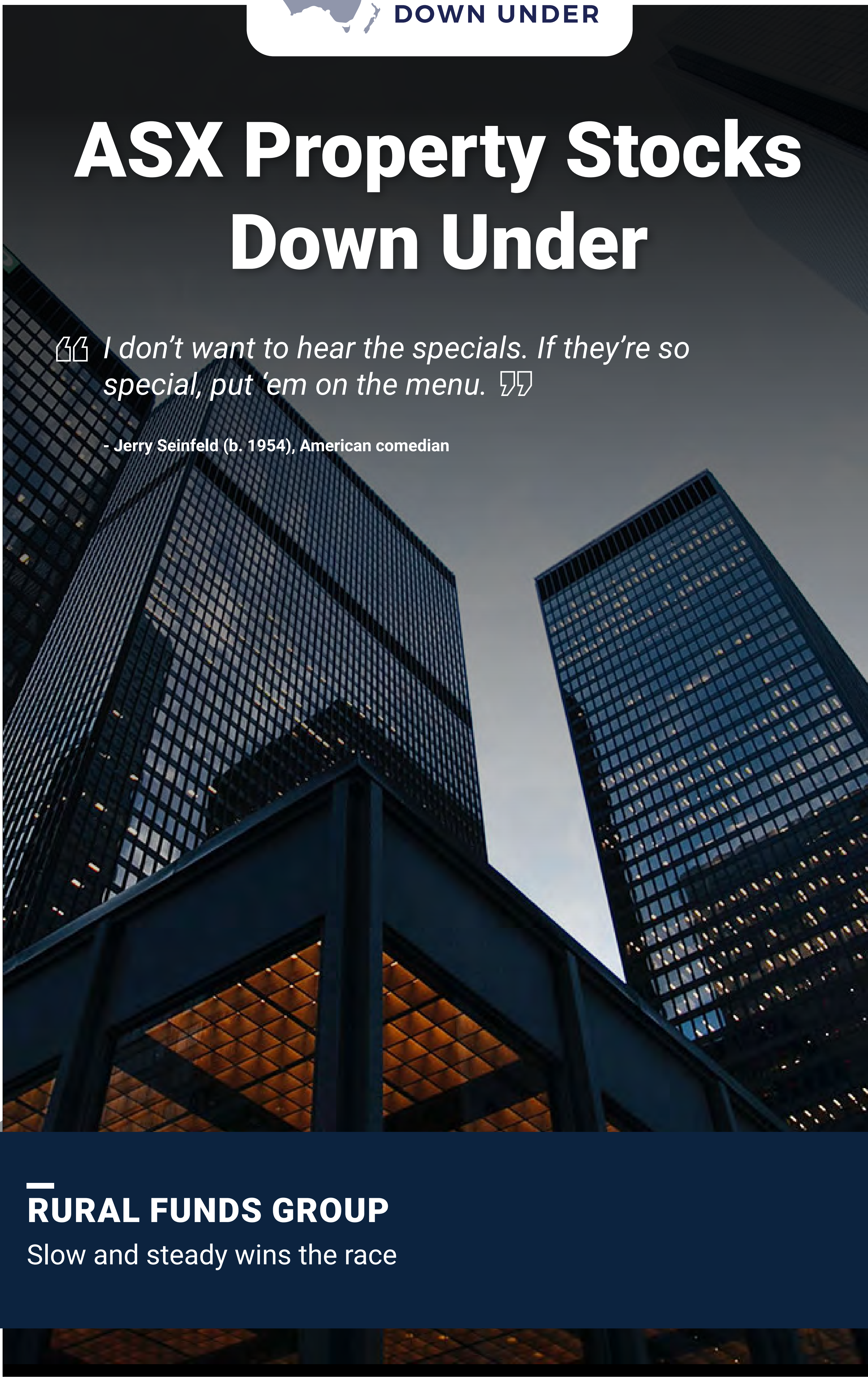
STOCKS DOWN UNDER

10 AUG 2022



ASX Property Stocks Down Under

> *I don't want to hear the specials. If they're so special, put 'em on the menu.*
>
> **- Jerry Seinfeld (b. 1954), American comedian**

RURAL FUNDS GROUP

Slow and steady wins the race

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Stocks Down Under rating: ★★★★

ASX: RFF
Market cap: A$1BN

52-week range: A$2.47 / A$3.22
Share price: A$2.73

Rural Funds Group (ASX: RFF) is one of the few ASX REITs offering exposure to the agriculture sector. The agriculture and property sectors can both be volatile in short-term horizons, but RFF has avoided the volatility and has a market capitalisation of over $1bn - nearly triple that what it listed at in 2014.

