

AGRICULTURAL INVESTING: A NEW NICHE ON THE INVESTMENT PRODUCTS' MARKET AND SUPPORT FOR GROWTH IN RURAL AREAS OF EMERGING COUNTRIES

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Abstract

Due to the global trends in world food and agricultural commodities' production, the prices of the agricultural produce have increased recently to the levels unknown for decades. Agricultural production has become more profitable and production companies are starting to enlarge into the new areas. The profitability increase has been signal for new companies to appear on the market recently. The working paper emphasizes the importance of the political climate, demographical structure and other exogenous determinants on the value of the investment for the stakeholders. The paper argues that the probability for increase in value of the investments can grow only if the other favourable conditions are in place. Main factor having influence to the value of investment are found to be more related to availability of resources than to the economical climate in the investee country. Share valuations have greater correlation to the area of land under control than to other factors. Such behaviour of the investors and analysts can be explained partly by the belief in economies of scale and partly by the limited availability of the resource.

1. Introduction

Following rapid increases in prices of food the agricultural sector has became interesting area of alternative investment for many investors. Additional support to that has provided volatility on the global credit and equity markets with much narrower possibilities for diversification of investment portfolios. Qualified investors in US and many institutional investors in Europe have had possibility to invest into agricultural sector of Central and Eastern European countries (CEE region) using some new investment vehicles listed on alternative lists of Scandinavian stock exchanges.

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The last three new listed companies investing in commodities producing in former Soviet Union and its former allies in Central- and Eastern Europe are First Farms and Trigon Agri in Denmark and Black Earth Farming in Sweden. When historically agriculture has been rather low-income sector, the time has come to prove the opposite. World main indicators are pointing to the future with significantly higher food costs for customers, but also with higher income for farmers. Profitability increase has become real due to the increase in global demand and decrease in supply.

Each of the named three companies has taken different approach to operations (see also Table 1). Whereas Black Earth has started from gaining as much land from the Russian black earth region under control as possible, it has not obtained control over the grain storage capacities. Trigon Agri has started by creating operational clusters in Estonia, Russia and Ukraine and is active both in dairy and grain business. First Farms is operating within European Union and is centring its efforts on dairy business and on grain production only after that.

All three companies are actively promoting the resources (mainly land) acquired and consider important the total quantity under control. In the following section, we are looking for the reasons for such behaviour.

Listing on a stock exchange gives to these companies source to financing, which in its turn is used for investing in Central and Eastern Europe (CEE) countries. Foreign direct investment (FDI) has played an important role in the re-emergence of the institutions of exchange in some CEE countries. Beyond supply of capital, foreign firms have offered producers a number of arrangements to encourage greater production and marketing and to overcome constraints that have limited economic activity since the onset of transition.(Rozelle and Swinnen, 2000).

There are difficulties obtaining external financing from banks in most CEE countries, because in most CEE countries land reform is still incomplete. In other words land is not fully tradable and this inhibits the creation of a land market and the possibility for the use of land as collateral. Agricultural credit supply is limited due to this reason in comparison with a well developed market structure. Legislation typically prevents the pledging of assets when they are under the process of privatisation and restitution. As long as property rights are not fully restored on all kind of assets, there will be a demand for government guarantees for the loans (Swinnen and Gow, 1997).

2. The global trends fuelling recent increases in the global demand for and supply of agricultural produce

The most important trend is the global population growth at the same time when the arable land per capita is limited. The world population has increased by 500 million since 1999, and the United Nations prognoses average global growth over the next decade of 1 per cent per annum. This translates into 7.6

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billion people in 2020, up from 6.7 billion at the end of 2007. Increases in population result in a direct increase in demand for food, particularly from developing countries such as India, Pakistan, and China, which have also taken into use nearly all the potentially arable land.

Climate change. Rising global temperature and soil erosion are likely to restrain agricultural production growth in traditional producer countries such as the US, Germany and France. The Black Earth Region will be less susceptible to the effects of climate change compared to other traditional regions of agricultural production and is therefore expected to be in an advantageous position vis-à-vis the above-mentioned producer countries.

