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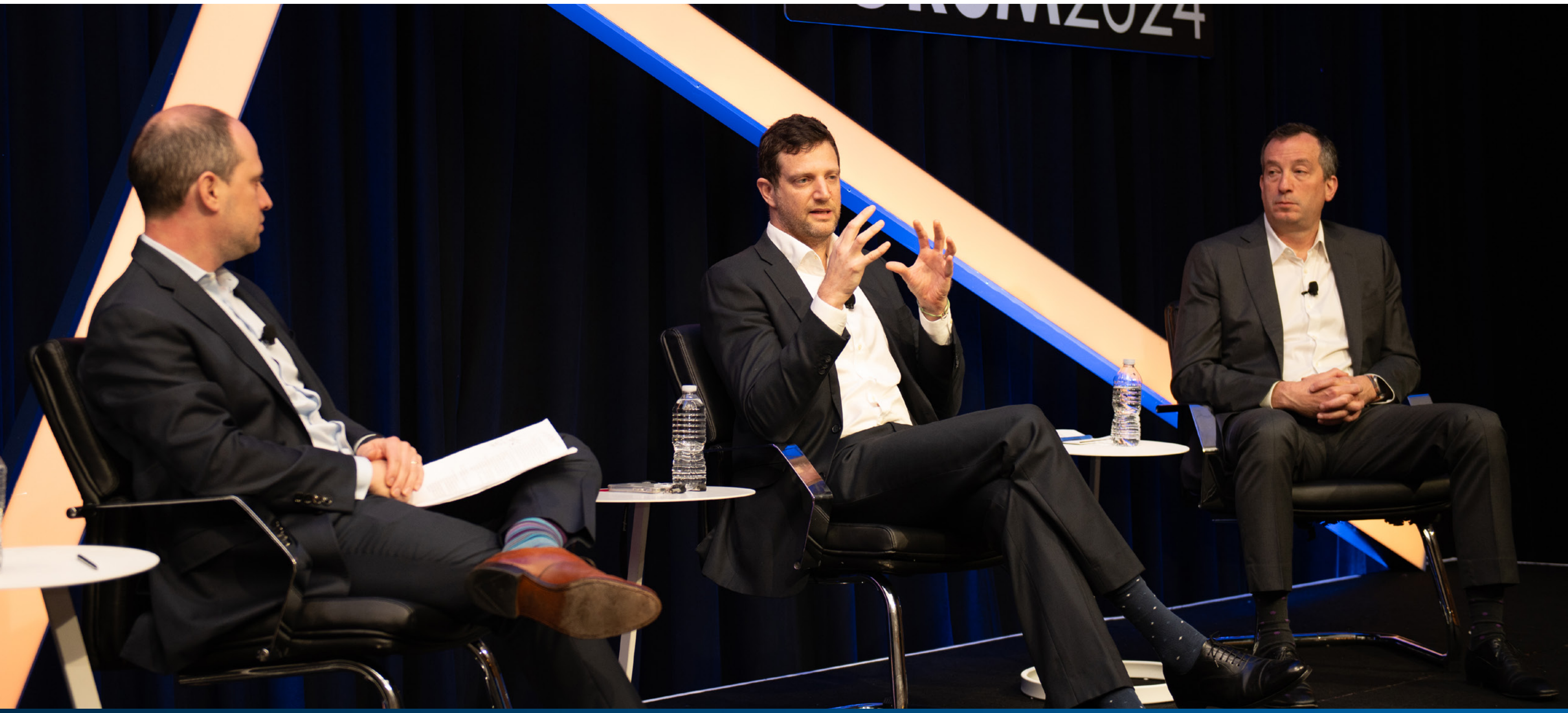
Not Your Grandparent's Farm: Emerging Opportunities in an Often-Overlooked Sector

A Commonfund Forum Spotlight



From left to right: Ethan Levine, Eli Ziskind and Ari Swiller

The Rationale for Investing in Agriculture: Growth, Diversification, Sustainability, Inflation Hedge

Commonfund Forum 2024 convened a panel to examine emerging trends and opportunities for private equity investments in agriculture. The expert panelists were Ari Swiller, Partner, Renewable Resources Group (RRG), and Eli Ziskind, Partner, Aqua Capital. Both firms specialize in agriculture. The discussion was moderated by Ethan Levine, Managing Director and Head of Real Assets and Sustainability, CF Private Equity. Excerpts from the exchange follow.

