Newsletter

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Rural Funds Management

Managing good assets with good people

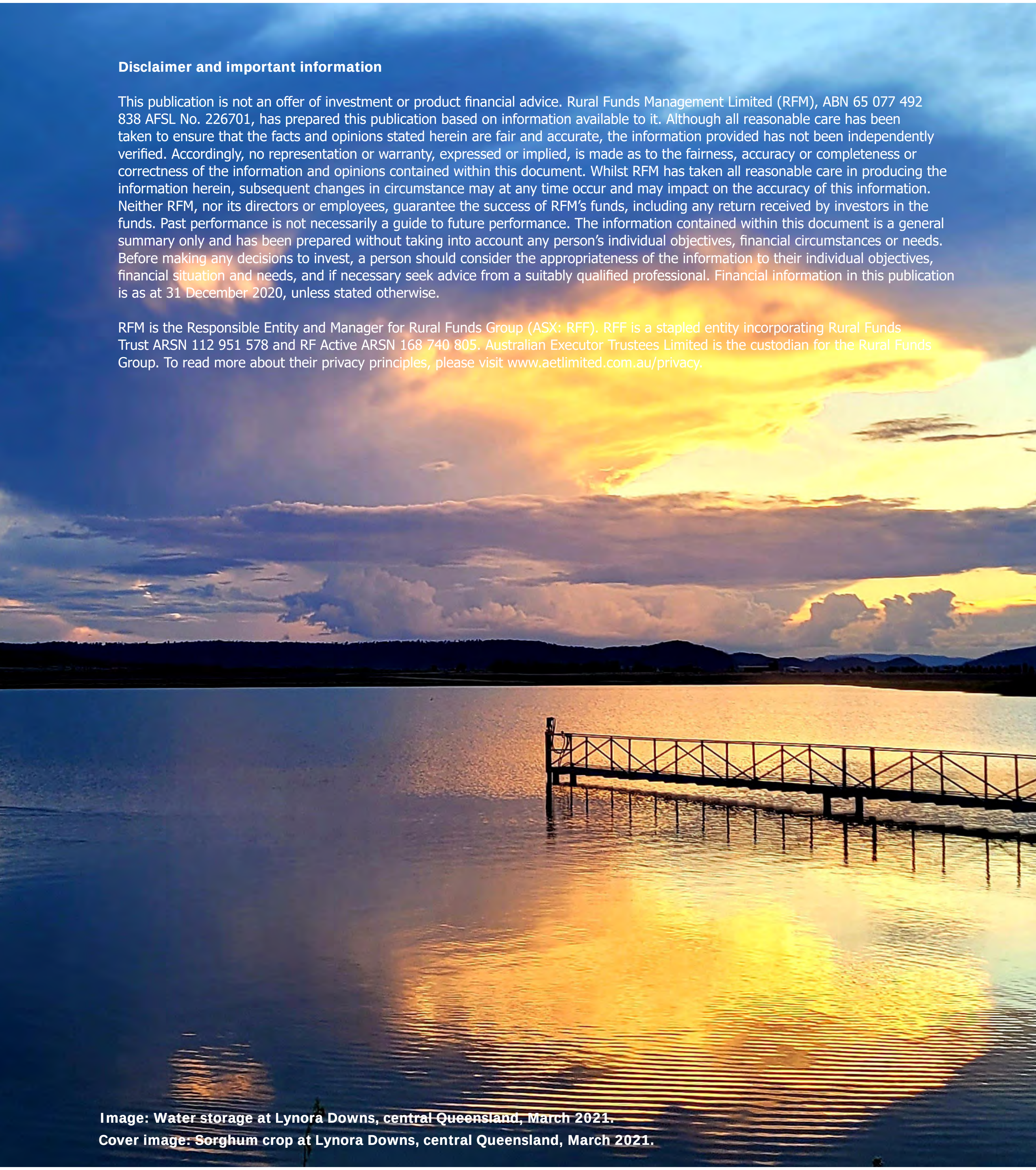

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Image: Water storage at Lynora Downs, central Queensland, March 2021.

Cover image: Sorghum crop at Lynora Downs, central Queensland, March 2021.

