



Australian Agribusiness Group

Submission on:

Non-Forestry Managed Investment Schemes

To:

Review of Non-Forestry Managed Investment Schemes
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1 Executive Summary

- Australian Agribusiness Group (AAG) do not believe that MIS investors receive unfair tax advantages over and above the average farmer.
- The issues paper did not include an important method by which farms can also conduct their business in addition to contract and share farming. Leasing is common to the typical farmer and is the usual method in MIS for accessing land and other assets.
- AAG refutes the view that MIS investors do not carry on a business due to the small size of an investment unit. The average investor in 2008 invested \$62,500 and committed in the order of \$30,000 in future development costs. This is a significant sum of money and in our view would certainly constitute the carrying on of a business based on size alone particularly when compared to small-to-medium sized enterprise funding requirements.
- MIS have invested significant funds and contributed to economic growth in regional areas.
- There are a variety of MIS project fee structures within the MIS industry and varying levels of risk assumed by investors and MIS managers. The common theme is that MIS investors pay lease and management fees and assume agricultural risk in return for crop income. The timing and quantum of fees is not significantly different to undertaking a start-up of any business where many major costs are incurred at inception.
- Product managers provide varying levels of information to the public on the performance of their previous projects. Some product managers could certainly improve in this area. AAG provides a Track Record review considering previous projects as part of its review on current investment offerings. This information is available to financial planners.
- While on the surface commissions paid to financial planners appear high, our analysis shows that the quantum of commissions are similar to that of a typical managed fund when considered over the life of an investment.
- The practical implications of PS170 mean that project managers do not have to include returns forecasts in their offer documents. We believe it is difficult for investors to make a reasonable assessment of the quality of an investment without such information and that there needs to be a review of PS170 requirements.
- AAG believe the fees for MIS are adequately disclosed in PDS, but that the exact quantum of commissions paid are not fully disclosed. The “marketing allowance” which is often listed in the PDS as being paid to financial planners along with quantified commissions is rarely quantified and can be a significant amount. Greater disclosure of the total commission and marketing allowance could assist with full disclosure to investors.
- There is no doubt that MIS operators have changed land use, but generally speaking land use has changed from that of low value production, such as cereals, to higher value and more intensive production activities such as horticulture and viticulture.
- MIS companies are large employers of regionally based people. There are approximately 550 people employed directly by MIS companies involved in non-forestry MIS in rural Australia. In addition there were approximately 1,800 contracting staff engaged in 2008. In the future when the non-timber MIS reach full production even more jobs will be created.
- In 2006 AAG undertook a review of MIS and land prices by comparing changes in land values in MIS and non-MIS regions and could not find any evidence that MIS (timber or non-timber) pushed up land prices.

2 Topic 1 – Is there a Tax Advantage?

AAG response to Paragraph 46

Paragraph 46 in the Non-Forestry MIS Issues Paper lists and discusses the alternative ways in which farmers can conduct their business, including contract farming and share farming. One important method in which farmers can also conduct their business, which was not considered in the Issues Paper, is 'leasing.'

Leasing is where a lessor leases assets such as farm land, machinery and stock from a lessee. Leasing allows farmers to free up capital to be used elsewhere in the business. Unlike share farming, the amount paid to the lessee is constant regardless of the returns derived from the leased asset. In other words, the lessor bears nearly all the risk of the leasing arrangement. Leasing has been part of the agricultural landscape forever and is becoming more and more common as farmers discover there is better use of their capital than in owning land.

AAG response to Paragraph 53

Paragraph 53 states that 'the size of the MIS participant's business does not support the view that a real business is being carried on.' AAG does not necessarily support this notion.

Although the allotment size of units in non-forestry MIS are usually quite small (~0.25 hectares each), it would be remiss of us not to point out the fact that the average investor does not just invest in one unit, but usually several. Data provided from AAG's Agribusiness MIS Industry Report Of Funds Raised for FY2008 shows that the average investment size for individuals in horticultural MIS was approximately \$62,500; equivalent to 11 allotments or 1.6 hectares of land. In addition there are future commitments of capital of in the order of another \$30,000. Although 1.6 hectares of horticultural land would not generally be a viable size for an independent farm operation on its own, it is a significant amount of money to invest. When we look at what it costs to invest in a well renowned mowing franchise in Melbourne's inner east for example (between \$15,000 and \$30,000) ¹, it is difficult to support the view that investment in horticultural MIS is not a real business being carried on.