Ethan Levine: The amount of arable land—that's land that can be used for farming in the world—has decreased by over a third in the past 60 years due to climate change and soil erosion. Couple that with geopolitical tensions in places like Ukraine, which produces 10 to 15 percent of the world's grain, and a growing global population that is projected to reach 8.5 billion by the end of the decade and the takeaway is straightforward: We have to do more with less in the agriculture space. From an investment standpoint, there aren't many pure play public opportunities to invest into, yet agriculture and food services make up 5 to 6 percent of U.S. GDP. We believe there are opportunities to invest in agriculture through the private markets and we are joined by two specialists in the field. Together, we'll explore the industry and look at trends as they relate to technology, water, farming, land use and sustainability. As agriculture is a field about which many investors may be less familiar, let's ask our experts to give us some background. Ari, let's start with you.

Ari Swiller: We got started 20 years ago with a focus around water resources—we looked at agriculture through that lens because we were seeing the variability of water delivery due to climate change, especially in California where we're based. So, we saw opportunities to invest in water itself and that led to agriculture directly. Specifically for us, that means high value crops like trees or vines for table grapes. We're not in wine or cannabis. Currently, we've built a platform where we invest from Washington state down through Latin America and in Australia. We like to be in Mediterranean climates because that's where a lot of your high value crops are developed. We pay close attention to climate trends and where we think they'll be over the next five to 10 years. Sustainability, renewable resources and habitat conservation are all central to what we do, and over the years we've had a close partnership with The Nature Conservancy.

Levine: Eli, how about Aqua Capital?

Eli Ziskind: Our firm was founded 12 years ago as a mid-market private equity entity focused on agricultural productivity, which is the right way to think about how we typically invest. We invest in either growth companies or family-owned businesses that are focused on four trends. The first is retail and market access, which is an important place in the ag value chain. The second is what we call high value inputs, an example being biological rather than synthetic crop protection. Third is services, an example being soil analysis labs. It could be physical services or it could be a digital service. Fourth would be emerging consumer foods. We invest in North and Latin America. Our core value is operational value creation, i.e., while we use leverage moderately, we're creating value by unplugging the growth levers of businesses, improving them, professionalizing them and making them ready for exit to a strategic buyer.

Levine: Ari, talk about how investors view you. Do a lot of your investors place RRG in their real assets bucket? And what kind of return profile are you looking to achieve for investors?

Swiller: When we got started, investors put us in the infrastructure bucket. But we didn't have contracted cash flow, so they moved us over to real estate because we were buying property with water. Real estate looked at us and weren't clear about what we do. So, we ended up in private equity. Now there's more interest in natural resources and there are natural resources buckets, some dedicated to agriculture and timber while some still include oil and gas. So, we have found each investor has a different sort of mandate. Typically, returns are in the high teens and we strive for a 2X exit.

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>
> *– Ari Swiller, Renewable Resources Group*

Levine: Eli, what about Aqua? You're more services oriented, so is that more of a fit for investors' private equity bucket?

Ziskind: We're definitely within the private equity bucket and we benchmark against private equity, which means 20 – 25 percent returns. We're trying to make more like 2 – 2.5X on average over three to five years.

Levine: From a diversification standpoint, do you see the trends within agriculture being correlated with other businesses or is it really a diversifier?

Ziskind: Ag is a huge industry, just as you described. It's probably one of the few industries that hasn't undergone full digitalization, which is where many of the opportunities lie. So, a lot of growth but also an inflation hedge and uncorrelated with many other industries.