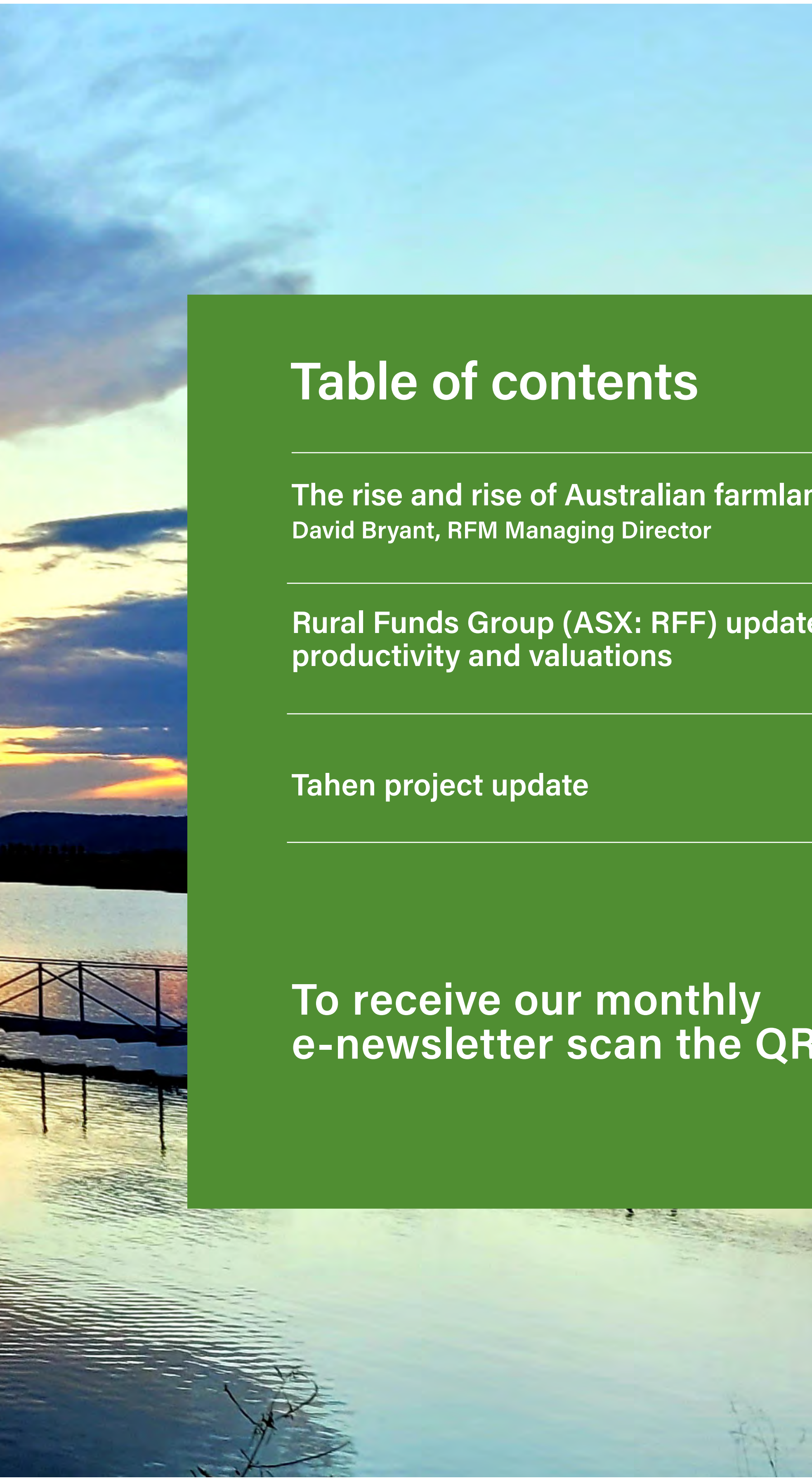

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Image: Moving cattle at Comanche, Rockhampton, central Queensland, May 2021.

The rise and rise of Australian farmland

David Bryant, Managing Director

Understanding the impact that capital growth has on your investment in the Rural Funds Group (RFF), will give you a better appreciation of how your investment will serve your needs over time. This article discusses capital growth in rural land and the impact it has on RFF.

Australian farm values have been increasing relatively quickly, driven by a period of generally rising commodity prices and record low interest rates. During calendar year 2020, national farm values rose 12.9%, according to the Australian Farmland Values report[1]. This figure was derived from 8,187 property transactions, covering 8.2 million ha worth a combined $10 billion.

Figure 1 sets out the annual compound growth rates for Australian farms over the past 20 years. These returns are based on around 200,000 transactions worth around $150 billion. What is evident from the table is that capital growth rates in rural land have been very high across the whole country over the past two decades. As a consequence of the 20-year compounding national growth rate, farm values have increased fourfold in that time. This has significantly increased the wealth of Australian farmers and those who have invested in rural land.

The rate of capital growth is important to RFF investors. This is because capital gains that accrue on the farms held by RFF become retained profits which are added to the net assets of the fund. From an accounting and valuation perspective, these capital gains add to the net asset value (NAV) per unit, which is often a useful metric for analysing aspects of a listed business.

While an increased NAV is a useful

Figure 1: Compound annual growth rates, Australian farmland

	1 Year	5 Years	20 Years
Queensland	11.8%	6.6%	8.8%
New South Wales	15.6%	12.2%	8.1%
Victoria	6.9%	11.1%	7.2%
Tasmania	25.3%	9.5%	8.1%
South Australia	10.9%	13.2%	7.2%
Western Australia	19.3%	8.9%	6.2%
National	**12.9%**	**10.6%**	**7.6%**

Increased valuations are evidence of underlying businesses capable of generating increased profits and sustaining reasonable increases in rent.

validation of the trading price of your shares, there is a more fundamental change occurring as the underlying value of RFF's farms increases in value over the long term. Increased valuations are evidence of underlying businesses capable of generating increased profits and sustaining reasonable increases in rent. In other words, increasing values are evidence from the real-world, that farm businesses are increasing their profits through the combination of rising commodity prices and increased productivity.

A secondary consequence of rising farm values is the increase in equity that is produced and retained in RFF. This can be put to work by using prudent debt levels to fund the acquisition of new assets, which in turn contributes additional income and capital growth over time. With time, this process compounds to become a significant portion of the investment return that can accrue to long-term investors.