AAG response to Paragraph 58

Regional Growth of MIS –

We have provided information on two specific regions to illustrate non-forestry MIS growth in Australia – being southwest Western Australia and the Robinvale district of northwest Victoria (Table 1). AAG has been collecting such data from MIS participants every year since 2001/02.

The Robinvale district has arguably been one of the largest beneficiaries of the MIS industry, with a significant area of permanent tree crops (16,262 hectares) having been established in the area since 2002. Almond crops account for the largest area in the region (12,517 hectares), followed by olives (3,207 hectares) and table grapes (538 hectares).

Region		Year							
		2002	2003	2004	2005	2006	2007	2008	Total
Robinvale	- almonds	1,100 ha	928 ha	343 ha	1,775 ha	3,282 ha	3,290 ha	1,799 ha	12,517 ha
	- olives	-	-	-	-	709 ha	601 ha	1,897 ha	3,207 ha
	- table grapes	-	125 ha	173 ha	240 ha	-	-	-	538 ha
	- TOTAL	1,100 ha	1,053 ha	516 ha	2,015 ha	3,991 ha	3,891 ha	3,696 ha	
	- CUMULATIVE TOTAL	1,100 ha	2,153 ha	2,669 ha	4,684 ha	8,675 ha	12,566 ha	16,262 ha	16,262 ha
Southwest WA ^{Note 1}	- wine grapes	-	66 ha	233 ha	432 ha	139 ha	230 ha	160 ha	1,260 ha
	- olives	82 ha	12 ha	-	240 ha	611 ha	178 ha	-	1,123 ha
	- truffles	-	-	-	-	10 ha	20 ha	40 ha	70 ha
	- TOTAL	82 ha	78 ha	233 ha	672 ha	760 ha	428 ha	200 ha	
	- CUMULATIVE TOTAL	82 ha	160 ha	393 ha	1,065 ha	1,825 ha	2,253 ha	2,453 ha	2,453 ha

^{Note 1} – takes into account region of Western Australia which is south of Perth and west of Albany

Southwest WA has also seen significant growth in the development of MIS, with the area developed by MIS operators increasing from approximately 82 hectares in 2002 to nearly 2,500 hectares in 2008. The majority of MIS businesses in the region involves either wine grape production (1,260 hectares) or olive production (1,123 hectares), with the establishment of oak trees for truffle production a niche business at just 70 hectares.

Structures and Fees of MIS –

The typical traditional agricultural business operation in Australia is family owned and managed. Generally, the traditional agricultural business involves a capital investment of between \$1 million and \$5 million, comprising land and water assets, plant and equipment, animals and machinery. The farmer will undertake much of the management themselves and in most cases will hire supporting labour units on a permanent or casual basis. They use cash, or borrow from banking institutions to purchase all inputs in producing the crop products. Crops produced from the farm is usually on sold to third party entities.

In comparison, an MIS is a pooling of investors to enable access to large scale agricultural enterprises. A Responsible Entity (RE) operates the scheme but may outsource the day-to-day operation to another entity – be it related or third party.

The RE or 'project managers' will generally have off-take agreements in place for the crop that is produced from the operation. Input costs will either be funded by cash or from a finance facility, often provided through the RE. Both the 'typical farmer' and MIS investors are exposed to this risk.

There are a number of alternative mechanisms in place for traditional farm businesses to finance their farming operations rather than using MIS as a means. These include external mechanisms such as leasing and equity raising and internal mechanisms such as debt. Debt and leasing facilities are the traditional sources of finance for farming businesses. These facilities are easily accessible to farm business through banking institutions, machinery dealerships and stock leasing businesses. For the most part, farm managers are educated in their use. Equity raising is a much rarer mechanism for typical farmers in Australia; only more sophisticated farmers or business would generally use it as a source of finance.

