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PERSPECTIVES

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ASIA'S FOOD BOWL

Factory farming or premium production?



Over the last year, there has been extensive discussion of Australia's potential to be the food bowl for Asia. We agree that there is significant economic growth potential in agriculture and primary production. But we think that much of the discussion has glossed over where the largest opportunities lie, and what action is needed to realise them.

Asia's population is set to grow by some one billion people over the next thirty to forty years, an increase of 25%. More importantly, the Asian middle class will grow by around 2.5 billion people over this period, a six-fold increase. Forecasts suggest that Australia can feed only a very small proportion of these additional middle class mouths. So the real question is how to extract the most value from the country's production, by targeting the most valuable consumers, rather than continuing a mindset inherited from Australia's colonial past of mass producing and delivering to port.

The last few years have seen an explosion of foreign interest in Australia's agricultural sector, reflected in a wave of foreign investment into both primary production and processing assets. Many major businesses have been acquired by international purchasers, including most of Australia's sugar mills, iconic Australian chicken producer (Inghams), and the Southern hemisphere's largest farm (cotton property Cubbie Station). Meanwhile, listed company Graincorp has accepted a takeover offer from US-based Archer Daniel Midlands. Substantial tracts of agricultural land have also been sold, including significant properties in the Kimberley region in Western Australia and prime cropping land on the East Coast.

Despite this inward investment, the large majority of agricultural land remains in Australian hands. This brings both benefits and challenges. Adding value to the Australian agricultural sector will generate significant economic benefits for Australian

farmers and investors in agriculture. The immediate challenge, however, is that there is relatively little domestic capital available to finance the investment that is needed to unlock these benefits.

The opportunity is substantial. Asia is likely to have doubled its share of global GDP by 2050, from around 26% today to over 50%, driven mainly by the continued development of China and India. Increasing affluence will drive a trend towards higher-value, higher-protein diets. Global food production will need to more than double to meet these demands. The numbers involved, when expressed in numbers of people or tonnes of agricultural production, are huge.

In choosing how Australia acts on this opportunity, it is critical to remember that the country will never meet a major portion of this growing demand from Asia. The food required to feed these 2.5 billion new middle class mouths is about 40 times Australia's current total agricultural production. Indeed the most optimistic estimates are that

Australia has the capacity to feed at best 150 million people, a very small fraction of Asia's food bowl. So the main opportunity does not lie simply in increased agricultural output.

Organic food specialist, not low cost supermarket

Every week, two large commercial transport aircraft leave Sydney filled with fresh milk, bound for China. The litre sold for \$1 in local supermarkets is a premium product in Asia and sells for many times the price. This is because Australian milk is perceived as a high quality product, produced in a safe and clean environment within a reliable and tightly regulated food chain.

This opportunity isn't just limited to milk – the same upside exists in many other categories. Earlier this year, we surveyed the differences in food prices between major Australian supermarkets and the prices in major supermarkets in Shanghai. The figures show clearly that significant premiums are being paid. Even allowing for transport costs,

Figure 1: Comparison of food prices between Sydney and Shanghai

Product	Chinese price (A\$)	Australian price (A\$)	Relative price
Natural Greek yoghurt (500g)	11.64	2.00	5.8x
Beef cube (per kg)	57.57	13.00	4.4x
Cheese (12 slices)	6.66	1.59	4.2x
Beef tenderloin (per kg)	141.12	39.00	3.6x
Semi skim (1 litre)	3.50	1.00	3.5x
Skim milk (1 litre)	2.88	0.99	2.9x
Full cream (1 litre)	2.47	1.00	2.5x
Beef mince (per kg)	11.15	6.00	1.9x
Sirloin steak (per kg)	40.79	21.49	1.9x

Source: Pottinger. A\$-Renminbi exchange rate as at 15th May 2013. Australian price reflects the lowest price found for the product type at either Coles or Woolworths on 15th May 2013. Chinese price reflects price of equivalent product at local supermarkets in Shanghai and Beijing.



this highlights the potential for Australian producers to achieve meaningful increases in selling prices with better access to these markets

And remember, virtually all Australian production is GM-free. Local consumers take this for granted and indeed very rarely are domestic products even labelled to highlight this. But whatever your views on genetically modified crops, the simple opportunity is that more affluent consumers in a number of Asian countries will pay a substantial premium for products made from GM-free crops.