The large increase in the value of Australia's agricultural asset base can be explained by three factors. Firstly, over the past 20 years, interest rates have declined. Secondly, since the year 2000, the prices paid to farmers for the commodities they produce have improved. Thirdly, productivity gains have increased the output and efficiency of farms, meaning they now produce more income per hectare.

Over the past two decades, the variable interest cost on a loan to buy a farm has reduced from 8% to 2%. This large reduction equals a rate of decline in borrowing costs of 7% per annum, which is about the same rate of capital growth recorded nationally in Figure 1. This reduction does not fully explain the high capital growth rates, because farmers typically only operate with gearing of about one third. For this reason, the contribution to capital growth from commodity prices and productivity improvements should be examined.

Something that Figure 1 does not record is the more recent surge in prices for specific agricultural assets. Small farms located near large cities are changing hands at twice the price of a year ago. Regional towns near these cities are now filling with black German SUVs on Friday evenings, while rural real estate agents complain about the lack of farms to sell. In the Southern Highlands of NSW, price expectations of some vendors have tripled compared to pre-COVID-19 values.

Far from the madding crowd, in central and north Queensland, RFF has acquired 47 farms over the past five years, at a cost of $292 million. Farm values in this important agricultural region have risen at a compound rate of 10.5% per annum over that time. Cattle farms purchased by RFF have risen in value. For example, Rewan, which was acquired by RFF in 2016 at a value of $4,250 per head of carrying capacity, was valued in December 2020 at $6,700 per head. Comanche, purchased in 2018 at $5,500 per head, was valued at $7,000 per head in June 2020. These increases in

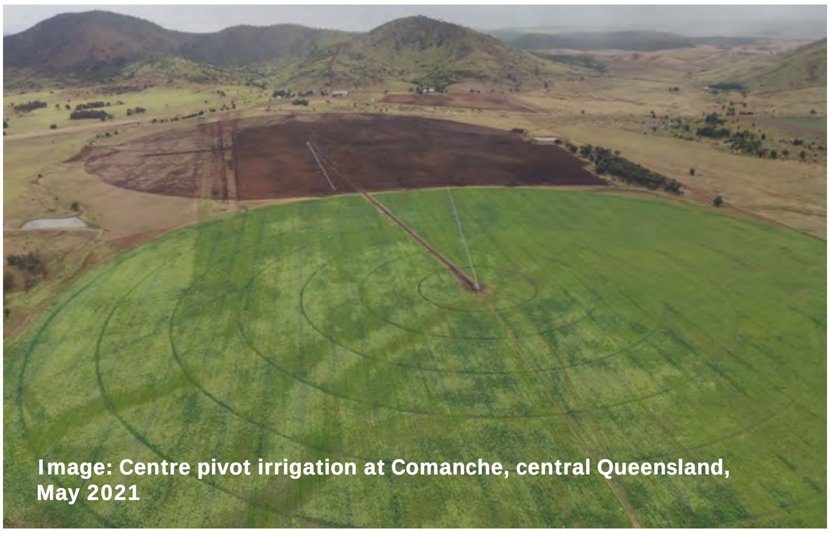


Image: Centre pivot irrigation at Comanche, central Queensland, May 2021

value over these periods have been around 12.5% per annum.

In recent months, the combination of high cattle prices and low interest rates, has seen farms sell at prices up to 100% higher than the values discussed above. The buyers of these assets are not well-funded city types, but farmers dependent on cattle sales, and many cattle producers wonder if it is sustainable.

Figure 2 attempts to answer this question by considering the profitability of a farm, excluding financing costs. The numbers are quoted as a profit per adult equivalent, which is explained in the table, but is essentially the profit per head of cattle carrying capacity. The table examines the profitability of a cattle operation based on two important variables: productivity and commodity price. Cattle are currently selling at $4 per kg liveweight – an historically high price driven by low cattle numbers here in Australia and a surge in demand internationally. While it might take a couple of years, it is expected that prices will decline, which is why the table includes lower prices.

The horizontal axis of Figure 2 presents the productivity of a cattle farm, based on the daily weight gain of the livestock. This factor will vary over the short term based on seasons, but over the long term, this measure of productivity is determined by the skill of the manager and quality of the farm.

Looking at the results presented in this table for a $3.50 per kg sale price, it is evident that there is a wide variation in financial results. A farm producing a daily weight gain of 0.4 kgs per day, will make less than half the money than a farm producing 1 kg per day. In the world of cattle farming, this wide variation in financial results is common. At high levels of productivity, the sudden surge in farm values is probably sustainable even with a retraction in cattle prices. At low levels of productivity, recently purchased farms will probably need to be sold.

Setting aside the recent surge in some areas, the capital growth of farmland over the past two decades has been impressive and understandable. But what does the future hold? The tailwind of declining interest rates will not be there, as the global economic recovery seems underway. Commodity prices will most likely increase in nominal terms and perhaps in real terms as increasing urbanisation and economic growth in Asia drives demand for higher quality commodities. Productivity will need to increase, since agriculture must feed more people with better diets, and it will do so as new technologies are deployed and more capital is invested. For these reasons, farm values will generally go up over the long term.