Economic prosperity. From 2000 to 2007, GDP in China grew on average 10 per cent per annum, India grew eight per cent and both Russia and Ukraine grew on average by seven per cent per annum. Sustained economic growth in developing and transition economies has resulted in an increase in disposable incomes, allowing people to change their eating preferences from staple foods towards a mixture of more expensive, higher value-added products. Meat consumption, which is highly correlated to economic development, has risen substantially in Asian countries, particularly in India and in China. Between 1998 and 2006 Russian real incomes rose by two thirds which resulted in an expansion of demand for poultry and pork.

Growing supply/demand imbalances. The U.S. Department of Agriculture (USDA) estimates that worldwide grain stocks are at their lowest level for thirty years, indicating a widening gap between supply and demand.

Growing demand for biofuels. Factors such as high oil prices and a desire for independent sources of energy have led nations worldwide to include biofuels in their national strategies. The increasing use of biofuels requires larger harvests of biofuel crops such as wheat, corn and rapeseed. Agricultural prices are expected to increase further as governments set national targets for the production of biofuels.

3. Comparison of the companies

Black Earth Farming Ltd is a leading farming and land owning company operating in Russia. It acquires and cultivates agricultural land assets primarily in the fertile Black Earth Region in Southwest Russia. Black Earth Farming was among the first foreign financed companies to make substantial investments in Russian agricultural sector and because of its early establishment, Black Earth Farming has now gained a strong market position in the Kursk, Tambov, Lipetsk, Samara, Voronezh and Ryazan areas. On 31 December 2007 the Company controlled over 280,000 hectares of what perhaps is the world's most fertile soil and this year's harvest comprised approximately 53,000

hectares. Founded in 2005 by Michel Orlov, the company has been developed by the listed investment companies Vostok Nafta Investment Ltd and Investment AB Kinnevik, which together still are the principal shareholders in the company.

Trigon Agri A/S was established in May 2006. The original investors to the Group committed start-up equity capital, with the money coming primarily from Finnish high net worth individuals. The Group made its first acquisition near St Petersburg in Russia in June 2006, acquiring control of over 840 hectares of land for farming. Following, two Estonian dairy farms were acquired in August 2006. Also in August 2006, the Group acquired its first cereal farming operations in Ukraine. During the following months, the Group took over eight former collective farms in the Kharkov region in Ukraine and entered into long-term leases for farmland cultivated by these former collective farms.

FirstFarms A/S is a public limited company, which invests in agriculture in Eastern Europe. The company has been listed on the Copenhagen OMX Stock Exchange since December 2006. FirstFarms is an investment company, which, by using its investment strategy, is utilising the favourable investment options in Eastern European agricultural activities by investing both shareholders' capital and external capital in Eastern European farming companies. FirstFarms is purchasing and modernising farming companies in Eastern Europe in order to optimise their operation with a view to future production of agricultural produce that will be competitive in terms of price and quality as well as making the operation profitable for the company's shareholders.

Table 1. Comparison of strategies for First Farms, Trigon Agri and Black Earth Farming strategies form the stock exchange releases

Strategy area	First Farms	Trigon Agri	Black Earth Farming
Operating locations	EU – Slovakia and Romania; plans to enlarge to Russia and Ukraine	Main locations Ukraine and Estonia, rapid expansion in Russia	Russia only
Main activities	Dairy farming; grain production only to support dairy farming	Main revenue from grain production from Ukraine and dairy farming in Estonia, but expanding into dairy farming in Russia	Grain production and trading in Russia
Key principles of operating	Optimising acquired agricultural operations	Operating on cluster basis with dairy and grain production clusters	Acquiring fallow land to put it into use
Management	Danish	Estonian	Russian and Swedish
Size of the land under control	Approximately 10 000 hectares	More than 120 000 hectares	More than 250 000 hectares

