

Many more mouths to feed

Global Resources research paper

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Agriculture is once again making headlines in the wake of the US Senate's vote to both cease a US\$6bn subsidy paid to encourage ethanol blending and to remove an import tariff on ethanol.

The US Congress is yet to vote but it is widely expected the subsidies will cease by the end of 2011. At this stage there is no change to the Renewable Fuel Standard (RFS) mandate requiring the minimum usage of corn-based ethanol at 12.6bn gallons in 2011 rising to 15bn in 2015.

The US desire to be less reliant on imported oil came into conflict with the need to cut the budget deficit, with the latter coming out on top. The issue also raised the increasingly important question of food security: with an expanding world population and a finite amount of arable land, should agricultural foodstuffs be diverted to produce biofuels such as ethanol?

As things stand, biofuel production accounts for just 2 per cent of global arable land, a relatively small piece of the food security puzzle.

While US ethanol production accounts for roughly 30 per cent of corn production, the real crux of the food security issue lies in a simple supply and demand dynamic: availability of arable land is finite, while the global population continues to grow with improved living standards.

It is estimated that the global population will have reached 9bn by 2050. Put simply, that is a lot of extra mouths to feed.

Grain inventories are already dwindling, as grain production has not kept pace with global demand in seven out of the past 11 years. Last year's grain crop was the third largest on record, and it was still insufficient to meet growing demand.

Forecasts

Forecasts this year suggest the grain harvest could reach new highs, but inventories will still remain tight.

Global food production will need to increase by 70 per cent, requiring some US\$80bn per year in additional investment over the next 30 years, for the world's food supply to keep pace with demand. To achieve food security, cereal production needs to rise from today's level of 2bn tonnes to 3bn, with similar gains required in meat production.

Significant investment is therefore a must to ensure increased demand can be met. A commitment to researching disease-resistant varieties of crops such as wheat is also needed; scientists internationally are currently exploring ways to combat wheat rust, a fungal disease capable of wiping out large swathes of a farmer's harvest.

For investors, the agribusiness companies that will capitalise on the vast investment needed to meet this challenge present a compelling investment opportunity.

The breadth of companies in a position to benefit from this trend is vast: firms that produce, process, distribute and market soft commodities, as well as the suppliers of fertiliser, crop protection and seeds.

Ultimately, the challenge is to produce more food with fewer resources which will require better seed, improved nutrient application, mechanisation and larger scale farms.

Since 1961, the amount of land cultivated globally has increased by just 13 per cent, while population expansion over the same period (from 3bn to more than 6bn) equates to 115 per cent. As a consequence, the amount of arable land per person has declined.

In China, 10m acres has been lost during the past decade because of desert encroachment and urban sprawl.

In spite of the high growth rates in both China and India, food consumption nonetheless falls below levels in developed countries such as the US and parts of Europe.

The swelling ranks of the middle classes wielding higher disposable incomes will inevitably lead to lifestyle changes for those in developing economies – most notably shifts in eating patterns and higher food consumption.

One obvious answer to the dilemma of land scarcity is Brazil, which has 60 per cent of the world's spare arable land capacity.

Brazil's challenge is to strike a balance between growing more food and improving the nation's quality of life while preserving the integrity of its rainforests.

Growth opportunities

The Chamber of Deputies recently voted to amend the Forest Code to reduce the amount of land that Brazilian farmers must preserve as forest.

The new bill means that small landowners will be exempt from replanting deforested land, while larger commercial farms have legal reserves of between 20-80 per cent, depending on the region.

With just a little more than 70m hectares currently cultivated, a further 100m hectares have the potential to be used for more intensive farming rather than their current use as natural pastures. However, such a conversion is likely to take time given Brazil's fledgling infrastructure developments and the sheer size of the land involved.

The majority of Brazil's spare land capacity is in a region called the Cerrado, an area with relatively poor quality soil.

This will require a sizeable application of fertiliser each year, which in turn should lend support to companies involved in their manufacture. As well as Brazil, several regions in Sub-Saharan Africa, Indonesia and Eastern Europe have the potential to become fruitful farmland, and to benefit from rising demand for food.

Investors have become increasingly switched on to the growth opportunities in the agribusiness sector.

The long-term investment story is particularly compelling due to the secular trend of higher commodity demand in tandem with the weighty investment needed to increase food production.

In particular, significant profit margins exist for businesses involved in food production across developing countries.

In the short term the cyclical nature of such businesses, vulnerable as they are to weather conditions, can lead to volatility for investors. However, equity returns from these companies over the longer term have compensated for that volatility.

Main points

- With an expanding world population and a finite amount of arable land, should agricultural foodstuffs be diverted to produce biofuels;
- Forecasts this year suggest the grain harvest could reach new highs, but inventories will still remain tight;
- Since 1961, the amount of land cultivated globally has increased by just 13 per cent;
- In China, 10m acres have been lost during the past decade because of desert encroachment and urban sprawl;
- As well as Brazil, several regions in Sub-Saharan Africa, Indonesia, and Eastern Europe have the potential to become fruitful farmland, and to benefit from rising demand for food;
- Significant profit margins exist for businesses involved in food production across developing countries.

Biographies

Renzo Casarotto – Senior Portfolio Manager

Renzo Casarotto is a Senior Portfolio Manager for Colonial First State Global Asset Management ('CFSGAM'). In his role, Renzo is the lead portfolio manager for the soft commodities fund and co-manager of the flagship global resources fund.

Prior to joining CFSGAM in February 2006, Renzo worked at Prudential as a Resource Analyst and then subsequently as a Senior Resource Analyst. After six years in Resources, he became Prudential's Asian Equities Portfolio Manager, managing the Asian equities component of Prudential's offshore investments.

In 1996, Renzo joined Nomura Asset Management as a Senior Portfolio Manager, managing the Australian Equities portion of Pacific Basin mandates as well as contributing to asset allocation within the Pacific Basin portfolios. Renzo holds a Bachelor of Business and has a post graduate diploma in Applied Finance and Investments from the Securities Institute of Australia.

Skye Macpherson – Portfolio Manager

Skye Macpherson joined Colonial First State Global Asset Management in January 2000, and was appointed to role of Analyst in the Global Resources team in November 2005. In her role, Skye is actively involved in the management of the soft commodities fund and has been researching forestry, pulp and fertiliser companies within the global resources universe over the past four years.

Skye originally worked in the finance department as a fund accountant while completing her final year of university. She then moved into an analyst role in the Investment Markets Research team, gaining experience in economic analysis and across the broader investment categories of the business. She then relocated to the London office to join the Information and Research team, where she managed the team responsible for all investment communications.

Skye holds a Bachelor of Agricultural Economics from the University of New England, Armidale where she won the University Medal. She also holds a Graduate Diploma in Applied Finance and Investments specialising in Investment Analysis from the Securities Institute of Australia. Skye is a Chartered Alternative Investment Analyst charterholder. Skye is the Global Resources team's representative on the Colonial First State Global Asset Management United Nations Principles for Responsible Investment committee and leads the team's approach to environmental, social and governance investment considerations.

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