This article has discussed the three factors driving the impressive capital gains achieved in agricultural assets over the past two decades. The first two, interest rates and commodity prices, are beyond the control of even good managers. The third factor, productivity, is actually a product of good management. It is the result of good managers managing good assets.

Figure 2: Cattle farm profitability per adult equivalent[2]

Cattle Price ($/kg)	Average Daily Gain (kg/hd/day)				
	0.2	0.4	0.6	0.8	1
$3.00	$49.35	$215.25	$337.95	$426.61	$490.75
$3.25	$69.96	$251.57	$385.91	$482.95	$553.16
$3.50	$90.57	$287.90	$433.86	$539.29	$615.57
$3.75	$111.19	$324.22	$481.81	$595.64	$677.97
$4.00	$131.80	$360.54	$529.77	$651.98	$740.38

> Productivity is actually a product of good management. It is the result of good managers managing good assets.

Image: Aerial of the Geier vineyard, Barossa valley, South Australia, Janary 2021

Image: Brahman cattle, Comanche, central Queensland, May 2021.

Rural Funds Group (ASX: RFF) update: productivity and valuations

Rural property values are enjoying beneficial tailwinds of low interest rates and higher commodity prices. In the previous article in this Newsletter, David Bryant considered how operators can sustainably fund the acquisition of farms despite the recent increases in asset values. One factor – improving farm productivity – was considered in some detail.

This article describes specific RFF productivity improvements which benefit both operators and investors, and how they are captured in the valuation process.

Productivity and profitability

Higher agricultural valuations are evidence of the underlying operations being capable of generating increased profits. This is important for RFF investors, as operators (or lessees) fund their rent commitments from current or retained profits.

Favourable seasons or commodity prices, while they remain, can improve farm profitability. An additional way to increase farm profitability is to increase its productivity. Comanche, an RFF cattle property in central Queensland, provides a case study.

Comanche is a 7,600 ha cattle backgrounding property located 65 radial kilometres west of Rockhampton. The property receives weaners, which are young cattle of around 175 kg. The weaners are onsold once they reach approximately 400 kg. In this scenario, the operator is seeking to maximise the number of weaners and their daily weight gain. Since purchasing Comanche in 2018, RFF has funded numerous improvements which aim to achieve these outcomes.

Comanche has a mix of highly productive soils, which support pastures on which cattle graze. However, the property had a lack of irrigation infrastructure and water points. Reluctant to leave drinking water, cattle were simply not grazing adequately over the total pasture area.

To improve pasture utilisation, RFF will fund 30 additional water points. Water from the river will be pumped to 'header' tanks then reticulated to the new water points providing an efficient and reliable water supply. Various water points will also be equipped with remote monitoring technology to improve efficiencies and reduce labour requirements.

Cropping areas will be supported by a recommissioned irrigation pivot and three new large pivots. This infrastructure will enable the ongoing cultivation of 280 ha of forage crops. Figure 1 shows the impact of this productivity development.

> **"This article describes specific productivity improvements on RFF properties which benefit both operators and investors, and how they are captured in the valuation process."**

Figure 1: Centre pivot irrigation at Comanche

The above image shows a recently installed pivot at Comanche (left) and forage sorghum growing under the pivot (right). Centre pivots are irrigation systems which irrigate crops in a circular pattern and are capable of applying water and fertiliser. This type of irrigation system is efficient and effective as it can apply a precise amount of water calibrated to the needs of the crop. Most systems have the capability of delivering up to 16mm per day.

In addition to the irrigated cropping area, RFF has funded the development of 500 ha for dryland cropping which will focus on suitable species such as oats, lablab, and forage sorghum.

Ongoing improvements to pasture quality will also be a focus, as well as introducing improved pasture species, particularly legumes. Legumes have a dual purpose of improving pasture quality and capturing nitrogen to improve soil health.

The development of irrigated and dryland areas, improved pasture area and additional water points will increase cattle-carrying capacity and average daily weight gains. Figure 2 shows the extent of improvements which have been, or are planned to be, implemented on Comanche.

Valuation process

Improved productivity is a driver for higher profitability and contributes to higher valuations; all being equal, a more productive property is more valuable to both operator and owner. RFM has a policy to independently value each asset at least every two years. Figure 3 lists the period in

