

# SWISS HEDGE

4<sup>th</sup> Quarter 2007

A Review on Developments in the Hedge Fund Market



Picture: Christian Forrer

## Long/Short Equity

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## How to gain exposure to agriculture?

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By: Victor Badin and Alexis Dawance | Global-Cap

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**The recent rally in soft commodity prices has brought a lot of attention to the agricultural sector. The rapid expansion of the Brazilian, Russian, Indian and Chinese economies or «BRICs», and the emergence of crops as a source of biofuels, has contributed to the soft commodity inflation experienced over the past few years. This marks the beginning of a long-term trend in the agricultural sector which will offer opportunities both on the long and short side as cycles develop. Investing in agriculture equities is difficult given the small sizes and the geographic dissemination of the companies but will prove to be much more efficient than futures. This article describes the opportunities of investing in this theme with a long/short strategy, what it entails, why timing is good and what the risks are.**

### **Soft commodities and agriculture**

The theme of investing in commodities emerged a while back and today most funds offering exposure to this sector are investing exclusively in commodity futures. The problem is that futures offer exposure to price increases only. After a long underinvestment period in agriculture, it is wiser to get exposure to the beneficiaries of this future investment boom. Unlike futures, equities will benefit from capital inflows and from volume increases in production volumes increases.

Investing in agricultural equities is similar to investing in a coal mine rather than buying coal futures. It offers a leverage play on the underlying commodity's price and a further upside if prices remain flat but volumes improve. This is an important difference. Investing in the futures only exposes the investor to price movements, not volumes. For the past 50 years, the performance of soft commodities has lagged financial assets as well as hard commodities such as oil or gold. Part of the reason is that agricultural yields have increased in line with the rising demand. This has allowed to keep agricultural soft

commodity prices low. Soft commodities are being increasingly solicited in order to feed the BRICs and produce biofuels which will probably mean that the next 50 years will be different.

### The equity universe

It is difficult to get exposure to agricultural equities. Part of the problem is that agriculture encompasses a vast number of sub-sectors such as equipment manufacturers, seed producers, poultry farms, cattle farms, irrigation, plantations, food processors, logistics and biotechnologies, just to name a few. There are close to 2,000 companies with exposure to this segment and only 10% of those companies have a market cap of more than USD1b. The majority are small or micro caps which also means that they are less covered by the research community. More than half of the universe is located in the emerging markets. The following table depicts the investable agriculture universe.

**Table 1 | Agricultural related stocks worldwide**

Market Cap Range	Description	Companies	As a % of total Market Cap
0 - 10	Penny	668	32.5%
10 - 250	Micro Cap	702	34.1%
250 - 1,000	Small Cap	428	20.8%
1,000 - 5,000	Mid Cap	207	10.1%
5,000 - 100,000	Large Cap	51.5%	2.5%
100,000 +	Mega Cap	1	0.0%
<b>Total</b>	<b>N/A</b>	<b>2,057</b>	<b>100.0%</b>

Source: Global-Cap Research, August 2007

### Supply dynamics

The availability of arable land is falling as a result of climate change, water shortage and urbanization. Water reserves per capita have fallen by 30% in the US since the 1970's and almost 50% in China as a result of pollution, declining groundwater levels and defective water infrastructures.

The amount of arable land per capita has declined from 1 hectare per capita in 1960 to 0.6 hectares in 2005 in the US. In India there are currently only 0.2 hectares per capita of arable land. Brazil has the largest stock of available arable land with close to 100m hectares. The particular favourable climate in this region for agricultural operations places it as a key player in tomorrow's agricultural landscape.

Climate change and global warming will have a negative impact on food supplies in the future. They will cause more frequent and extreme weather events such as tropical storms and cyclones, an increased risk of drought and

more violent precipitations with more extreme heat waves. This is reducing the amount of available arable land and also destroying harvests which can result in temporary supply shocks of a particular commodity.

Technology has helped to revolutionize agriculture, mainly in the developed world. Wheat yields in France are almost 4 times higher than in India and twice what they are in China. Mechanization, irrigation, fertilizers and better seed technologies have largely been the cause of this yield improvement. Emerging economies will need to close the yield gap between them and the West which will require large investments in tractors, fertilizers and better seeds.

