



AG Chat

Episode Four, Part Two

Guest: George Rohr, NCH Capital

George, when we left off, we were discussing models for acquiring and operationalizing farmland in the Ukraine and Russia, in particular.

I want to move to transportation and infrastructure, both of which are, obviously, critically important considerations for agribusiness investment.

If we use Russia and Ukraine as examples—because they are your largest investment target regions at this point—what kind of issues does a prospective investor face in relation to transportation and infrastructure in those areas? I’m sure that there are a number of people out there who have some, perhaps, misconceptions about the state of infrastructure in Eastern Europe, in general.

George: Absolutely. Well, let’s start with storage as a key component of infrastructure. We have been careful to—and we continue to do so on an ongoing basis—to locate our farms in territory where we do have access to pre-existing storage facilities that we can upgrade, as opposed to building from scratch. In certain situations, we will build greenfield in order to accommodate our needs.

When you talk about misconceptions, the fact is that the Soviet system did have a very good network of storage facilities that the State had put in

place, as well as a rail transport network down to the Black Sea, both in Russia and in Ukraine. That remains and it remains accessible to farmers.

That said, the farmland mass and the land bank in both countries is so vast that not all of it has proper access to infrastructure. So, the governments in both Russia and Ukraine have a very active policy to upgrade the overlying infrastructure for both road and rail in order to expand the transportation capacity to encourage grain exports.

Now, you have to understand that for both governments, this is a hugely important equation. If you go from slightly negative on your agricultural trade balance—or even significantly negative in your agricultural trade balance, which is where both countries started—to even slightly positive, that means massive increases in foreign currency reserves.

So, you are going to see increasingly a diversification in both countries away from natural gas and oil and other harder natural resources as a source of foreign revenue toward agricultural commodities. This sector really is the sleeping giant for both countries. So, there are very, very direct and profound incentives for the government to really implement these policies to continue to develop the infrastructure.

For us, it also represents an opportunity because we opportunistically will buy existing storage capacity that perhaps is not up to the kind of quality standard that we would want, make the investment in that facility to bring it up to standard and then run those storage facilities for third-party farmers. That, in itself, is an extremely attractive business, as well.

So, as you mentioned earlier, the need and the opportunity for capital investment, not just in Russia and Ukraine, but Eastern Europe in general, is obviously quite massive. But as I understand it the international investment community has—particularly in the West—been slow to throw in here. Why is this, do you think?

George: Well, I think that ever since the Soviet Union fell in 1991 there has been a disconnect between perception and reality, primarily in the Western press about the things all of us care about as investors in any part of the

world when it comes to Russia. Things like the rule of law, property rights, minority shareholder rights, transparency, corporate governance, all of the things that need to be working properly in any environment for there to be a sustainable investment climate.

What a lot of folks forget is this whole fascinating story really is only 20 years old. That's an instant in the sweep of history. We are in our third century here in the United States in terms of developing all those systems and establishing them.

Russia, the whole region really, the whole former Soviet Union, has gone through a phase of shock therapy where the former order collapsed. In very short order they needed to establish and implement new structures and new systems and an entirely new way of life and an entire new legal infrastructure and so forth. So, of course, it's imperfect. But, it is far less imperfect than the Western press would have you believe.

I think that probably for the purposes of a conversation like this, it's useful to use some shorthand. In America, we like to rate things on a scale from 1-10. So, if we were to take that scale and, say, on criteria like the fairness of the courts and the functioning of the justice system, ownership rights, minority shareholder rights, etc.—all the things that we mentioned earlier that matter so much—we would rate the US a ten. Maybe not. Maybe we used to rate the US a ten (laugh). So, maybe our Canadian friends are a ten or the Germans are a ten, whichever country you want to rate as a ten.

What's interesting to me is that over the last ten years, international investors who look at emerging markets and would look at countries like Poland and Hungary and the Czech Republic, countries in Eastern Europe that have done a great job in terms of their economic reform and privatization processes that have joined the European Union, interestingly, investors would give those Governments and those economies an eight or an 8.5 on a scale of 1-10. I don't argue with that. I think that's a reasonable rating. Of course, pricing reflects that, right? Pricing of assets, including in the agribusiness space, reflects that high rating.

What's peculiar is those same investors, when it comes to Russia, would say that after the Russian debt crisis of 1998, Russia was a zero on a scale of 1-10, which was unfair. That's an unfair rating. But now, maybe as a result of some progress that the government under the leadership of Mr. Putin has been successful in implementing, maybe it's a two on a scale of 1-10, which is much better than the zero that they gave them in '98.

But, in fact, it's not a two. It's a five or maybe even a six and it's stumbling steadily toward the same rating that you would give the rest of Central and Eastern Europe at this stage. *But, because of this misconception, assets are priced like a one or a two.* That's where the opportunity is. You have assets and a system that's making tremendous progress that are significantly underpriced and where the shortage of capital provides those investors willing to make long-term investments and to be patient and to deploy their expertise and their management, those investors will be rewarded.

It's because of that disconnect that it's a good news/bad news proposition. It's bad news because countries have had trouble attracting capital as a result. You compare foreign direct investment into Brazil or China or India to FDI that has gone into Russia, for example, and it dwarfs the amount of capital that has been attracted into Russia. That's simply not fair given both the progress that the country has made both macro-economically and in terms of its legislative infrastructure and in terms of the scale of opportunity.

So, let's say that if we were to take perception vs. reality aside, if we were to take the inaccuracies and misconceptions that you've just outlined with regard to Russia and Ukraine, for example, as fact, this is still a very attractive space. Am I wrong?

