AGRICULTURE – A CYCLICAL INVESTMENT OPPORTUNITY

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Agriculture as a sector is largely uncorrelated to, and unaffected by, COVID-19. There have been other pressures, notably the severe drought on Australia's east coast. As many companies started to feel the impact of the drought, the share prices fell to levels well below our assessment of fair value.

For cyclical sectors, such as agriculture, we believe the best way to value companies is to consider the normalised "through the cycle" cash earnings, an approach that's not unique. We overlay this with another analytic approach to investing in cyclical companies, namely, a focus on investor emotion and the prolific short-termism affecting markets.

Investor behaviour

Within agricultural companies, rainfall is one of the main earnings drivers. This determines the price and availability of water, the volume of wheat cultivated, the volume of milk produced and the yield of different crops. This cycle is completely independent of the economic cycle, which is one of the attractions of the sector.

We believe the best opportunity to buy agricultural companies comes about during periods of drought when company earnings and share prices come under pressure. Investors typically get overly pessimistic during drought periods and overly optimistic when conditions are good.

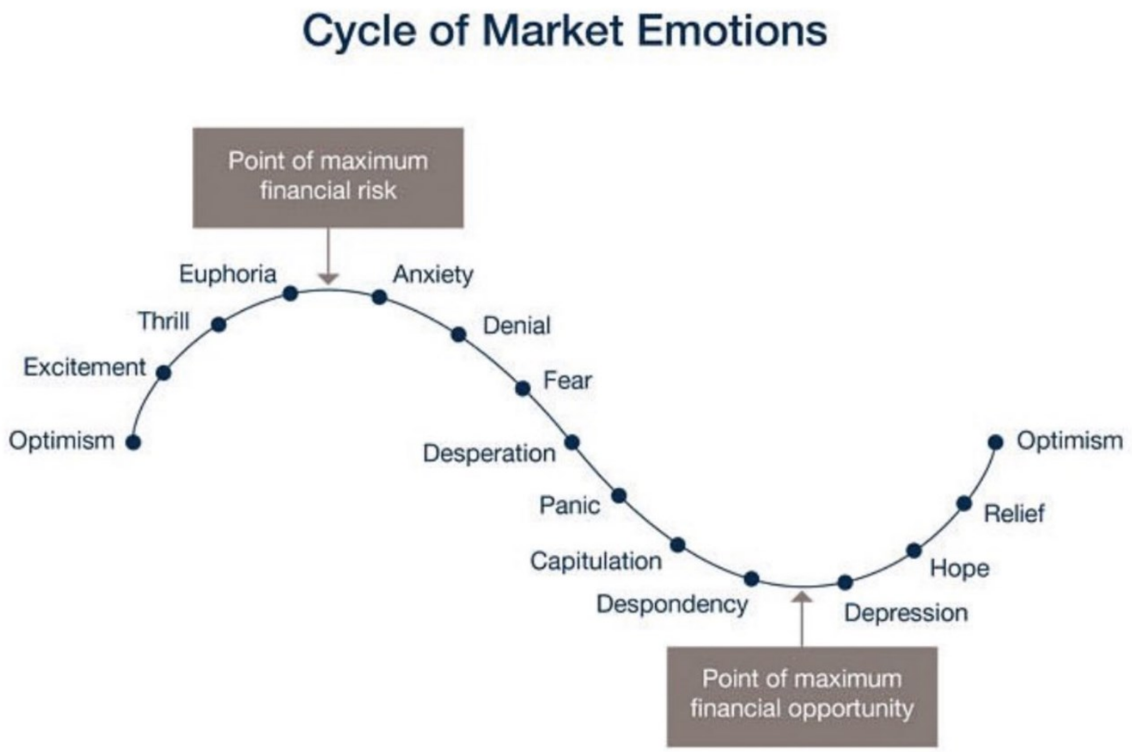

Figure one: Cycle of market emotions

Source: Forexlive

Figure one is often used to reflect the market's psychology towards investing in cyclical companies. We believe this is particularly relevant when investing in agriculture and accurately depicts why we are able to buy companies during droughts well below intrinsic value, and sell them during good times well above intrinsic value.

Investment horizon

We have observed the broader market being intently focused on buying companies that have near term earnings certainty, or those expected to beat expectations at the next result. Agriculture, however, requires a medium-term investment horizon.

When we invest in agriculture, we're not trying to predict the weather; rather we're making a call that, at some point in the future, the drought will break. Many in the market would struggle with this, they need a catalyst to invest.

In our view, trying to time the bottom of any cycle is a fool's game. As long as we believe there is material upside, the exact timing is not important. For example, even in late 2019 we did not know that 2020 would see significant rainfall. We could have been holding agricultural positions for a few years before there was any change to the seasonal conditions and earnings recovered. The uncertain time horizon in a thesis playing out is not attractive to some investors, but creates opportunities for others.

The shift away from active management

There's been extraordinary growth in quantitative, momentum and passive money flowing into markets in recent years.

The quant money reacts to sell side earnings changes and as such, when there are earnings downgrades, these funds will sell. Conversely, when conditions are good and earnings are growing, these funds buy. These funds are heavily dependent on analysts, who have been shown to halve or double valuations over a twelve-month period. This pro-cyclical investing adds selling volume when conditions are poor and buying volume when conditions are good, again creating opportunities for fundamental investors.

Case study: Bega Cheese (ASX:BGA)

Due to the lack of east coast rainfall, pasture growth on dairy farms deteriorated significantly over past few years, resulting in dairy farmers being more reliant on buying water and feed grain. With the higher cost of water, hay and feed, dairy farms faced a significant increase in on-farm costs, which impacted profitability.

As a result, due to lower on-farm productivity and dairy farmers leaving the industry, total milk volumes in Australia in 2018-2019 were down 5.7%. The reduced milk supply resulted in increasing competition for milk from processors, putting pressure on BGA's direct milk intake and margins.

As the seasonal conditions have improved over the last few months, the market has begun to price in a more favourable outlook, with agricultural share prices outperforming the broader market. Since the start of the calendar year, the ASX 300 is down 20%, while BGA is up 32%. Despite its outperformance, we believe BGA continues to trade below its intrinsic value at current prices and, given the lack of correlation to the COVID-19, remains an attractive investment.

While investor sentiment towards agricultural stocks has started to improve, we are yet to see earnings upgrades, or the better rainfall conditions flow through to a better cropping outcome, which we believe will result in further share price support. If conditions to continue to be favourable, the stocks in our portfolio will benefit from the opposite effect of the impacts we saw during the drought, with all likely to see an earnings benefit.

Just as we looked to mid-cycle earnings during the drought, we will remain disciplined. Should the share price of our agricultural holdings move above our fair value, no matter how good the seasonal conditions, we will reduce our holdings and take advantage of other opportunities arising as a result of the broader market sell-down.

Find out more about the performance, strategy and holdings of the Perpetual Share-Plus Long-Short Fund.

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Visit our COVID-19 Insights Hub for economic and market updates to keep you informed as the situation evolves.