**Slim pickings for the tree-crop investor**

What to replace the mining boom?

After experiencing the resources rout of recent years, Australian investors have been forced to consider this pressing question... and look to possible answers.

One sector that has garnered a great deal of interest in recent years is agriculture. And as I’ll argue below, some of the hype is probably deserved.

But before going any further, there is no denying the fact that many investors who have backed companies in this sector in the past have found themselves badly burnt. The basis for an investment in this sector thus has to be carefully examined on a case by case basis.

In Australia, talk of the agriculture sector naturally brings to mind images of cattle stations, Jackaroos and the pastoral scenes of the Heidelberg School. But pastoralism is perhaps an example of an area of agriculture that is not quite all it is cracked up to be.

To produce just one kilo of beef requires 15,000 litres of water, making the livestock industry one of the most water-intensive agri-industries. Given that Australia is one of the driest continents on the planet, a question mark hangs over the sustainable growth of this industry.

But there is one particular area of agriculture which really does look to be set for a boom, and unlike the rather niche cattle industry, this is one in which all states across the nation will be able to share.

The Australian horticultural industry – and particularly growers of tree-crops- looks like it could be on track to become one of the money-trees of the future.
Listed Australian tree-crop stocks

In this article, the terms ‘tree-crops’ and ‘horticulture’ are used interchangeably, even though there is a difference between the two: the growing of tree-crops is a subset of horticulture.

The reason for my lack of distinction here is simply because almost all of the listed Australian horticulture companies happen to be in the business of growing tree crops, with a few (the Costa, Buderim and Rural Funds groups) also involved in other areas of horticulture, as outlined in the table below.

<table>
<thead>
<tr>
<th>Company:</th>
<th>Code:</th>
<th>Crop Type:</th>
<th>Enterprise Value:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costa Group</td>
<td>CGC</td>
<td>Citrus, Berries, Tomatoes</td>
<td>$990 million</td>
</tr>
<tr>
<td>Dongfang Agri.</td>
<td>DFM</td>
<td>Citrus, Camellia</td>
<td>$820 mil.</td>
</tr>
<tr>
<td>Webster Ltd</td>
<td>WBA</td>
<td>Walnuts, Cotton</td>
<td>$456 mil.</td>
</tr>
<tr>
<td>Select Harvests</td>
<td>SHV</td>
<td>Almonds</td>
<td>$415 mil.</td>
</tr>
<tr>
<td>Rural Funds Group</td>
<td>RFF</td>
<td>Almonds, Macadamias</td>
<td>$351 mil.</td>
</tr>
<tr>
<td>Buderim Group</td>
<td>BUG</td>
<td>Macadamias, Ginger</td>
<td>$33 mil.</td>
</tr>
</tbody>
</table>

As is evident from the above, an investor looking for some exposure to the Australian horticulture sector doesn’t have a great deal to choose from. Viniculture is the only notable horticultural activity which has been left out here, given the focus of the article on food producers, but there are only a few listed wine companies anyway.
The two largest stocks in this table—Costa Group and Dongfang—are also the newest, with both having listed only within the past 12 months. It does appear that the entrance of these new horticultural giants might have served to suck some of the oxygen out of the share price of the former leaders, Select Harvests and Webster Ltd, as is apparent from a 12 month chart of the share prices of these companies.

But even with these two new entrants joining the listed horticulturists club, investors are not exactly spoilt for choice. It should be noted that Dongfang isn’t really an Australian company anyway: all the orchards owned by this company are located in China, so presumably part of the logic behind the Australian listing is that it will impart some kind of ‘premium cachet’ on their brand, as Australian food producers enjoy a good reputation in China.

This serves to remind that the Australian horticulture industry is held in high esteem by many in Asia, a view which is certainly not unmerited. Growers of Australian food plants enjoy several significant competitive advantages, and it is worth examining these in more detail.
The Australian Edge: Competitive advantages

In the field of horticulture, Australia enjoys significant competitive advantages: With one of the lowest population densities in the world and counter cyclicality to the northern hemisphere, Australian food growers have an edge over farmers in all other food-producing areas. In addition, Australia is also one of the only countries in the world to remain unaffected by the blight of ‘bee disease’.