Investors invariably pay an 'upfront fee' when they invest in a MIS, the total of which will vary according to the type of investment. This 'upfront fee' is used by project managers to fund the cost of establishing the project including amongst other things, the planting of trees and installation of trellis and irrigation infrastructure. The 'traditional farmer' would also be exposed to these costs, but would often undertake the physical work themselves, or use contractors for larger activities.

The risk profile assumed by MIS participants will vary according to the fee and asset ownership structures in place for each specific project. Some projects are structured so that management and lease fees payable to the project managers are fixed each year – 'fixed fee paying project'. In this circumstance, the project manager is not directly exposed to crop related risks. The biggest risk to project manager's involved in 'fixed fee paying projects' is default by the individual MIS investors on their management and lease payments. The reasons for default may include those which are out of the hands of the company (i.e. divorce, death and unemployment). Another reason for default is poor project performance of the schemes. Poor project performance can be attributed to any number of agricultural, market and management risks materialising.

Other MIS projects are structured such that ongoing management and lease fees are paid as a proportion of net or gross income received from crop sales. In this case, the project manager is directly exposed to crop related risks – essentially sharing the risk of the project with the MIS investor. Like those project managers who release 'fixed fee paying projects', those who release 'variable fee paying projects' are also at risk from individual MIS investors defaulting on their payments due to any of the reasons described above.

For the most part, the project manager, or related company, will own the underlying land and water assets of the project. In this case, the maintenance of these asset values is a major risk. The value for land assets owned by project managers is invariably influenced by the market for rural properties, as well as the profitability of the businesses which the land assets support. The value of water assets is largely dependent on the dynamics of the resource in terms of volume available for sale and demand from other water users. Trading fees will also impact on the value of water. In a small proportion of MIS projects, investors will own part, or all of the underlying assets of the project, and this is usually through an associated trust or company structure. In this case, project managers are not effected by changes in land and water values.

Paragraph 58 comments that as part of the fee structure of MIS, there is a disparity between initial and ongoing fees. This is largely true but entirely justified, the reason being that the level of initial capital expenditure is a significant component, with for example the planting of trees and installation of irrigation and trellising infrastructure for a horticultural development occurring in this period. Ongoing costs associated with horticultural operations remain reasonably constant as time goes on, but are significantly less than the initial costs incurred as a result of horticultural developments.

It is important to note that the disparity between initial and ongoing fees in non-forestry MIS is no more than the development and ongoing management costs incurred by traditional farm businesses. This fact is highlighted in Figure 1 which graphs the timing of fees payable by MIS investors for two wine grape projects recently analysed by AAG against the development and management costs derived from gross margin figures from Peter Gartrell’s ‘Fruit Development Budget Guide for the South-West of Western Australia,’ released in 2003.

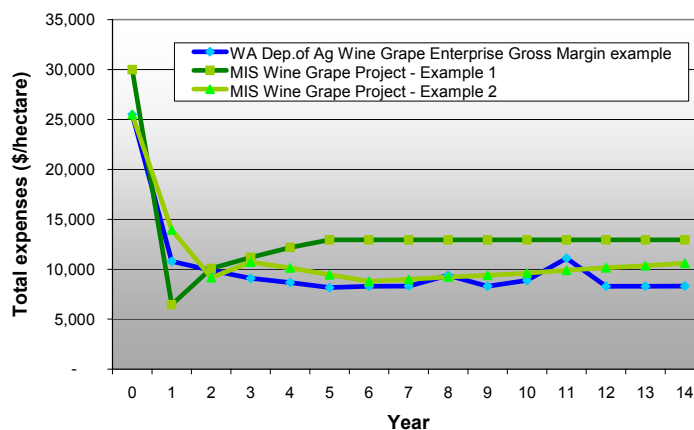


Figure 1 – Chart comparing the timing of fees for MIS wine grape project and development costs for vineyard (all on per hectare basis) 2

It is clear that expenses are higher in the initial years than they are on an ongoing basis under an MIS and ‘traditional farming’ structure (Figure 1).

3 Topic 2 – How well do non-forestry MIS perform?

AAG response to Paragraph 68

Returns and track record information –

Although non-forestry MIS projects have been available for investment since the late 1990's, the vast proportion were only released within the last five years. Given that for most non-forestry MIS projects, returns are either yet to occur, or in the case of older projects, are in their growth phase, it is difficult to make a generalised statement regarding the performance of MIS to date compared to industry averages and those forecast in the Product Disclosure Statement (PDS) and by research houses.