Share price chart

Source: Tradingview

Another agriculture performer

As we've observed a number of times this year, companies in the agriculture sector have held up well relative to the broader market. This followed a rough decade for the sector, culminating in the bushfires of 2019-20. Companies such as GrainCorp (ASX: GNC) and Elders (ASX: ELD) have outperformed the broader indices, all thanks to solid agricultural conditions. Some companies have nonetheless been inhibited, particularly those with exposure to China because of tariffs, as well as those solely with exposure to one segment.

RFF, however, has been a solid performer. In the last 12 months it has gained 8% while the ASX 200 A-REIT Index has shed 6%. It also successfully survived an attack from short-seller Bonitas in 2019. Bonitas claimed the company had grossly overstated the value of its assets, but RFF didn't just rebut their claims, but sued the short seller in court and successfully obtained a judgement that Bonitas' claims were false and misleading.

A record of growth, but not the greatest diversity

As you might have observed, we at Stocks Down Under are fan of companies with long term records of growth and RFF is one of them. As we mentioned above, it listed in 2014 and has nearly tripled since then. It has an even longer history as a private company, having been founded in 1997. Today, RFF has a $1.3bn portfolio of 69 Australian agricultural assets, split across 5 states, and aims to generate earnings and income growth through productivity improvements and conversion of assets to higher and better use. It targets distribution growth of 4% per annum and has delivered this in spades.

Looking to its revenues, as at 31 December 2021, it generated 42% of income from cattle, 40% from almonds, 10% from cropping, 6% from vineyards and 2% from macadamias. 78% of land is leased to listed companies and corporates, two examples being fellow ASX listees Select Harvests (ASX: SHV) and Treasury Wine Estates (ASX: TWE). The balance shared by private farming businesses, investment funds and farming leases. It may not have substantial diversity in respect of asset sectors and land tenants, but it does have diversity in climatic zones and specific asset types. The former reduces the likelihood of adverse weather events, particularly drought, impacting all the relevant agricultural prices. Although its assets are mostly on the East coast, these are evenly spread along the coast. This is a key reason why RFF has not been as impacted as many of its peers have.

Trading at a higher multiple, but we think it's worth it

For the upcoming reporting season, RFF gave FY22 distribution guidance of 11.73c per unit from Funds from Operations (FFO) of 11.9c per security. This will represent a yield of roughly 4% and distribution growth of just under 4%, although FFO would be in line with FY21.

Looking to FY23, the company anticipates 12.2c distributions per unit, inclusive of franking credits. If we assume FFO for FY23 will be 1.4% higher than that, as RFF has guided for FY22, that equates to FFO of 12.37c which gives it a P/FFO ratio of 22x. This is on the higher side among ASX REITs and this will likely only increase when the company delivers its results. RFF has told shareholders its total assets are expected to increase by $118m at annual results time. It has a pro forma balance sheet capacity of up to $185m to fund additional acquisitions and macadamia orchard developments.

Although its share price appears to be in an uptrend, the broader ASX REIT sector remains significantly underwater as investors consider what a cooling property market and rising inflation will mean. Investors in RFF also have to consider agricultural commodity prices and how these might be impacted by inflation. It is possible that agricultural prices get hit by inflation, but for agriculture REITs like RFF, property values will be more important.

RFF has admitted to shareholders that, with 42% of its debt hedged, each 1% rise in interest rates would increase expenses by $2.5m per annum. But it can offset this from increases in rental income. 44% of leases are indexed to inflation and 34% have fixed annual increases. We also observe that the company has been resilient to commodity price decreases. Even though almond prices have reflected an industry oversupply, its almond orchard values are up 22% in 7 years. Admittedly, this growth has been less than the growth value of its cattle assets and water license values, which have both gained over 90% in the same time frame.

We also like the ESG element to RFF. The agricultural sector may not appear an ESG friendly sector because it is a significant greenhouse gas emitter. But many tenants of its lands are undertaking sustainability initiatives, including using renewable energy and the use of methane reduction technologies, such as feed additives. Assuming that RFF can meet its FY23 guidance and that it can continue to grow property values no matter what commodity prices do, we think RFF deserves four stars.

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