Levine: Ari, what kind of addressable market do you see and how do you view the level of competition?

Swiller: Consumers are going to buy fresh produce. Over the last 20 years, the produce section of most grocery stores has seen an increase averaging 5 to 7 percent in terms of square footage. That trend tells you where the retailer wants to be. The trend for us is continued growth but it is a competitive landscape. Private investment accounts for about 3 percent of investment in the ag space. We are specialists, not generalists. We want to know the geography, what the crop type is, what the water situation is, the transportation, the processing, everything.

Levine: Eli, how do you characterize risk in the ag space and what can you do to mitigate it?

Ziskind: Commodity risk is a factor and we try to stay two iterations away from that risk. So, think about corn prices that go up and down. You have the farmer who is directly exposed. Then you have the trading companies. It still affects them, but not as much as the farmer. We don't like to invest in either. What we do like is someone selling seeds to that farmer, someone selling fertilizers, someone selling biological crop protection or providing services. There's still some impact but it is greatly smoothed. In addition, investing in both North and South America gives you some climate protection.

Levine: Ari, how about from the perspective of an operator that has more of that direct exposure. How do you account for something like weather in the risk around commodity prices.

Swiller: A lot of it is geographic diversity. We are in the Pacific Northwest, California, Latin American and Australia to mitigate for weather events.

Levine: Eli, what's your perspective on operator quality in terms of execution and success?

Ziskind: It's extremely important with ag, especially for us as we are focused on operational value creation. The ability to be an alpha operator versus a B or a C operator has a huge impact on return. Our key when we acquire new companies is to get the wrong people off the bus and the right people on. In many cases, that's 60, 70 percent of what we do.

Levine: Ag is one of the last industries to go through the level of innovation that we've seen in in other areas. What are some of the trends, Eli, that you're seeing in the implementation of technology?

Ziskind: To pick two trends that excite us I would first mention biologicals. Basically, this is the replacement of synthetic products, be they fertilizers, crop protection or other crop nutrition functions with compounds made out of biologics, which are basically fermented or generated through plant extract. This is a huge theme in our space and we have invested in five companies in this area. The second is what we call precision ag or digital ag and that is basically moving from farming whereby the farmer makes decisions based on gut feel and instead makes much more precise and automated decisions. We are still early in both of these developments.

The big headline with biologicals is decarbonization. It's using less carbon to produce inputs, be it fertilizer or crop protection. Equally important is the question of how the soil biome plays into this. Biologicals are about synergy with the soil—getting the soil to work for you and so you get healthier soils, reduced emissions and increased yield.

Latin America was a big beneficiary of biologicals. The North American farmer has the benefit of the North American winter. It kills everything. Latin America doesn't have that kind of winter so nothing really dies and the biome remains very active. As a result, the Latin American farmer has been quicker to adopt biologicals. But I think we'll start to see more of it in North America.

Levine: What's an example of a portfolio company in the biologicals space?

Ziskind: We essentially incubated a small company that had $5 million in sales. When we raised the hood, we found great technology that had been researched for years and was at the stage of market readiness. We just had to commercialize it. Another business had great go-to-market access and excellent research. We tripled R&D to expand the pipeline and within four or five years we grew it from about $5 million in sales to $100 million.

Levine: Let's shift to more water-focused investments. Ari, your firm originated around water so tell us about the circumstances around water currently and how they impact your investment decisions.

Swiller: To cite an example, farmers in California receive water two ways: through a canal stream or through the extraction of groundwater. What we've seen over the last 30 years is a trend away from row crops in the Central Valley to permanent plantings that need water every year. So, the demand on a diminishing resource increased as farmers started to extract more groundwater.