Having said this, as part of our analysis of MIS projects (a service we have been providing since 2000), AAG provides a track record review of all previous operations of the RE or 'project manager' in question. Amongst other things, this Track Record Review examines the performance of those projects which have commenced production, including a comparison between the actual yields and prices achieved in the projects against those originally forecast in the respective PDS.

Generally speaking, results for those projects which have commenced harvesting and are currently providing annual income to investors, have been mixed to date. Returns for several projects, especially those in the almond industry, have been in line or greater than those originally forecast. The performance of several wine grape projects ranges between very good to poor, while returns for earlier released olive projects have generally been down on forecast, although those released more recently are showing significant promise.

Commissions –

As is a standard practice in the investment services industry, project managers in the agri-MIS sector generally pay commissions to financial planners and dealer groups. An often held view of these fees is that they are much higher than industry standards.

Operators in the agri MIS industry generally pay total commissions equivalent to between 5% and 15% of the upfront subscription fees. Most commissions are paid on an upfront basis, with a minor proportion having both an upfront and trail component.

In Table 2 below we show a fictitious, but typical non-forestry MIS scheme commission arrangement.

Table 2 – Example of commissions paid from agri-MIS project managers											
	Year										
	0	1	2	3	4	5	6	7	8	9	10
Investment	\$10,000										
Commission rate	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Commission amount	\$1,000	0	0	0	0	0	0	0	0	0	0
Discounted @7%	\$1,000	0	0	0	0	0	0	0	0	0	0
	Year										
	11	12	13	14	15	16	17	18	19	20	
Commission rate	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
Commission amount	0	0	0	0	0	0	0	0	0	0	
Discounted @7%	0	0	0	0	0	0	0	0	0	0	
PV of Total Commissions	\$1,000										

PV = Present Value

In comparison to MIS, commissions for other managed funds usually comprise an upfront and trail component. The upfront fee for these investments generally range between 2% to 5% of the investment amount, with a trail of around 0.3% to 0.5% p.a. payable for the investment term.

We have detailed the commission payments for a fictitious, but typical, managed fund in Table 3 and have assumed a 2% commission upfront payment with a trail commission of 0.4% paid in each year for the term. Assuming 8% annual growth on the investment, the commissions paid over the term of the investment (in today's present value) totals \$1,083, slightly more than that paid for the example used for the agri-MIS project (Table 3).

Table 3 – Example of commissions paid by typical unit trust style Managed Investment project manager

	Year										
	0	1	2	3	4	5	6	7	8	9	10
Investment	\$10,000										
Investment value (@8%)		\$10,800	\$11,664	\$12,597	\$13,605	\$14,693	\$15,869	\$17,138	\$18,509	\$19,990	\$21,589
Commission rate	2.0%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%
Commission amount	\$200	\$43	\$47	\$50	\$54	\$59	\$63	\$69	\$74	\$80	\$86
Discounted @7%	\$200	\$40	\$41	\$41	\$42	\$42	\$42	\$43	\$43	\$43	\$44
		Year									
		11	12	13	14	15	16	17	18	19	20
Investment value (@8%)		23,316	25,182	27,196	29,372	31,722	34,259	37,000	39,960	43,157	46,610
Commission rate		0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%
Commission amount		\$93	\$101	\$109	\$117	\$127	\$137	\$148	\$160	\$173	\$186
Discounted @7%		\$44	\$45	\$45	\$46	\$46	\$46	\$47	\$47	\$48	\$48
PV of Total Commissions		\$1,083									

PV = Present Value

It is clear that despite the noise surrounding the supposed high commissions for MIS, it is clear that when compared to managed funds over the life of the investment, not just the first year, MIS managers do not pay comparably high commissions.

Adequacy of Financial Information in the PDS –

In the early days of agri-MIS, project managers were able to outline in their prospectuses their predictions for returns based on yield and price estimates. There is no doubt that a number of prospectuses included misleading information in relation to returns forecast.