### Demand dynamics

Population growth, rising income in Asia and the popularity of biofuels are the main drivers of demand for soft commodities. Global population will expand to 9.3b people by 2050 from 6.3 billion in 2004 which equates to an additional 80m individuals each year. This is mainly driven by the population boom in the BRICs and will create tremendous pressure on precious resources such as arable land, water, energy and biological assets to feed the population.

Evidence suggests that when individuals become wealthier diets evolve towards a higher protein content. China's rapid growth is resulting in higher incomes which is influencing eating habits and over time, the Chinese people will eat more proteins. In absolute terms, the current income per capita remains low but the growth rate of income levels is high in developing countries. Since 1990, the Chinese average protein consumption per day has grown at an annual rate of 14%. It still lags the average US consumer by 80% in absolute terms but this gap will close.

Global meat production increased more than fivefold since 1950 and more than doubled since the 1970's. Beef, however, has the weakest feed conversion ratio (8.3) which is the amount of resources or feedstuffs used to generate one unit of protein or beef. At 8.3, it means that it «costs» 8.3 units of protein equivalent to produce 1 unit of beef. For salmon, the feed conversion ratio is the highest in the protein world with a ratio of 1.2. Ultimately this means that producing meat is a costly operation from a resource standpoint which will further exacerbate the shortage problem.

Higher oil prices and a need for countries to gain their independence to oil has motivated some politicians to introduce a mandatory blending of biofuels such as ethanol and biodiesel. This means that an increasing amount of

food is diverted away from the food cycle and into energy consumption. Brazil has almost 50% of its cars running on pure ethanol produced from sugar cane. In the US sugar cane cannot be grown due to climate constraints so corn has been used instead to produce corn-based ethanol which is uneconomical without state subsidies.

### **Sub-sector dynamics**

One of the key sub-sectors in agriculture and possibly the only protection for global food shortages is fertilizers. Corn yields need to expand by three times in order to meet tomorrow's demand. China uses twice as much fertilizer as the US which is already making China a net importer of potash. Ethanol and other biofuels are made from crops that require intensive amounts of potash. For example, sugar cane used in ethanol requires four times as much potash as soybeans. The 100% surge in potash prices since 2002 is a reflection of the increase in production of soft commodities.

Almost all the food produced today is the result of scientific and genetic engineering. Genetically modified crops have allowed land to produce an increasing amount of food with the same amount of land. In the US, hectares of genetically modified crops have doubled since the turn of the century and continues to be far ahead of the rest of the world in terms of adoption rate. Despite the risks highlighted by certain scientific research of using exclusively GM crops, this trend will have to continue because there will be few alternatives to produce tomorrow's food needs without GM crops. Not all agricultural sub-sectors are exposed to GM crops or fertilizers. Fisheries is a good example. The global demand for seafood is growing at approximately 8-10% per annum but pelagic fishing has reached its maximum sustainable level, limited by natural stock levels. Sustainable fish farms are the answer which means that in the future fish farming will not only be used to breed salmon and trout but also other species which today cannot be bred in captivity. Fish feed is comprised of fish oil and fish meals which are produced from wild catch. Feeding fish to fish is the only source of breeding fish. Technological improvements will eventually allow this to evolve reducing the strain on wild fish reserves but currently nobody knows how or when this will occur. At current production levels, global production utilizes some 80% of the licensed capacity. The remaining 20% are uneconomical to exploit. Canada, the UK and Norway

have clearly stated that they would not release additional licenses until 2009 which means that salmon prices will need to increase significantly to make the remaining licenses economically attractive to operate.

### **Shorting opportunities**

The sector will arguably offer significant upside on the long side but short selling may also be profitable. Developing a detailed knowledge of the sub-sectors creates opportunities and turning points in some sectors may be easier to identify. Some companies will be particularly exposed to certain soft commodity prices which may decline as a result of substitution, over-supply or demand shocks. One example is the mad cow disease which has resulted in certain countries imposing bans on meat imports from regions affected by the mad cow disease such as the UK. Feed suppliers to the mad cow infested regions would also see a decline in their sales.