Through the Central Valley there are places where the soils have impacted and collapsed as much as 12 feet. It's not a sustainable model. So, the state stepped in with a regulatory regime called the Sustainable Ground Water Management Act, passed in 2014 and initially implemented in 2020. By the time of full implementation, you will only be able to extract as much water as you replace. What that did was create winners and losers within water districts because some districts have access to surface supply and groundwater while some are limited to groundwater. The areas that just have groundwater are going to decrease in value because access can't be sustained. But if we can deliver surface supply and make it available in an area that doesn't have it, we can bring back land that 10 years ago was worth $20,000 an acre but today is worth about $5,000. We can bring that value back because we can extract and deliver water 10 miles away under most circumstances.

Levine: Eli, are there ways that you are able to invest in companies that can use water more efficiently?

Ziskind: People tend to think about the key macro inputs for farmers as seed, fertilizers and crop protection. We're beginning to see water as the fourth input. The reason is climate change. You have less steady rainfall in the Midwest than in other places, meaning you cannot rely on weather and rain-fed land. Water is the one factor that can elevate your yield during the season, which is why we're seeing infrastructure opportunities the companies that, for example, provide irrigation management. And then related to that is water management, as water is a very expensive resource. For the farmer, the issue is doing more with less and that is giving rise to technologies like precision watering. Perhaps the most exciting of all, water is becoming a delivery mechanism for other inputs. Fertilizers and crop protection are being fed by the irrigation system, so the company that controls the irrigation system, in many cases, can control the other inputs.

Levine: What about the social tensions related to water? People expect a right to low-cost water while you are looking to generate a risk-adjusted financial return to your investors. How do you balance those various interests?

Swiller: We don't invest in the municipal water market for one thing and in the wider view the amount of water we're taking is minimal. We also try to demonstrate the benefit of storing water in the off-season and then making it available when it's needed. A larger problem is that since the 1980s California's population has doubled and we've seen vast acreage planted in almonds, pistachios and citrus but without the benefit of new infrastructure. So, we do not compete with municipal water buyers, and we are very conscious of serving as a reliable partner for the irrigation districts in which we work.

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>
> *– Eli Ziskind, Aqua Capital*

Levine: Transitioning from that to a broader ESG discussion, Ari you mentioned earlier your partnership with The Nature Conservancy. How do you interact with them and how do you incorporate ESG into what you do?

Swiller: We've done projects alongside The Nature Conservancy for the 20 years we've been investing in agricultural water resources in California. The Conservancy sits as a formal advisor to the fund but has no fiduciary responsibility. In order to create the partnership, we put part of our promote at risk so that if we didn't deliver impact as defined by each deal in a given region, we would have to write a check up to 20 percent out of our promote to buy some of the impact that we didn't deliver.

An example of what we've done is storing water for birds as they migrate from Latin America to Canada. The Central Valley used to be a great watershed for them to rest. But much of that watershed disappeared as agriculture increased. We're able to flood a field and over time we've learned that if we get the height right for the birds' legs it is a great resting place.

Levine: Eli, how do you integrate ESG into your process?

Ziskind: While we're not an impact fund per se, we do invest almost entirely in companies that are impact positive. We have an impact team that is integrated within our diligence from day one and they're part of our investment committee as well. In our quarterly review of portfolio companies one of the categories is ESG because at the end of the day a good catalyst for success in private equity is aligning interests.

Levine: Maybe just to wrap up, what excites you the most about agriculture and the investment opportunity moving forward? Eli, maybe you first.

Ziskind: I would say we see a breadth of new technologies coming into the space. While we don't like to take technology risk, we see a lot of technologies, and see an opportunity now for commercialization and pushing through commercialization of new technologies. I think that would generate a huge wave of new opportunities for us.

Swiller: I think there are two things for me. One, it's a very challenging market and every day more challenging. And so, trying to figure out how to sustain and continue to grow within that challenge. Two, as I touched on earlier, I think the talent coming into agriculture from different perspectives is going to make us successful. And it's just exciting to see more younger folks coming into this sector than when I started twenty years ago.

Levine: Thank you both very much. Hopefully, this has been insightful and helpful as institutions think about the agriculture space now and going forward.

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