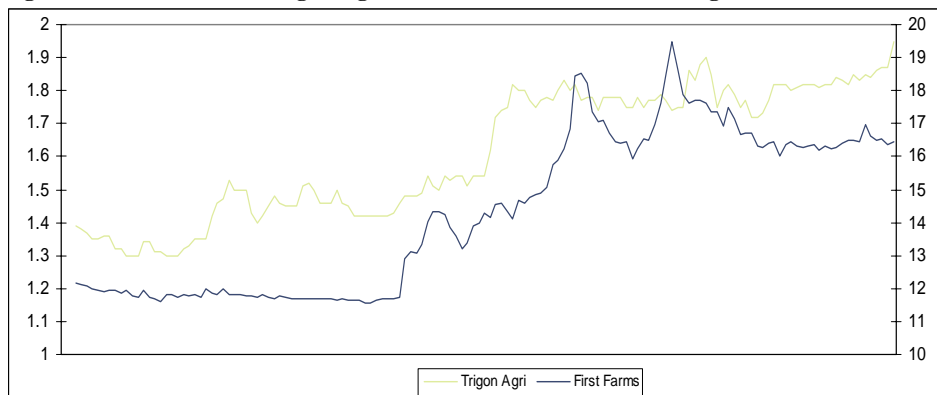
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From the table 1 it is possible to see that there are substantial differences in the operating strategy of these companies. When the time passes, the better strategy will bear the most fruits. Each of these strategies has its plusses and minuses. Farming only in EU area (First Farms) does not allow to use full potential of the black earth soils. Acquiring as much land as possible without looking at the other production factors may increase future operating costs significantly. Having operations on large territory with significant distances between clusters may decrease the ability to control operations or increase costs of control.

4. Share price comparisons

All three companies have enjoyed significant increase in share price during the first year of trading. Despite the bear markets in the end of 2007 and beginning of 2008 the value of these companies has not declined, but has been stable or even has increased a bit.

Figure 1. Share values of Trigon Agri A/S and First Farms A/S during 2007



Source: Authors' calculations, OMX Nordic Exchange

The significant jump observable in the middle of 2007 has occurred synchronously with the increase in commodity prices for wheat and corn. Such increase has not taken place during last 20 years and this is probably reason for higher valuation of agricultural companies.

The third company, Black Earth Farming Ltd. was listed only in the end of 2007 and started trading in 2008. By the time of finishing this working paper, the shares of Black Earth Farming have gained more than 30% in value compared to the time of the initial public offering. Good performance of the

share value of these companies probably takes up followers and hopefully we can see increase in numbers of listed agricultural companies.

5. Global grain market volume

Agricultural grains are commonly divided into: (i) wheat, a main consumption food that is also used for producing alcohol; and (ii) coarse grain, a category that includes barley, oats, rye, sorghum, corn, rice and mixed grains. According to industry analysts, the global grain market is dominated by international producers and traders from the major producing countries, whilst the local operators have a secondary role in the market. The USDA predicts that world grain consumption will reach 2,091 billion tonnes in the Agricultural Year 2007/2008, up 2.4 per cent on 2006/2007. Coarse grain accounts for more than two-thirds of this amount, while wheat accounts for one-third. Over the last three decades, global grain consumption has grown steadily alongside rising global population and sustained economic development. Nevertheless, global cereal stocks continued to decline, reaching their lowest level since 1983. The table below illustrates global grain production, consumption and ending stocks during 2001-2007 (in million tonnes).

Table 2. Global grain production, consumption and ending stocks 2001-2007 (million tonnes)

	2001	2002	2003	2004	2005	2006	2007
World grain production	1,875	1,822	1,862	2,043	2,017	1,992	2,077
World grain consumption	1,902	1,909	1,934	1,990	2,019	2,043	2,091
Ending stocks	533	440	355	403	388	355	315

Source: USDA, Statistics Estonia

The table below summarizes the world's leading global grain producers in the 2007/2008 Agricultural Year:

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Table 3. World's leading global grain producers in the 2007/2008 Agricultural Year

Country	% of world grain produced
United States	20.0
China	18.6
EU-27	12.4
India	9.2
Russia	3.7
Brazil	3.1
Canada	2.3
Argentina	2.1
Ukraine	1.4

Source: USDA, Statistics Estonia

6. Prices

The Chicago Board of Trade EXW wheat futures have seen a threefold increase since the beginning of 2006, reflecting globally adverse climatic conditions and dwindling grain stocks. Prices had eased in September 2007 before resuming growth two months later. Grain prices are subject to a high degree of seasonal fluctuation. If a good harvest is forecasted prices tend to fall at the outset of the growing season in late spring. If the harvest proves good oversupply may depress prices further in the period from August to November. Prices tend to recover at the end of the calendar year as supply gradually decreases. Prices normally remain high until the next sowing season and are influenced by the national grain stock. Prices in markets with significant restrictions on the import and export of grain may be affected by domestic supply and demand, varying from international price levels.