Low population density: It says a lot that the only significant countries in the world with a lower population density than Australia are Namibia (largely desert), Greenland (mostly ice) and Mongolia (the closest neighbour to the Russian district of Siberia).

The remarkably low population density of Australia (just 3.13 people for every km²) is of benefit to all Australian agricultural industries, and not least the horticulture industry. Essentially, the low population density means Australian growers of food plants face less competition for water than their counterparts in more populated nations.

Because of the low population density, Australian growers are also isolated from other industrial activity, which helps to reinforce the clean reputation of Australian food.

Season counter-cyclicality: As Australia is wholly located in the Southern Hemisphere, the companies listed above (excepting, of course, Dongfang) are producing food in the counter season to the northern hemisphere, home to the majority of the world’s population.

As such, Australian horticulture companies are harvesting and/or marketing their crop at a time of the year when hardly anyone else in the world is doing so. This provides Australian ag companies with an enviable competitive edge over farmers in the US, Europe and in other northern hemisphere countries.

Bee health: Many of the crops grown by the companies mentioned above rely on bee pollination. This is true for the almond orchards of Select Harvests and the Rural Fund Group, as well as the berries and citrus fruits produced and marketed by the Costa Group.
The importance of this is that most countries in the world are currently struggling with ‘bee disease’ (colony collapse disorder, CCD) which can be a major complication for farmers who rely on bee-pollination in the afflicted regions.

So far, Australia remains one of the few countries to remain free of CCD. As such, Australian growers of bee-pollinated food crops enjoy yet another significant competitive advantage in that it is far easier, and cheaper, for them to pollinate their crops.

As highlighted above, there is much to like about Australian horticulture. However, the sector is highly volatile, and a prospective investor in the sector must therefore be cognisant of the risks. Some of the challenges faced by the industry are examined next.

**Drivers of the tree-crop sector**

*As with any sector, companies involved in the growing of tree-crops are influenced by a variety of global trends. Below I examine the three of the major drivers which impact the share-prices of tree-crop stocks: Climate Change, the shift towards Healthy living and the interrelated Obesity problem, and Energy Prices.*

**Climate Change**

Eastern Australia is currently at the tail-end of an El Niño weather event, the most significant to occur since 1998.

Such weather events are associated with high temperatures, and this year was no exception. But what is notable is the extent to which the temperatures experienced in the current El Niño exceeded those of 1998.

For example, in the town of Ouyen, Victoria, at the heart of one of Australia’s chief horticulture regions, there were six days in which the mercury hit 40 degrees in the first three months of 1998. By comparison, during the first three months of this year, there was twice as many 40 degree days recorded at the same location.
The significant increase in the number of excessively hot days could be problematic for growers of tree-crops, as heat stress can impact the yields of such crops. In addition, the warmer weather leads to a higher cost of irrigation water.

Should the global-warming trend be a concern for investors in Australian horticulture? The answer to this question would have to be ‘yes’. Only late last year, the Australian walnut grower Webster identified a nut-set issue in some of their NSW walnut orchards, which significantly reduced the yields of these orchards. This problem seems to have resulted from record high temperatures in the Riverina region in late 2014.

But on the whole, for Australian growers of tree crops, climate change is probably more of a positive than a negative, provided they remain alert to the risks.

The main reason for this, again, goes back to Australia’s low population density. As has become increasingly apparent, climate change is a global issue. In recent years it has contributed to drought in California (a major grower of many tree crops including almonds, walnuts and oranges), Hawaii (a significant grower of macadamias), Spain (the largest olive-producer worldwide, and also a significant producer of almonds and oranges) as well as Brazil (the largest orange grower worldwide). In all these regions, the high population density means that growers in these areas are faced with more competing demands for water than is the case locally.

In addition, various measures can be adopted by local growers to reduce the impact of extreme heat on crops, for example, by investing in shade-netting to protect crops from heat and reduce transpiration evaporation.