Figure 2: Productivity improvements on Comanche

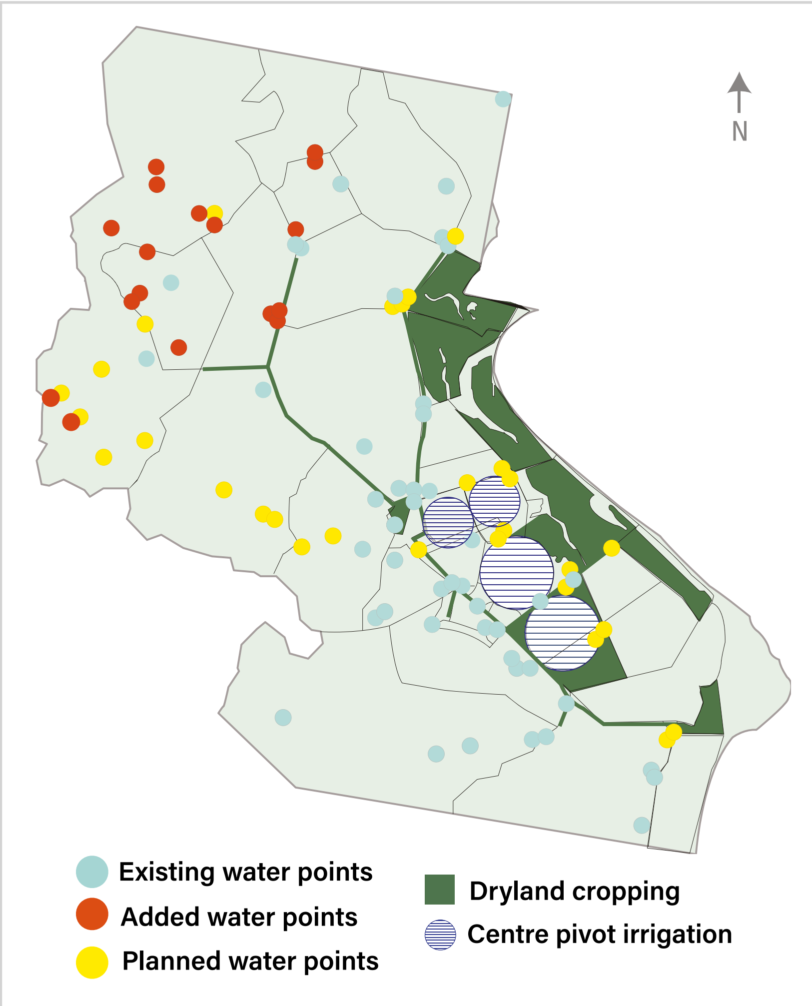


Figure 3: Details of RFF property valuations[1]

Property by sector	Valuation date (reporting date)	Valuation	Valuer
Almonds			
Yilgah, NSW	Jun-2020	$ 105.0m	JLL
Tocabil, NSW	Jun-2020	$ 47.0m	JLL
Kerarbury, NSW	Jun-2020	$ 223.0m	JLL
Cattle			
Rewan, QLD	Dec-2020	$ 50.4m	JLL
Mutton Hole, QLD	Jun-2019	$ 8.7m	CBRE
Oakland Park, QLD	Jun-2019	$ 5.4m	CBRE
Natal Aggregation, QLD	Dec-2019	$ 63.7m	JLL
Comanche, QLD	Jun-2020	$ 22.0m	CBRE
Cerberus, QLD	Jun-2020	$ 13.8m	CBRE
Dyamberin, NSW	Jun-2020	$ 13.9m	Colliers
Woodburn, NSW	Jun-2020	$ 7.3m	Colliers
Cobungra, VIC	Jun-2019	$ 35.0m	Colliers
Petro Farm, High Hill & Willara, WA	Jun-2020	$ 21.5m	JLL
JBS feedlots QLD & NSW	Oct-2018	$ 53.4m	Purchase price
Wattlebank, QLD	Jun-2020	$ 1.8m	CBRE
Homehill, QLD	Jun-2020	$ 12.1m	CBRE & Purchase price
Yarra, QLD	Jun-2020	$ 6.2m	CBRE
Cropping			
Lynora Downs, QLD	Jun-2019	$ 33.1m	CBRE
Mayneland, QLD	Jun-2020	$ 17.5m	JLL
Maryborough (22 properties), QLD	Dec-2020	$56.4m	CBRE
Macadamias			
Swan Ridge, QLD	Dec-2019	$ 6.4m	Colliers
Moore Park, QLD	Dec-2019	$ 4.0m	Colliers
Bonmac, QLD	Dec-2019	$ 2.9m	Colliers
Cygnet, QLD	Oct-2019	$ 1.6m	Purchase price
Swan Ridge South, QLD	Mar-2020	$ 1.6m	Purchase price
Nursery Farm, QLD	May-2020	$ 2.2m	Purchase price
Riverton, QLD	Nov-2020	$ 6.5m	Purchase price
Stoneleigh, QLD	Dec-2020	$6.6m	Purchase price
Maryborough (3 properties), QLD	Dec-2020	$ 18.3m	CBRE
Vineyards			
Kleinig, SA	Jun-2019	$ 22.7m	Colliers
Geier, SA	Jun-2019	$ 28.2m	Colliers
Dohnt, SA	Jun-2019	$ 1.0m	Colliers
Hahn, SA	Jun-2019	$ 4.9m	Colliers
Mundy and Murphy, SA	Jun-2019	$ 3.8m	Colliers
Rosebank, Vic	Jun-2019	$ 3.4m	Colliers

Figure 4: Valuation firms

CBRE (www.cbre.com.au)

CBRE Group Inc. (NYSE: CBRE) is the world's largest commercial real estate services and investment firm, with 2020 revenues of $23.8 billion and more than 100,000 employees (excluding affiliate offices).

Colliers (www.colliers.com.au)

Colliers (NASDAQ, TSX: CIGI) operates in 67 countries and has more than 15,000 employees providing advice to real estate occupiers, owners and investors. Colliers has annualised revenues of $3.0 billion and $40 billion of assets under management.