In-depth knowledge of the sub-sectors and the companies will allow for divergence in the pricing to be discovered and exploited. These dislocations in valuations may be the result of over bullish expectations on certain companies which will give rise to short selling opportunities. Good knowledge of the food supply chain is crucial as upstream players will see their margins fluctuate differently than downstream players across cycles. As soft commodity prices increase upstream players will most likely benefit the most from the leverage effect of fixed input costs (labour) and higher average selling prices. For downstream players such as food processors or distributors, margins will tend to compress when soft commodity prices increase since their procurement costs increase but passing this on to retailers is difficult or often comes at the expense of volumes. For instance, feed prices have increased which is affecting margins of poultry farmers. If this is not offset by an increase in volumes (very likely given the growing protein diet) it could affect the performance of these companies over the next quarters until retailers or consumers take on this additional price increase.

As competition intensifies, countries will specialize and emerge as low cost producers of a particular soft commodity. Labour intensive operations will gradually move to countries where labour costs are low and capital intensive operations will move to countries where capital is more readily available. These shifts can take time but are in some instances almost inevitable. Whether US ethanol producers will go out of business is unlikely but the arbi-

trage with Brazilian producers is interesting. In Europe, farming would largely be unprofitable if it was not subsidized. The sugar refiners, for instance, are suffering from over-capacity. Refineries are closing down but ten years ago they were very profitable businesses. This is an example of an industry that has created excess capacity and destroyed itself. In the future it is very likely that other sub-sectors in the food value chain will experience similar trends.

### **Shorting also enables the investor to hedge against certain risks**

Clearly, there are risks inherent to the strategy such as the emergence of trade barriers, climate shocks, health scares or technological breakthroughs. Commodity futures offer a good way of hedging against adverse commodity prices but will prove to be quite inefficient to hedge political risks or the risk of investing in smaller companies.

Since the vast majority of this sector is either a small or micro caps, it carries an additional layer of risk which demands different skills and experiences. These small companies are often neglected by Wall Street. Many small companies in the agriculture segment are not covered by the research community which complicates the due diligence exercise. The skills required to complete this due diligence are important. Meeting with management on more regular occasions and carrying out site visits more frequently than when investing in larger companies is an example.

Small and micro cap companies are volatile and the low liquidity that characterizes this segment is an important risk to bear in mind. It means that investors will need to take a longer term horizon on their investment but will get rewarded for it. Managing a portfolio in this space will also need to mitigate the liquidity risk by sometimes taking a basket approach in order to gain exposure to a specific sub-sector.

### **A good hedge to inflation...and a weaker dollar**

Energy is an important input cost to agricultural operations. Tractors run on petrol and fertilizers are produced from natural gas (80% of costs). Oil is approaching USD100 per barrel which has pushed fertilizer prices higher. This has already had repercussions in a number of soft commodity prices that are not very much correlated to oil such as milk. Milk in the US has doubled this year and

China's rampant inflation is a sign that this global trend is perhaps going to last for some time longer. Agriculture is a good hedge to inflationary trends and during periods of high inflation, agricultural operations should see good margin improvements. In addition to this, because soft commodities are very often denominated in US dollars, a weakening dollar appreciates the prices of soft commodities.

### **Conclusion**

We believe that we are at the beginning of a long term bull cycle in agricultural equities. Investing in agriculture will offer significant upside and a good way to gain exposure to the expansion of the BRIC economies with a hedge to inflation. It also offers a good diversification to an equity portfolio because the types of companies that are in the universe are often neglected by the investor community and not in the typical asset allocation. A net-long approach, with some alpha generation on the short residuals, will give exposure to the trend whilst at the same time allowing the investor to capture the over-reactions and market exaggerations that are almost inevitable when investing in equities.

We believe that equities of agriculture companies do carry risk but are the best way to participate in the next investment cycle within agriculture. Agricultural equities can outperform in an environment where soft commodities decline because of the capital inflows that will be directed to this theme and provide a good exposure to the ongoing agriculture investment cycle.