**Healthy eating and obesity**

‘An apple a day keeps the Doctor away.’ The point of this old adage is to remind that prevention is better than cure. It also serves as a reminder that some of the most potent health foods on the planet are grown on trees.

The medical journal *The Lancet* recently released a study revealing that for the first time in history, the number of obese people globally now exceeds the number of those who are underweight.
This trend is certainly one of the factors behind the growing popularity of health foods in recent years, and while this is a positive for all the listed horticulture companies, I would argue in particular that it is also likely to generate significant demand for tree-nuts in future. This trend may thus be particularly positive for the four listed companies involved in nut-growing, Webster, Select Harvests, the Rural Funds Group and the Buderim Group.

The link between tree-nuts and the challenge of the global obesity problem lies in the fact that nuts are amongst the most potent ‘satiating’ food type. Essentially, satiate foods are those that stave off hunger for longer, in other words, those foods which suppress the appetite.

There is strong evidence that snacking on nuts can help to prevent obesity: For example, a 2007 Spanish study found that participants who ate nuts twice a week were 31% less likely to gain weight than the participants who rarely or never ate nuts.

This study specifically looked at almonds, but all nuts have the satiating quality, although almonds are generally considered the most potent. Other studies have found other health benefits of regular nut consumption, including reducing the risk of heart disease and possibly also reducing the risk of developing type 2 diabetes.

Eating a handful of nuts on a daily basis is probably one of the easiest ways to prevent weight gain, so the global obesity epidemic could be a powerful driver for tree nut consumption over the long term.

**Energy Prices**

One final factor which a prospective investor in any agricultural company needs to bear in mind is the energy price. Horticulture, as with agriculture in general, is an energy intensive business. As such, over the past two decades there has been a noticeable inverse relationship between the oil price and the share prices of the listed horticulture companies Select Harvests or Webster.

Partly, this is simply because higher energy costs increase the expenses of these companies. In the case of Select Harvests, one of the largest Australian nut-growers, energy costs typically represent between 10-15% of the total company costs, for example.
But there is another, indirect impact of high energy prices on Australian agricultural companies. Australia is a major exporter of petroleum, gas and coal. As a result, when energy prices are high, it usually provides a boost to the Australian dollar. A stronger dollar is a headwind for exporters such as Australian agricultural companies.

So, higher energy prices can adversely impact agriculture companies both by increasing their expenses and by reducing their competitiveness, and so this is a risk that must be borne in mind by prospective investors in the sector.

This risk can be mitigated to a certain extent. Select Harvests, for example, is currently building a biomass plant fuelled by almond hulls and shells in an effort to reduce their energy expenses and reduce the risks associated with high energy prices. This example also highlights how tree-crop stocks have the potential to intersect with the shift towards ‘clean energy’.

Conclusion: Last of the Summer Fruits?

It is a commonplace understanding that Australian agriculture stands to benefit from the economic growth of the Asian region, but less well appreciated is the fact that one segment of Australian agriculture, horticulture, is positioned head and shoulders above the rest.

Thanks to the competitive advantages detailed above, the horticultural industries, and particularly tree crop growers, are well placed to fill some of the void left by the retreat of the mining industry.

But surprisingly, investors who are looking to get exposure to this growth story have limited options. As mentioned previously, one of the few listed local horticultural companies, Dongfang Modern Agriculture, is not an Australian company.

The following comment, from page 15 of the Dongfang annual report, perhaps provides a little more insight as to why this company has opted for an Australian listing:

...We continue to identify and assess opportunities in Australia and China that take advantage of the ChAFTA (China free trade agreement), including partnerships and/or acquisitions of Australian agribusiness companies...
It could be that the 'slim pickings' faced by the prospective Australian horticulture investor may instead turn out to be the last of the summer fruits.

Note: this is a general overview of the companies mentioned above rather than an in-depth financial analysis, and so as always, do your own investigation into these stocks before committing to any course of action.

Disclosure: The author owns shares in Select Harvests