JLL (www.jll.com.au)

Jones Lang LaSalle Incorporated (NYSE: JLL) is a global commercial real estate services company providing investment management services worldwide, has more than 90,000 employees in 80 countries, and revenue of $16.6 billion.

which independent valuation reports were last prepared for each property.

RFM engages a range of global real estate service companies who are qualified in preparing valuation reports for numerous property classes including agriculture. RFM will also generally rotate valuers, so the same party is not used to value a particular asset over a period greater than five years.

The valuation reports are prepared in accordance with recognised international valuation standards with certified valuers. For example, when preparing valuations, at least one qualified valuer physically inspects each asset; a second qualified valuer reviews the work and co-signs the completed report. More information on three of the valuation firms which have recently prepared reports for RFF's assets, is presented in Figure 4.

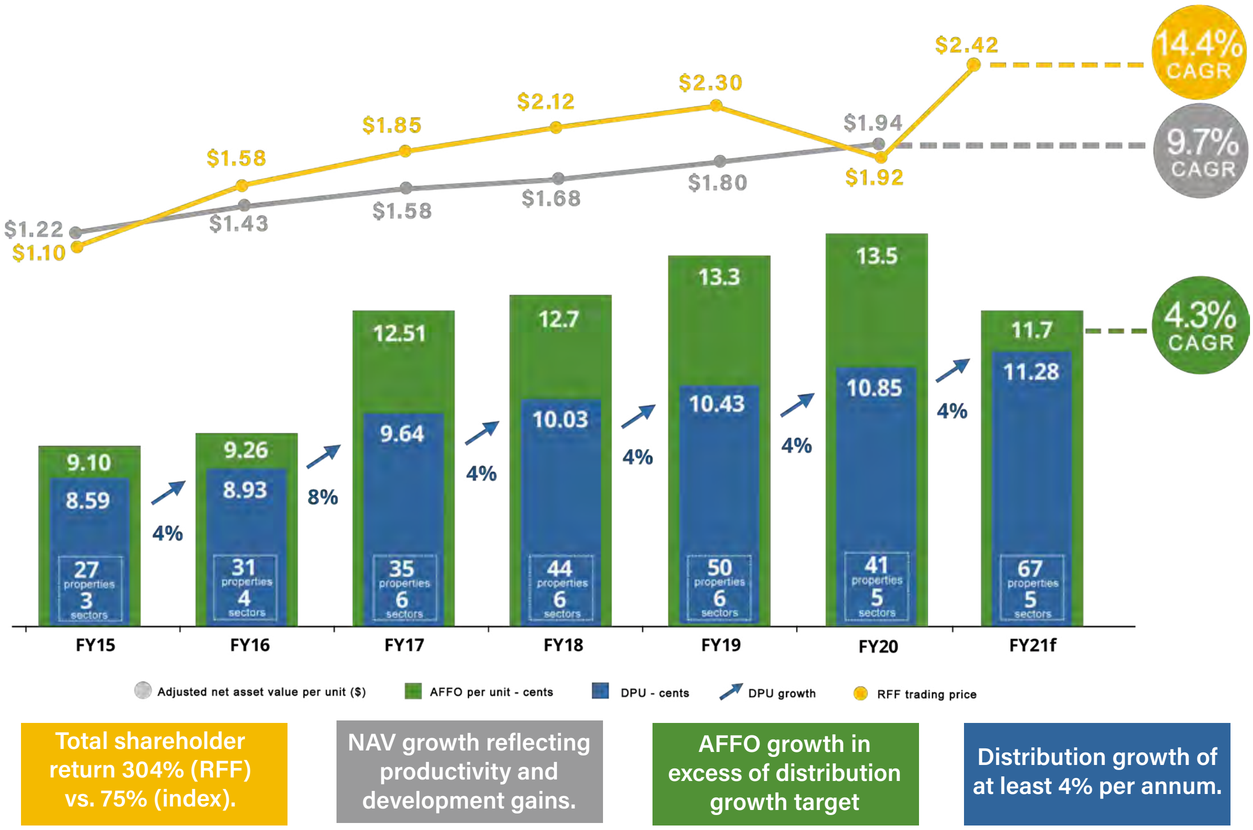
> "RFF investors can be optimistic about benefitting from rising agricultural asset values as well as RFM's strategy of improving the productivity of suitable assets."

Productivity, valuations and investment performance

Given RFF's valuation policy, various assets within the portfolio are expected to be revalued each financial half-year, resulting in an updated adjusted net asset value (NAV). Valuations will take into account future lease income, comparable sales data and profitability metrics.

The benefit of productivity improvements is not just reflected in valuations and RFF's NAV. They also have the potential to benefit

Figure 5: Historical performance metrics (inc. FY21f)[2]



immediate, and future, cash generation by the Group. This is because firstly, the capital which RFF provides to fund the productivity improvements usually attracts additional rent as that capital is deployed. Secondly, leases for assets which have the ability to have their productivity improved typically have a market rent review mechanism which monetises any valuation increase.

For these reasons, investors can be optimistic about the long term benefits of RFM's strategy of improving productivity and asset values.

Figure 5 shows RFF's track record in growing cash generated by the Group (measured by adjusted funds from operations, or AFFO), distributions and adjusted NAV.

Image (left): Mungbeans under pivot irrigation, Lynora Downs, central Queensland, March 2021.