In 2002, ASIC issued the 'Regulator Guide 170 – Prospective Financial Information (PS 170)' for investment offer documents which outlined when financial information could be used, what were 'reasonable grounds' for its inclusion, when it could be disclosed and what could be disclosed in its absence. The admirable objective of PS 170 was to prevent financial forecasts that were not based on reasonable grounds and financial forecasts from project disclosure documents which were misleading and unlikely to be achieved.

The vast majority of project managers outline likely yield and price scenarios for their investments in the PDS. Yield and price information is usually provided by both the project manager and an independent expert. However, the practical outcome of PS 170 is that project managers rarely include returns forecasts (i.e. IRR calculations) in their disclosure documents. We believe that there should be an adjustment to ASIC's view of what 'reasonable grounds' is such that project managers should be required to include returns forecasts in PDS's. In this way it will be easy for investors to determine if annual returns are being achieved in line with forecasts. This would have to be done carefully so that a repeat of the misleading figures from the past does not occur.

AAG believes that generally speaking, project managers are thorough in ensuring that the fees are clearly outlined in their offer documents. Certainly some of the more complex fee structures may be more difficult to understand, but our view is that an investor who takes their time in reading the fees section should be aware of what fees are payable.

Commission rates are paid by the project manager and not directly by the investor. Commission rates are generally included towards the back of offer documents and not always easy to find. In addition to the outlined commission rate, there is often a statement about 'marketing allowances' also being payable to financial planners but there are very rarely quantified. As a consequence, the total of the fees payable to financial planners is rarely disclosed in the PDS.

AAG response to Paragraph 82

Have MIS changed land use? –

There is no doubt that MIS operators have changed the land use in which they are active. In most cases, land use has changed from low value production activities such as broadacre cropping and livestock grazing to higher value and more intensive production activities such as horticulture and viticulture.

Using the Robinvale district of northwest Victoria as an example, most of the almond and olive development has occurred on land which was once used in very low value extensive cereal cropping. The most obvious change to land use has been the establishment of irrigated permanent tree plantings, replacing the annual cereal cropping activities which once took place. The development of the higher value activities has also resulted in significantly greater capital investment, such as the installation of water delivery systems including pumping stations, filtration systems, pipelines, storage dams and fertigation systems. Other capital developments include the construction of roads for access and property management, construction of processing, grading and packaging facilities, and installation of management infrastructure, such as shedding, offices, visitor centres, manager homes and workshop facilities.

Demand for labour –

The non-forestry MIS industry is a substantial direct and indirect employer of both rural and urban people. This is evident in Figure 2 which outlines the approximate number of people employed directly or on a contractor basis in the non-forestry MIS sector. The data, which tracks employment over a seven year period, has been derived from AAG end of year surveys. Today there are approximately 550 people employed directly by the MIS companies (involved in non-forestry MIS) in rural Australia, with the total direct employment including head office staff coming is just under 1,000 people (Figure 2). Those companies also employ close to 1,800 people through contracting companies e.g. planting and establishment crews, fertiliser applicators and harvesting.

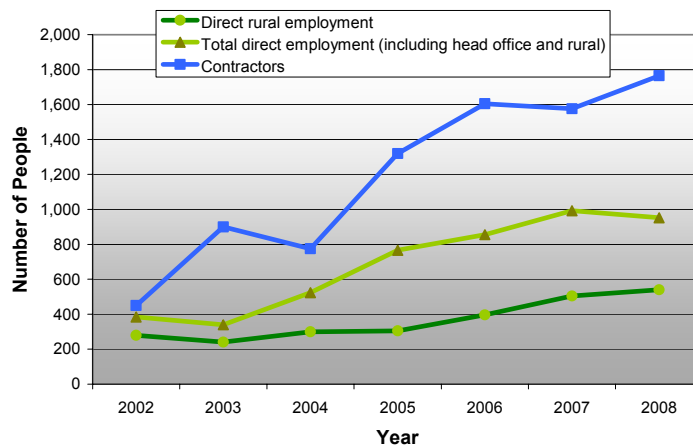


Figure 2 – Chart showing the direct employees at MIS companies and the contractors employed by those companies across Australia

The last five years has seen large areas of horticultural crops established, all of which are now at a stage where they will begin being harvested on an ongoing basis. Harvesting and processing of agri crops are intensive operations and require a substantial number of people to be involved. Consequently, we expect a significant increase in employment in the future, both directly and contractor based, to meet this demand.

