STATE OF THE MARKET

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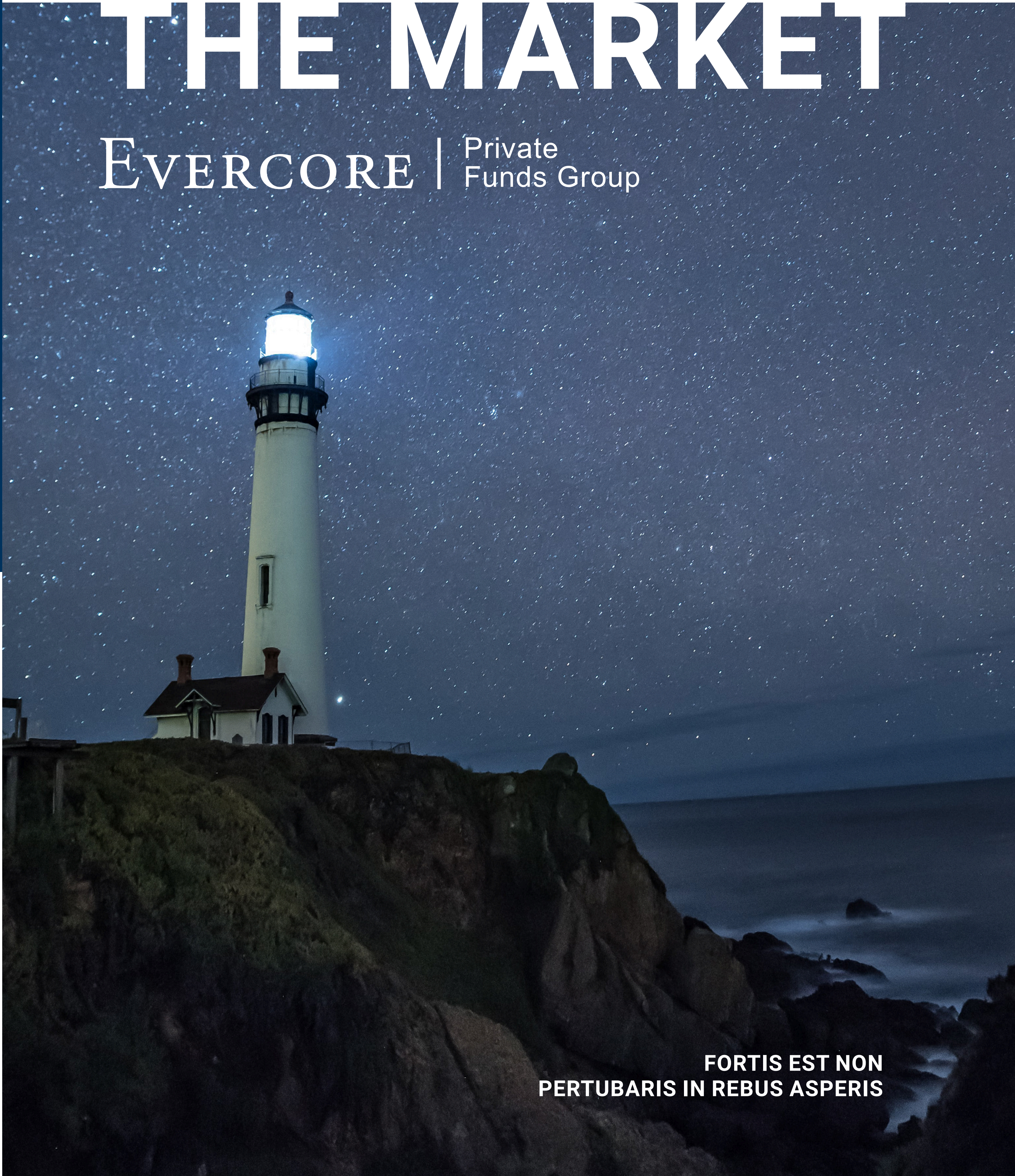

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Harvesting returns: The relationship between environmental sustainability and investing in farmland

BY DANIEL LITTLE AND GABE SANTOS, CEOS AND CO-FOUNDERS OF HOMESTEAD CAPITAL AND REVIVE AG, AND MARK LAMBERT, CEO OF REVIVE AG

Environmental sustainability is a growing area of focus in agriculture, driven by increasing awareness from consumers, investors, farmers and food companies. Smart farmland asset managers must determine how to increase their exposure to these themes. We believe that this exposure can create greater value, but scaling these strategies can present challenges requiring a new approach for institutional farmland asset managers and their investors.

Homestead Capital is a private equity firm that employs a value-add strategy to investing in United States farmland. We combine a strong local presence and top-down portfolio construction to help manage the risks inherent in farming, including weather variability, water availability, and commodity price volatility. We believe this approach positions us to deliver attractive, risk-adjusted returns to investors from the US farmland market.