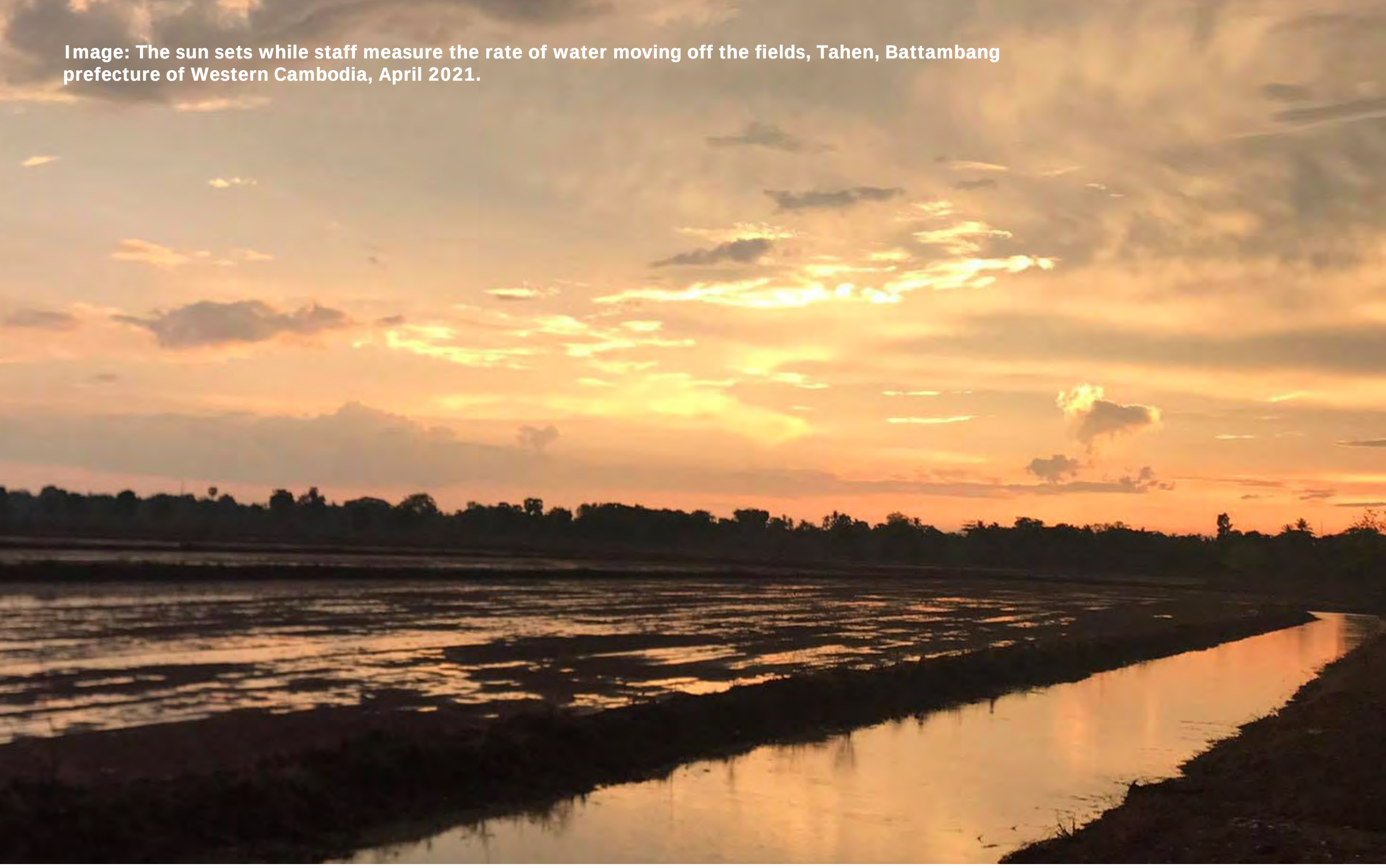


Image: The sun sets while staff measure the rate of water moving off the fields, Tahen, Battambang prefecture of Western Cambodia, April 2021.

Tahen project update

In May 2019, RFM committed to providing resources to establish an agricultural project in the Cambodian village of Tahen, approximately 350km north west of the capital Phnom Penh.

The second year of RFM's three-year Tahen Project has concluded, with many team members reflecting and commenting on the challenges faced over the past twelve months.
The year was marred by two extraordinary events. Firstly, Cambodia, which had contained the COVID-19 virus relatively well early in 2020, experienced multiple and lasting outbreaks later in the year resulting in longer term lockdowns with severe economic hardship experienced across the country. The result of this economic contraction led to rising levels of crime and domestic (family) violence issues, with the impacts of unemployment and unrest felt across the country.

Our Project has been fortunate in that RFM has made available resources to fence a significant part of the land where the Project operates, however there remains a continual challenge to maintain security of our crops and equipment.

With a growing COVID-19 backdrop, the second extraordinary event occurred as heavy rain caused destructive flooding across the country. The UN office for Coordination of Humanitarian Affairs estimated approximately 800,000 people across Cambodia's 19 provinces, were affected by the floods. The Ministry of Agriculture estimated that 310,000ha of agricultural land was affected with 120,000 ha being completely destroyed.