7. New source of demand

The recent increase in global energy prices combined with an increased concern for the environment have led to the establishment of biofuels as an important consideration in the energy strategies of many nation states. Biodiesel, produced from oilseeds, such as rapeseed, soybean and sunflower seed, and bioethanol, mostly derived from crops such as corn, sugar cane and wheat, are the two major biofuel groups representing 80 per cent and 20 per cent of European Union biofuel consumption respectively. Growth in biofuels is reinforced by government policies and subsidies that have resulted in an increased demand for energy crops such as wheat and rape. The European

Commission has set ambitious targets for biofuel consumption aiming for 25 per cent of transport fuel to be catered for by biofuels in 2030, with half of the requisite crops imported from outside of the European Union. The Ukrainian government has pledged to raise the share of biofuels in total fossil fuel production up to 10 per cent by 2011, up from its current level of 1 per cent. [During a press conference on 12 March 2008, the Russian prime minister Victor Zubkov stated that a new bill would help increase bioethanol output to 2 million tonnes, from almost no current production, without mentioning specific deadlines or consumption targets. Mr. Zubkov also promised the construction of 30 new bioethanol factories.]

8. Global dairy market

Most of the global dairy trade is in processed milk products, such as milk powder, cheese and butter, rather than in raw milk. This is because raw milk has a short useful economic life and transporting milk is expensive relative to its selling price. Dairy farming is a local business, with raw milk usually transported to processors within a 200 to 300 kilometre radius of the farm.

According to an estimate of the United Nations Food and Agriculture Organization (FAO), worldwide milk production reached 678.2 million tonnes in 2007, up by 2.3 per cent from 2006. Asia has become the world's leading milk producing region in 2007 with an estimated 20.8 per cent of global output, followed by and the U.S. Driven by factors such as strong import demand from developing economies and the stagnation of production in major exporting regions, such as Western Europe and Oceania, the FAO International Dairy Product Price Index continued to rise throughout 2007, reaching an all-time high in September of the same year.

There is substantial variance in the productivity per cow among the major dairy producing countries. Productivity per cow is typically 6-9 tonnes in North America and Western Europe, 3-5 tonnes in the former Soviet Union, Oceania and China, and below 2 tonnes in large countries with large but inefficient dairy sectors, such as India, Brazil and Mexico. Different productivity levels are explained by factors such as superior management skill sets, mechanical, fertilizer and chemical technology levels and soil quality.

The table below summarizes annual productivity per cow in selected countries in 2007:

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Table 4. Annual productivity per cow in selected countries in 2007

Country	Milk productivity, tonnes per cow per annum
United States	9.38
Estonia	6.29*
EU-27	5.56
Argentina	4.65
Ukraine	4.15
China	4.00
Russia	3.30
Brazil	1.73
India	1.11

* 2006 figure

Source: USDA, Statistics Estonia

9. Conclusions

Agriculture has historically been a sector where only few companies have been listed publicly and the whole industry sector has not been traded on equity markets of many countries. After recent changes in global trends agricultural sector has become more interesting investment opportunity, which in its turn has ignited initial public offerings for newly listed companies. Public trading gives possibility to assess the potential of commercial agriculture as a profitable industry in future and hopefully also increases the reliability of data.

The new companies listed on Nordic stock exchange have selected different strategies for business operations. These differences enable future analysing of the strategies and can be used for case studies for both these companies who look for equity financing and for the academic studies. Hopefully after few years conclusions about success of these strategies can be drawn. Agriculture as a new niche area of investing has been opened and the outcome will be seen soon.

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