Farmland is an attractive investment in a diversified portfolio. Historically, farmland has delivered robust returns across various economic environments, with total annual returns from income and price appreciation averaging 9.5% since 1960.[1] Moreover, farmland investments typically perform well during inflationary periods given the inherent tie between food prices — which generally increase with inflation — and revenue from crop sales. Lastly, farmland has low or negative correlation to most traditional asset classes and is a reliable store of value during periods of economic volatility, offering safe haven characteristics to investors.

Only about 3% of the 900 million acres of US farmland is institutionally owned and managed today. Institutional interest has grown rapidly over the past decade, with an estimated $8.7 billion in institutional funds focused on the asset class in the past five years.[2] However, the asset class is on the cusp of a significant transition, with the average age of the American farmer recently surpassing 58. Tens of millions of acres of US farmland are expected to change hands over the coming decade. Faced with rising interest rates, a tightening farm labour market, and changing consumer preferences, farmland owners will have an increasingly difficult decision to make: whether to invest the requisite capital to position their farms for the future, or sell their land. We believe this will create significant opportunities for institutional investors to increase their exposure to the farmland asset class in coming years.

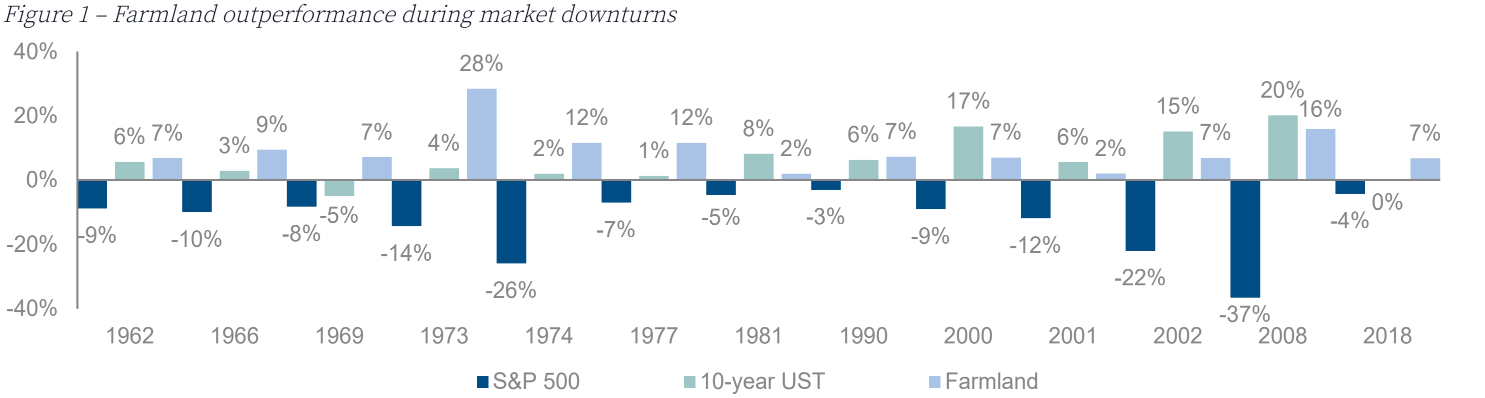
Environmental, social and governance (ESG) considerations are driving greater and greater investor interest, and scrutiny, in the farmland asset class. Much has been written about the growing investor demand for ESG-themed investments, and sustainable investing has rapidly moved from fringe to mainstream over the past decade. Capital allocations to sustainable investing topped $17 trillion in 2021,[3] and by some estimates will exceed $50 trillion — more than one-third of global AUM — by 2025.[4]

Several factors play into the increasing attention on the farmland asset class from ESG-oriented investors.

First is the recognition of agriculture's significant contribution to climate change — and its potential to mitigate it. It is estimated that more than one-third of global anthropogenic greenhouse gas emissions directly result from agricultural production and the food system.[5] But changes in farming practices have the potential to transform agriculture from net contributor to net mitigator of climate change. Certain 'climate-smart' farming practices have been proved to lower greenhouse gas emissions and remove atmospheric carbon by storing it within farm soils. Accordingly, investors that desire to create climate impact and reduce carbon emissions see significant potential to achieve these objectives via investments in sustainably managed farmland assets.

Second is the recognition of the risks that a changing climate poses to infrastructure and other real assets, in particular nature-based real assets like farmland. Increasing weather variability associated with a changing climate

Figure 1 – Farmland outperformance during market downturns



Source: S&P 500 and 10-yr US Treasury data obtained from the Federal Reserve database in St. Louis, as sourced via New York University Professor Damodaran. Farmland data through 1991 reflecting the total rate of return on farm assets as published by the USDA; subsequent data from NCREIF is expected to disproportionately impact the agricultural sector, limiting productive potential and impairing asset values. Indeed, climate-related challenges are already impacting consumer products: in 2022, extreme heat and drought led to shortages of Dijon mustard and the disappearance of sriracha hot sauce from shop shelves. These trends are motivating investors to pay closer scrutiny to climate-related risks and the steps being taken by real asset managers to adapt to these challenges. See, for example, Climate Action 100+, an investor-led initiative representing $68 trillion in assets and 700 investors working to ensure the world's largest corporate greenhouse gas (GHG) emitters take necessary action on climate change. The SEC is taking note as well, having proposed new climate disclosure rules in March that would require public companies to report climate-related impacts and risks to their businesses. If enacted, these would mandate the disclosure of supply chain, or 'Scope 3' emissions, if they are material investors. Critically, Scope 3 emissions include those associated with agricultural production for large food and beverage (F&B) companies.