This flooding event caused major issues at the Tahen farm, with the rice planted on our newly laser levelled fields, and the fields themselves, severely impacted. Around 100cms of water remained on the fields for more than one week, causing widespread damage across the farm and to the homes of our farm staff. Although our farm produced a higher yield

> **"approximately 800,000 people across Cambodia's 19 provinces were affected by the floods."**

Image: Water is pumped into the main delivery channel from the Stung Kiv water storage, Tahen, Western Cambodia, April 2021

than neighbouring plots, production was well below expectations with the huge quantity of water causing the rice plant to lodge, and the grain itself to develop mould.

Once the water subsided, it was evident that the massive volume of water, and our inability to pump the water away from the fields, had eroded the land development done earlier in the year. Whilst disappointing, this event gave team members the opportunity to see first-hand how we could improve our irrigation and drainage design.

Consequently, we re-engaged the land development contractors, with the laser levelling team returning to Tahen last month. Our fields have now been redeveloped and we are looking forward to seeing the results of the rice crop to be planted in June 2021.

The banana and mango farms, covering 4 ha and 5.6 ha respectively, continue to thrive. These are low value, low maintenance crops with production contributing only a small amount to the economic outcome of the project, but a large amount to knowledge and capacity building at Tahen.

At the banana farm, a groundcover of peanut was planted in a portion of the farm to prevent soil erosion and weeds, with the added bonus of providing nitrogen to the bananas. Other ground cover crops planted at the banana farm include turmeric, finger roots, cow pea and crotalaria.

Likewise at the mango farm, Chinese ginger root bulbs, cow pea and crotalaria were planted intra row. These crops will improve the soil structure and provide the basis for our cow ration.

Animal production at the Tahen Project has seen several improvements over the past year. Mortalities of goats and cattle have reduced, with better control of feeding, tidiness and cleanliness of pens and successful fattening. In addition, to reduce the possibility of theft, our 34 goats and 8 cows now have identity tags.

The goats are released each day and a field rotation system for foraging has been established to provide sustainable food source for the goats, while protecting the Project's crops. The floor of the goat shed has been raised to enable easy cleaning, promoting a cleaner environment for these animals.

"Our team of approximately 16 farmers and administrators continue to benefit and learn from the Tahen Project funded by RFM."

Our cattle team is growing in confidence. Several workshops have been held, organised by the RFM funded Australian agronomist. The workshops have focussed on creating a self-sustaining feed supply based on using our ground cover crops. A systematic approach to fattening the cattle has been established based on corn, banana stems, rice powder, sesame sugar and forage and roadside vegetation.

As we move into the last year of the Project, we continue to build capacity at a local level. On farm, workshops in pest identification and management, basic soil science, organic fertiliser production and other topics were undertaken. In the office, a different approach was taken with English classes, team building activities and communication skills training offered. Our team of approximately 16 farmers and administrators continue to benefit and learn from the Tahen Project funded by RFM.

About Rural Funds Management

Rural Funds Management Limited (RFM) is one of the oldest and most experienced agricultural fund managers in Australia. RFM has a 43-year history and operates from a head office in Canberra, and offices in Sydney and Queensland. The company employs more than 100 staff in fund and asset management activities.

Established in 1997, RFM manages approximately $1.4b of agricultural assets. This includes three investment funds for which RFM is the responsible entity. Assets are located across New South Wales, Queensland, South Australia, Western Australia and Victoria.

The Rural Funds Group (RFF) is RFM's largest fund under management. RFF is an ASX-listed real estate investment trust and owns a $1.1b portfolio of diversified agricultural assets including almond and macadamia orchards, premium vineyards, water entitlements and cattle and cropping assets.

RFM's company culture is informed by its long-standing motto of "Managing Good Assets with Good People". Scan the QR code to learn more.

Newsletter references

The rise and rise of Australian farmland

1. Australian Farmland Values 2021, Rural Bank, a division of Bendigo and Adelaide Bank Ltd, April 2021 afv-national-2021.pdf (ruralbank.com.au)
2. This is a representation of a hypothetical cattle enterprise using various assumptions for operating and overhead costs.

Rural Funds Group (ASX: RFF) update: productivity and valuations

1. Where no independent valuation has been conducted since acquisition, the purchase price and acquisition date has been listed. JBS Feedlots are not independently valued in financial statements as they are accounted for as a finance lease and are measured at amortised cost. Homehill includes an additional area purchased in December 2020 for $4.3m.
2. Adjusted NAV and trading price are at relevant financial year end except $2.01 (as at 31 December 2020) and $2.42 (as at 17 March 2021 closing price). Compound annual growth rate (CAGR) calculated daily (1 July 2014 to 17 March 2021). Total unitholder return assumes RFF dividends are reinvested. Index return S&P/ASX 300 A-REIT Accu-mu-lation Index.

Image: Cotton bales, Mayneland, central Queensland, March 2021.

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Rural Funds Management Limited

ABN 65 077 492 838
AFSL 226 701

Level 2, 2 King Street Deakin ACT 2600
Locked Bag 150 Kingston ACT 2604

T 1800 026 665
W www.ruralfunds.com.au
E investorservices@ruralfunds.com.au
E adviserservices@ruralfunds.com.au

LinkedIn - Rural Funds Management
YouTube - Rural Funds Management