

Global agribusiness (Soft commodities)

Q&A

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- Joined First State Investments' Global Resources team in February 2006.
- Has over 28 years of investment experience.
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- Joined First State Investments in January 2000 and joined the Global Resources team in November 2005.
- Grew up in central Western Australia with a genuine interest in and knowledge of agriculture.
- Holds a Bachelor of Agricultural Economics from the University of New England and a graduate diploma in Applied Finance from the Securities Institute of Australia.

Q1: What are the drivers behind the soft commodity sector?

A1: Demand for soft commodities is set to grow due to a number of structural changes that have been occurring in the developing world. This growth will underpin the need to invest in improving productivity and volumes in the sector, which in turn should benefit listed agricultural companies.

Population growth in developing economies means there will be more people on the planet to feed in the years to come. In addition, the rapid economic development and increasing urban populations that many developing nations have experienced over recent years has seen a growing affluence, with a growing middle class now being able to afford protein in their diet. These dietary changes are important due to the amount of grain required to produce protein. For example, seven kilos of grain are required to produce one kilo of beef.

At the same time, the world has already farmed its most productive agricultural land and there is limited land to bring on new capacity. Prime agricultural land is competing with alternative uses including urban encroachment, industrial uses and forestry. Environmental impacts and water availability provide further constraints. The reality is that there will be less land per person to produce agricultural produce from, with more limited resources, and we will need to continue to improve yields per hectare in order to feed the world. Simply put, supply will need to increase in order to meet demand.

Overlaying these strong fundamentals supporting agricultural product volumes, we have witnessed many governments, most notably the USA and the EU, mandate or subsidise the production of bio-fuels such as ethanol. This has created a new source of demand for agricultural products as governments subsidise new ways of producing energy with renewable resources.

Q2: What are the major influences on soft commodity prices?

A2: It's likely that we will see short-term soft commodity prices impacted by current negative sentiment in the market and concerns of reduced demand. In the longer term, demand growth for soft commodities will be driven by developing countries such as India and China.

Low grain inventories are also expected to support soft commodity prices. 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. It will require several years of record grain crops to bring the global inventory balance back to more comfortable levels, creating a supply/demand scenario which is expected to support long term prices at higher levels than in previous years.

In the meantime, a new factor beginning to influence the market is China. China only recently entered world markets to import corn and wheat. Their strategy seems to be to buy opportunistically when prices fall, which we believe will also provide a floor to soft commodity prices going forward. Importantly, an agricultural equities fund benefits more from rising volumes than from higher prices. In an environment where the world needs to produce more to meet demand, we believe that agricultural equities that have exposure to the volume growth in the industry will perform more strongly than the underlying commodity prices. While we know that food prices cannot continue rising forever without inflationary implications eventually leading to demand destruction, we believe that the current level of the soft commodity prices are sustainable enough to encourage new production, without being demand destructive for the end-consumer.

Q3: Is the soft commodities sector gaining popularity with investors?

A3: Since late 2009, we have seen many new agricultural companies list via IPOs or raise capital to grow. We believe that the sector will expand in the future due to the significant amount of capital that's needed to be invested to grow the world's agricultural production in the future. We believe that this capital requirement could result in increased competition in the agricultural equity fund space going forward. However, we do believe that specialist skill set is needed to successfully manage this type of specialised portfolio.

Q4: How do government policies impact investing in soft commodity equities?

A4: The role of governments in the trade and use of agricultural products is part of the agricultural landscape that investors need to consider. A government's priority is to make sure they have enough supply for their domestic demand. We saw Russia impose a wheat export ban in 2010 after severe droughts significantly reduced their wheat yields (this ban has since been lifted). We are also seeing governments trying to influence demand. For example Brazil reduced their ethanol blending limit as domestic production of ethanol couldn't keep pace with demand, while in China there has been a price freeze on soyabean oil at the refining level despite soyabean import prices rising leading to negative margins for the refiners. Reactions by governments when this type of situation occurs can start a chain reaction. For example, if wheat exports are halted, then prices are pushed even higher, which in turn causes food inflation and security fears across other countries.

The attractiveness of a global soft commodity equity portfolio is that it can provide investors with geographical and crop diversification that will reduce the risk of being exposed to one climatic region, to one source of demand and to the impact of one government's decision. Global soft commodities can also offer diversification benefits when combined with other traditional asset classes and help reduce overall portfolio risk due to the relative permanence of the fundamentals supporting the soft commodity sector.

Q5: What about the food versus fuel debate?

A5: Around the world, countries have outlined green energy policies, mandating the use of renewable fuels, which are blended into the more conventional gasoline and diesel. However, recent food price inflation has spurred the 'food or fuel' debate, whereby food crop production is being diverted to bio-fuels production. Global production of soft commodities has not been able to keep pace with consumption growth, and therefore inventory levels of soft commodities, particularly corn, have declined which in turn has led to higher prices.

Despite 30% of the US production of corn being consumed by ethanol production, if we look globally bio-fuel production accounts for just 2% of global arable land; a relatively small piece of the food security puzzle. The real crux of the issue lies in a simple supply/demand dynamic: availability of arable land is finite, while global population growth and improved living standards is leading to increased demand for food.

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