The figures above show that there is much more value in moving up the value chain with premium products and brands, rather than simply *expanding* the volume of production. This is because what Australians see domestically as a low cost commodity product is a premium purchase in offshore markets. As an example, imagine a business that generates an EBITDA margin on its production of 20%. If production increases by 100%, then profits will roughly double – economies of scale are typically relatively modest in agricultural production once critical mass has been reached. In contrast, if the selling price can be increased by just 25%, profits will increase by 150%. These

figures may sound fanciful, but remember the dramatic increase in the value of Australian milk when viewed through the eyes of consumers in Shanghai.

Australia already has the all the key elements in place to produce premium quality food. The country has a pristine growing environment, a transparent food chain and high levels of regulatory supervision. The challenge for local producers is to make sure that they collect this premium for themselves.

Brand Australia: pure, fresh, amazing!

Whilst companies such as BHP, CSL, QBE, Rio and Westfield operate global businesses, many ASX 100 companies generate the large majority of their revenues and profits in Australia and New Zealand. Historically, much of corporate Australia has understandably focussed on meeting domestic demand. Export industries, including resources and agriculture, have focussed on “what we do best”. This translates into low-cost production and the export of raw materials, be it iron ore, coal, wheat or wool. It seems intrinsically logical that, with an increasingly high-cost economy, Australia must place greater emphasis on finding ways to move up the value chain,

NSW Sugar, the owner and operator of the state's only sugar mills, together with Manildra Harwood Sugar, has recently become the first sugar producer in the world to receive Bonsucro certification across the complete sugar supply chain. This certification assures consumers that the sugar that they purchase and consume has been produced in an ethically, environmentally and economically sustainable fashion. As a result, NSW Sugar is now the only Australian-owned manufacturer of locally-produced, certified sustainable sugar.

Customers have already begun to demonstrate their enthusiasm for Bonsucro certified production, with global confectionary-maker Ferrero the first to purchase 5,000 tonnes of Bonsucro certificates from NSW Sugar and Manildra Harwood Sugar.

With the growing focus on the importance to offshore purchasers of the quality of Australia's agricultural production, this achievement provides a neat example of how better quality can translate into superior outcomes for Australian growers and producers.

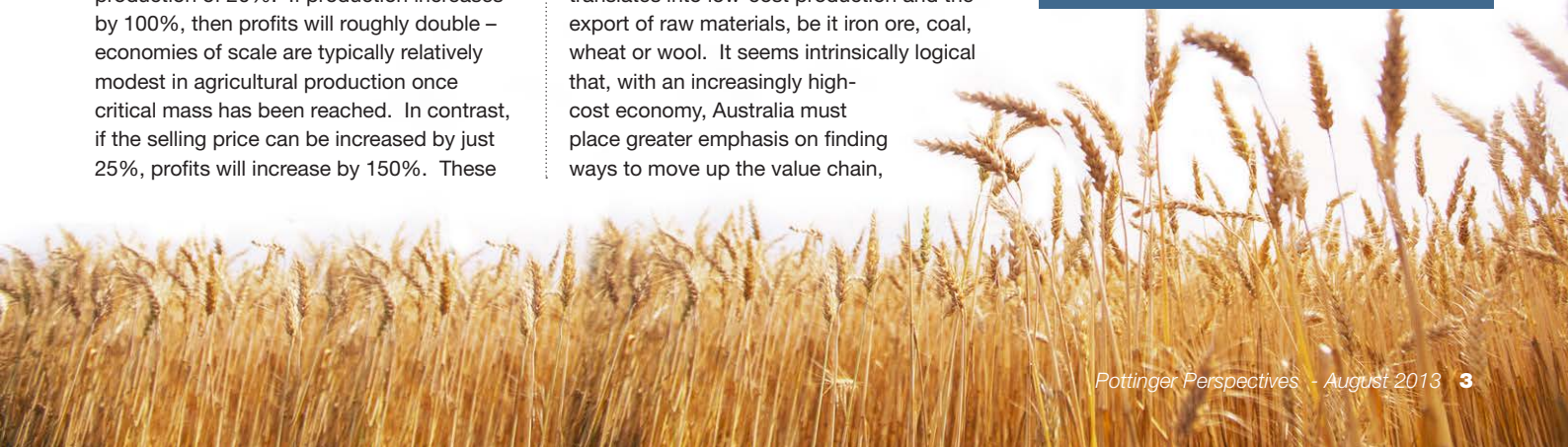


Figure 2: Examples from the UK's recent national advertising campaign



not simply through scale and automation, but also through adding value to products.