Figure 2 does not account for downstream job creation of MIS, which is significant. AAG has reviewed data from the Australian Bureau of Statistics ⁵ to determine the flow on effects of employment and investment derived from non-forestry MIS. While we recognise that this data is general and in some cases dated, it does provide some indication of job creation from non-forestry MIS.

According to ABS data, the simple employment multiplier for agriculture is 22, with the total multipliers being 28 times. Using these multipliers and taking into account the approximate 2,800 people that are directly employed or employed on a contract basis in non-forestry MIS, the economy wide multiplier effect is between 61,500 and 78,400 people (where those products produced have displaced imports). It is likely that only some production displaces imports, and hence we would be cautious in applying the full value of the multiplier factor to non-forestry MIS projects. However, even at half of the effect, the impact of non-forestry MIS on employment in Australia is very significant.

There have been considerable claims that the introduction of MIS has driven up land prices in areas where they are active. In the case where broadacre cropping land has been purchased for horticultural activities such as almond and olive establishment, this is partly true. The reason being that when land use changes from low value to high value, and the higher value use is more profitable, land prices will trend higher. It follows that a purchaser will be prepared to pay more to acquire such land for almond or olive production, rather than a purchaser who sought to grow cereals. End use therefore has a significant impact on land values.

AAG undertook a study on land price growth in Victoria in 2006 using data supplied by the Victorian Department of Sustainability and Environment LANDATA® - Property Sales section. The goal was to select land price data for areas likely to have been affected by the impact of MIS expansion and compare these to areas unlikely to have been affected.

As MIS activity in non timber investments has been most intense over the last five years, we compared the averaged land prices in the latest five year period to the have averaged land prices over 11 years. From this data it was concluded that MIS area land price growth is not unusually high or inconsistent with land price growth in other actively developing areas. Given that tens of millions of dollars have been invested in the MIS active areas, we would have expected to see a higher rate of land price growth in those areas. Two conclusions that could be drawn are that perhaps the supply of suitable land for horticultural MIS purposes is still significant, and/or the price offered by MIS project managers is sufficient to attract sellers.

One point that is important to make when looking at the impact of MIS on property markets is analysing trends in other property market sectors across Australia. Figure 3 compares capital returns of rural property ³ over the past decade against industrial, office and retail property values ⁴.

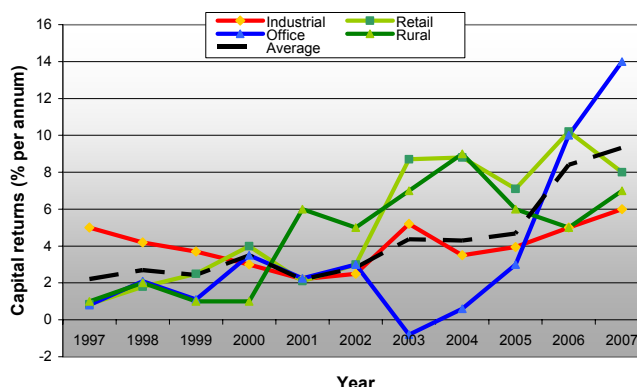


Figure 3 – Chart comparing capital returns of rural property against industrial, office and retail property and the average of the latter three

The data shows that land prices have not trended upward exclusively for those agricultural areas affected by MIS projects, but have been rising in general residential, commercial and industrial property markets as well.

5 References

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6 Australian Agribusiness Group

The Australian Agribusiness Group was formed in 1997 and provides expertise in research, investment management and agribusiness consulting nationally.

AAG is the leading provider of research into the Managed Investments Sector (MIS) in Australia. Its research is read by over 9,100 financial planners and is distributed by Standard and Poors.

AAG undertakes research reports, feasibility studies, consulting projects and assists in facilitating funding for private and public clients. It provides the management skills, expertise, staff and office support to develop, incubate and launch new agribusinesses.

AAG focuses on agribusiness and particularly the commercial aspects of this dynamic sector.

For more information about AAG, please visit our website at www.ausagrigrp.com.au.