The growing interest in agricultural sustainability extends well beyond the investment community. Consumers are demanding healthier food grown with greater transparency and lower environmental impact. Carbon labelling and sustainability certifications are creating opportunities for food companies to differentiate their products with consumers, and potentially secure price premiums. Many of these companies have committed to reduce their corporate carbon footprint or decarbonise their supply chains entirely through 'net zero' emissions pledges. Among them are multinational giants like Unilever, PepsiCo, and General Mills. And given that 90% or more of a F&B company's GHG emissions are produced in their upstream supply chains (which includes the production, processing, and transportation of crops), helping these farmer suppliers adapt will be critical if reduction targets are to be achieved. This creates opportunities for investors and asset managers that can influence production practices on their farmland assets.

As responsible stewards of a natural resource, Homestead Capital has always sought to integrate sustainability into our management philosophy. This has the added benefit of diversifying our exposure to various operating strategies. Thoughtful portfolio construction is vital to delivering superior risk-adjusted returns to farmland investors. Homestead takes a multi-faceted approach to portfolio construction, with diversification across 13 states and 17 crop types, and relationships with over 100 farmer tenants operating under a variety of lease structures. Sustainability-focused farming initiatives offer further opportunities for diversification. To date, this has involved conversion to certified organic production, restoration of wetlands to create saleable mitigation credits, and efficiency improvements in on-farm water and energy use.

More recently, we have augmented our roster of sustainability initiatives with 'climate-smart' farming practices, which can reduce carbon impact while improving profitability and long-term asset value. In addition, these practices boost the resilience of farmland by improving soil health and protecting farms from climate variability, water stress, and other natural risks. When used in concert with innovative technologies (such as low-emissions equipment or products that help reduce the use of fertilisers), we believe these practices can uniquely position Homestead to serve the growing investor, consumer, and corporate interest.

However, it can be challenging for Homestead, and by extension other institutional and non-institutional landowners, to identify tenants who are willing to or capable of employing climate-smart farming practices. This is in part due to the specialised knowledge and relationships that these crops and practices typically require. This has frustrated efforts by investors and asset managers to boost their exposure to climate-smart farming practices and achieve ESG or impact objectives. It has also prevented the supply of climate-smart crops from scaling at a pace commensurate with the growing demand from consumers and F&B companies.

In 2021, we founded Revive Agriculture to address this issue and help fill what we perceived to be an unmet need in agriculture — a national-scale farming company focused on implementing climate-smart farming practices and innovative technologies. As a tenant, Revive provides Homestead with greater exposure to climate-smart operations and more control over lease terms, types of crops grown, and farming practices employed.

Revive's services also include the collection and reporting of farm-level environmental impact data, which supports not only rigorous impact reporting to ESG-oriented investors but also unlocks an opportunity for carbon and other environmental credit sales. With the increasing focus on GHG reductions, the sale and trade of carbon credits has become big business — a record $1 billion of voluntary credits (that is, those outside of government-controlled carbon schemes) were transacted in 2021, with some projections suggesting a total market size of $30 billion by 2030.[6] Rises in GHG reduction commitments from global F&B companies, together with sharpening appetites for carbon credits from corporate buyers in other sectors, are creating significant demand for credits produced from agriculture.

We believe Revive can play a valuable role for landowners, including other institutional land managers, seeking to expand their exposure to climate-smart management. Given the shifting risk and opportunity landscape that natural real asset managers must contend with under a changing climate, such an approach may soon be relevant to more than just those who are seeking ESG exposure. What's smart for the climate today could well become what's smart for all investors tomorrow.

1. Reflects NCREIF farmland index data for all post 1992 data, USDA Farm Income and Wealth Statistics data for all pre-1992 data
2. Financial Times, Investors seeking inflation hedge snap up US farmland, 6 April 2022
3. US SIF, Report on US Sustainable and Impact Investing Trends 2020
4. Bloomberg, ESG assets may hit $53 trillion by 2025, a third of global AUM, 23 February 2021
5.M. Crippa, E. Solazzo, D. Guizzardi, F. Monforti-Ferrario, F.N. Tubiello, A. Leip, Food systems are responsible for a third of global anthropogenic GHG emissions, Nature Food, 2 (2021), pp. 198–209
6. McKinsey & Company, A blueprint for scaling voluntary carbon markets to meet the climate challenge, 29 January 2021

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Mark Lambert is CEO of Revive Ag. *He has over 15 years of experience working at the intersection of finance and sustainable agriculture. Mark was formerly VP at Quantified Ventures and the Co-Founder of the Soil and Water Outcomes Fund. He holds a B.A. from the University of California, Berkeley.*