An immediate opportunity for Australia is to build a brand for its agricultural production which captures clearly and simply what the country offers: high quality farm output, produced in a pristine environment and grown using sustainable practices. Around the world, consumers need to know that products that are grown in Australia are absolutely dependable. Recent press aside, New Zealand has strong and well-marketed attributes of pure and fresh – and Australia needs the same. Indeed there may be merit in working with New Zealand to position the two countries as similarly reliable in consumer's eyes. In addition, both countries offer the benefits of a Southern hemisphere growing season, helping to meet demand for agricultural products that are required all year round, and offering exposure to a different set of environmental and weather variations.

This helps to reduce risk and thus cost for companies that are dependent on these agricultural inputs.

Either way, a significant national investment needs to be made in building this brand and marketing it consistently over the medium to long term. Ideally this will be done in a way that supports emergence of a true Brand Australia that benefits other key industries such as innovation, tourism, education and financial services. If you haven't seen it, the UK's recent branding campaign, run in parallel with the UK Olympics, is an example of what can be done.

Expanding the farm

Of course there are still worthwhile opportunities to increase the amount of land under production. The growth in demand will be so large that Australia's agricultural sector could be transformed in scale – with a doubling or tripling of output over the near to

medium term – and could still concentrate on the premium quality end of the Asian market. This will require careful design and significant investment. We see three key issues that any project or initiative must address clearly at the outset:

- Location:** Although Australia is a vast country, only a relatively small proportion of the land is suitable for the types of agricultural production that are being considered. Before it progresses too much further with developing policies to drive increased primary production, Australia needs to identify *precisely* where the new agricultural land will be located. Armed with this information, there can then be a proper assessment of the viability of the proposed agricultural model for the project in question, sustainability issues (such as availability and reliability of water flows), and medium to long term climatic effects,

including as a result of climate change;

• **Logistics:** For any major export crop, the practical logistics considerations of where and how crops will be processed, how they will be transported to ports, and any requisite investment in infrastructure will be critical. In addition, careful consideration will need to be given as to how best to access the most profitable export markets, remembering of course that Australia must focus on maximising the value of production, not simply the number of ships filled;

• **Long term results:** All of these factors have dramatic impacts on the overall economics of any particular project. In addition, many crops in Australia are subject to significant variations in volumes year by year. This results from a combination of day to day weather

variations which impact volumes and quality, as well as more severe effects which can destroy entire crops. So investors need to take a long term view – typically at least 20 years – to average out the peaks and troughs caused by weather and commodity price variability year by year. Meanwhile, traditional discounted cash flow valuations based on “base case + scenario” modelling techniques simply cannot accommodate variations of this magnitude. As a result, new, more sophisticated approaches are needed which test and embrace these uncertainties in a statistically rigorous way.

The attractiveness of the Australian agricultural sector has clearly not gone unnoticed, with a number of the largest ever Australian transactions having been completed in the last few years or currently under consideration. The scale of investment

that is required means that the most impact is likely to come from large projects designed to deliver new, sustainable farming ecosystems that benefit from industrial scale production and processing efficiency and are supported by highly cost-effective logistics. Meanwhile significantly more patient capital is needed, not just from offshore but also domestically, to invest in the land, processing capacity and logistics infrastructure. Once the cut and thrust of Australia’s Federal Election is over, the spotlight will rapidly return to the practical challenges of how best to unlock these opportunities on offer. In exploring this potential, it’s critical that attention is focused on opportunities to add value, rather than simply volume to Australia’s agricultural industries. Ultimately Australia’s prize is to be Asia’s leading premium agricultural producer, not the lowest cost factory farm. **P**

By Nigel Lake and Jonathan Wong

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Cassandra Kelly
Joint CEO



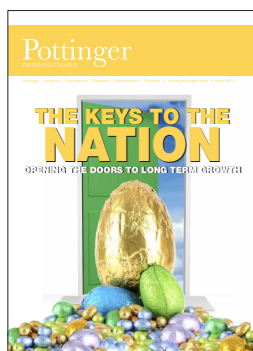
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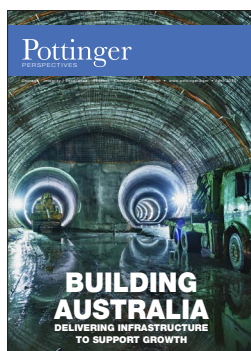
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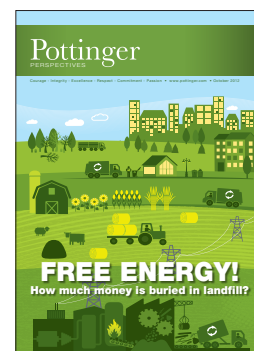
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