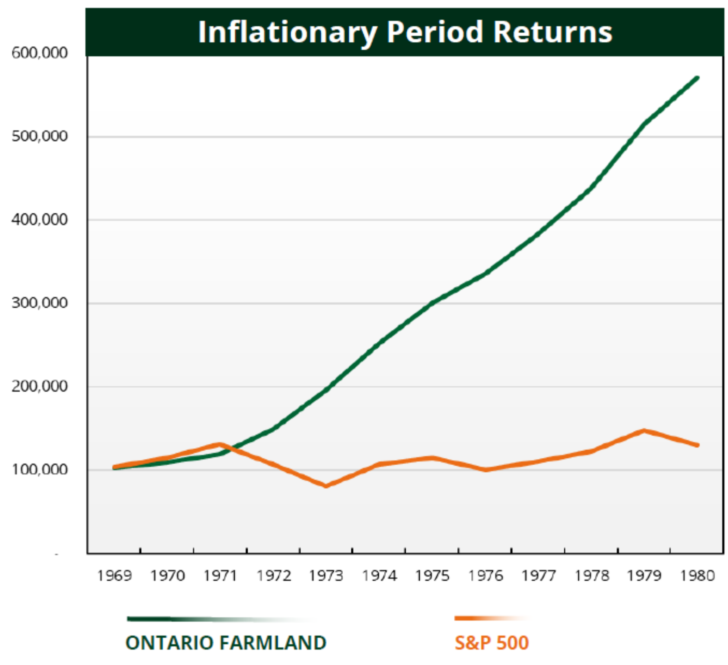
Farmland may be the last trillion-dollar asset class that has not been 'financialized' or taken over by investors. Given the significant capital needs, ownership of farmland could very well transition to investors much like large real estate assets transitioned from individual and family ownership to pension funds, insurance companies, REITs, and other investors. In the meantime, the fragmented ownership has made the market less efficient, while the lack of financial players has meant no boom-bust cycles like those seen in financial assets.

### Real Asset

Farms produce the food we need regardless of business cycles. Farmland has long been a safe haven investment with financial yields tied to food prices. Farmland has provided income during economic downturns and periods of uncertainty. The farmland in Canada and in Ontario in particular, is some of the best in the world. Glaciers bulldozed their way over the vast Canadian Shield and left deep lacustrine (rich) soil behind in the most southern regions of the province. Those same glaciers also carved out the five great lakes leaving behind one of the best farming regions on the planet. While farming regions such as California deal with a decreasing water supply, Ontario receives consistent rainfall throughout the year and is surrounded by vast amounts of freshwater. Water is crucial to farmland productivity and ensuring a stable food supply. This consistent and reliable source of water means the crop insurance in Ontario is among the lowest in the world. Those tasked with assessing risk have determined little can go wrong in Ontario. The combination of rich fertile soil, consistency of water, and an increasingly longer growing season means Ontario farmers can grow many different insurable crops. The region is a one-day truck drive from up to 200 million consumers and access to nearby ports along the St. Lawrence Seaway means millions more in addressable markets. The region is a critical source of the food supply for millions of North Americans and consumers around the world.

> “ WHILE FARMLAND VALUES HAVE COMPOUNDED DURING ALMOST ALL PERIODS, RETURNS DURING PERIODS OF INFLATION HAVE BEEN PARTICULARLY STRONG.

Figure 1




### Real Returns

While precise numbers are difficult to establish, recent estimates put farmland ownership in Canada by financial players at less than two per cent. This means valuations are determined by farmers and based on fundamentals, not liquidity in financial markets. Farmers look to buy the neighbours' farm if the economics are viable, not in the hopes of flipping it. Farmland prices in Ontario have appreciated at a compound annual growth rate of 8.2 per cent over the past 71 years, with only eight years of price declines, the worst being an eight per cent drop. Farmland values have a history of preserving capital during the worst of economic downturns. Prices of Ontario farmland remained positive during the implosion of the tech bubble, the great financial crisis, and the sell-off following the COVID shutdowns. The asset has shown it can play an important role in a diversified portfolio.

While farmland values have compounded during almost all periods, returns during periods of inflation have been particularly strong. During the last extended period of inflation, farmland proved to be a particularly effective store of value (see *Figure 1*). From the period beginning in 1970 through to the end of 1981, the S&P 500 realized a 12-year CAGR of only 2.2 per cent (before dividends) resulting in a material loss of purchasing power. Over that same period, Ontario farmland generated a 15.5 per cent CAGR (before financial yields from farming). While owners of financial assets saw a sharp reduction in purchasing power, owners of farmland saw an increase in their purchasing power, as farmland prices more than kept pace with inflation. ❖

**Anthony Faiella**
*is a partner at AGinvest Farmland Properties Canada.*

## Farmland Offers Real Alternative

Investors looking for an asset uncorrelated to financial markets or business cycles, should look at farmland as one of the true assets able to provide that return profile. Over the years, more sophisticated investors have been able to diversify into other asset classes. But as assets became more "financialized", they increasingly tracked the performance of stocks and bonds. As investors demanded more liquidity to move in and out of these asset classes, the investment vehicles began to trade much like other financial assets. They came to rely on the same cheap, easy money in the financial system that drove markets higher and remained vulnerable to interest rates and business cycles.'

While investors push for more liquidity, it doesn't always work to their advantage. Farmland is a great example of what happens when daily liquidity is provided. A recent headline read 'U.S. Farmland Escapes Real Estate Slump as Prices Soar to Record' and explained how farmland has continued to appreciate and how it has once again been a great hedge against inflation. The article noted that farmland prices in the Midwest were up 20 PER CENT year over year at the end of the third quarter. But that hasn't been the experience of farmland REIT owners in the U.S. The two largest farmland REITS, Farmland Partners Inc. (FPI) and Gladstone Land Corporation (LAND) realized returns in 2022 of 6.12 per cent and minus 44.4 per cent, respectively (both are before dividends). It seems a tough year in the stock market leads to a difficult year for publicly listed REITs, regardless of what is happening to the underlying asset. The daily liquidity has made farmland ownership look more like stock ownership.

Farmland prices in Canada have had no correlation with financial assets over the past 100 years. Private ownership of farmland is likely the best way to ensure uncorrelated returns and most reflective of the returns on the asset. Unlike financial assets that ride the wave of liquidity and low interest rates, farmland values are driven by the improvements in production yields and efficiencies realized by the newest innovations in equipment. Farmers don't look to trade farmland, so farmland prices aren't subject to the volatility seen in most financial assets. Farmland values have appreciated consistently because every innovation that makes farmland more productive or farming more efficient has accrued to the value of the land.

Farmland values don't suddenly drop because of an interest rate hike. The productivity and profitability of a farm doesn't change overnight and since farmers are all looking to grow the size of their operations, there is no sudden drop in 'value.' The ownership is also very fragmented in much of the country, but particularly in Ontario, making it difficult for large financial players to accumulate significant positions. Buying in this region can be time consuming and labour intensive. In Ontario, acquisitions are made based on 'small farm' economics, meaning the opportunity to consolidate ownership and achieve economies of scale may prove to be materially accretive. Farmland provides investors the opportunity to own a critical and strategically important asset that has compounded in value more than 70 years. ❖