George: This is still a very attractive space. We had this discussion with one of our institutional investors not long ago who was a great and enthusiastic investor with us in Russia and in Ukraine. His point to me was: "Look, if I was to believe the *New York Times*' version of the state of play in both Russia and Ukraine, which is very often a very negative one. Supposing I was to take that as gospel and that what the *New York Times* writes is always 100% accurate and that they never make mistakes..." I'm picking on

the *New York Times* unfairly, but let's take them as a proxy for much of the Western press in general. If we were to take that presentation lock, stock and barrel and believe that that's, in fact, an accurate portrayal of the situation and the opportunity there and of the challenges there, is this still, therefore, in that context, an attractive investment opportunity? The answer is absolutely yes.

Of course, our view is that those perceptions are not correct and that, in fact, the real picture is far, far better. It's not yet what you'd like it to be, of course. I should stress this is not yet the US or Canada or even some of the more developed emerging markets in terms of the legal infrastructure, but it is far, far, far better than the Western press would have you believe so that, therefore, it goes from being, in our view, a very attractive investment opportunity to an extraordinarily unique and really historic investment opportunity.

So, for example, you mentioned that currently, perhaps the press or general perception would rate a two vs. the reality of a five. So, why is a two still attractive there?

George: A two is only attractive...

If it were accurate, which you contend it's not.

George: Well, two is attractive, but what's attractive about it is the reality is a five, but the pricing is that of a two. So, to use shorthand again, you are buying a five for the price of a two. And that's really where the opportunity lies.

Now, to be fair, the legal infrastructure and the court systems, obviously they still have a long way to go. There's no getting away from that. It will be far, far better even two years from now than it is now because it's far better now than it was two years ago. But, as perception starts to match reality, obviously pricing is going to catch up with that. In the next five to ten years, you simply won't be able to make these investments at these valuations anymore because things will be "normal" in that part of the world from that perspective.

Given everything you've told us, what would you say are the general advantages to investing in agribusiness in Eastern Europe compared to, let's say, one, developed markets and two, let's say emerging markets, some of the other BRICs that you mentioned.

George: Well, in the case of the advantages to developed markets, obviously your cost basis is a fraction of what it would be in Iowa or in Nebraska or anywhere in Western Europe. That's really the main advantage. In a case of a comparison with other emerging markets, take for example Brazil, which is a giant not only potential actual global participant in agribusiness markets and in the fullness of time will continue to expand its presence. They are plagued with enormous infrastructure problems. They've got inland tremendous agricultural wealth, but it doesn't take much Googling for you to find the extraordinary level of bottleneck that's going on in getting your goods to market. So, infrastructure remains for Brazil and other emerging markets a huge, huge, huge problem. Until those are resolved, it will present enormous challenges for investors in the agribusiness space there. So, our markets in accessing the Black Sea, given the existing infrastructure which, while not perfect, gives us far more convenient access to world markets.

They certainly have great ports.

George: That's exactly right.

Is currency an issue?

George: It hasn't been. Obviously, currencies are very volatile. But, if the question is getting your money out of those countries, convertibility of currency and so forth, has that ever been an issue? It has never been an issue for us. It wasn't even a challenge during the very, very difficult crisis of 1998 when under Yeltsin the Russian Government defaulted on its debt. That really roiled the economies of all the countries in the former Soviet Union. Even then, which was the moment of maximum stress, there was no issue with respect to currency convertibility.

In terms of the volatility and the value of currencies, that you're going to have in any international market. The ruble has done extremely well against the US dollar in the last few years. The Ukrainian currency, as well. So, we feel pretty sanguine on that score.

When we look at...First of all, the quality of the actual farmland itself certainly ranks among the best in the world. We've looked at infrastructure. We've looked at some perhaps misperceptions about the willingness of these governments to attract and support international investment. Currency, legal, political. It seems to me that based on everything that you've outlined for us—and I think this is the most salient point that you made earlier—the opportunity cost currently of not deploying capital in Russia and Ukraine far outweighs the risk. Would that be a safe statement for me to make?

George: I think that's right. Absolutely. I think maybe another useful metaphor as you and our listeners think about this market is that I mentioned earlier that the development and restructuring of the farming and farmland sector in both countries—which historically were breadbaskets to Europe, to the world and so forth—they are now in the early stages of regaining that status. It is very early on. If we think of the opportunity and the valuations associated with the opportunity, you have to know that there are great returns to be made from riding the elevator from the fourth subbasement to the ground floor, right? That's where we are now. We're somewhere just off the fourth subbasement on our way to the ground floor. By the time valuations and the state-of-the-art and the level of operating efficiencies of these farms get to what you might call the ground floor in the West, there are many, many folks who will be attracted to this part of the world because it will be considered mainstream. So, the great opportunities are when it's not yet considered mainstream.

George, I think you've just schooled all of us in a course I'll call: "Investing in Eastern Europe, Russia, Ukraine 101" with a Masters and a PhD bent to it. This is absolutely invaluable information and I think probably for those listening, fairly eye-opening.

On that note, I want to thank you very much for joining us.

This concludes this two-part episode of “AG Chat”.

For more insight on investment trends in agribusiness along the lines of those that George Rohr has so generously outlined for us, be sure to join us at the AG 2.0 Global Investment Conference in Toronto, Canada November 7-8.

For more information or to register, please visit www.ibclifesciences.com/globalaginvesting.

And for those who might be thirsty for insights on the future of the water industry, please keep in mind that AG 2.0 will be immediately followed by the Water 2.0 Investment Summit at the same location on November 9.

Until next time, I’m Marc Dresner. Thanks for tuning in!