

RDA Grampians & Wimmera Development Association

Understanding investment in agriculture

Final report

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1 Introduction

1.1 Background

The installation of the Wimmera Mallee pipeline has provided access to water resources that were previously not available, thus creating new opportunities for agricultural investment and development.

The Wimmera Development Association (WDA), in conjunction with other regional agencies, has been collating and preparing information about opportunities for agricultural investment in the Wimmera. The existing database of information needs to be packaged for agricultural investors so that it meets their requirements without providing a large workload for WDA.

This document is based on RMCG's and Luke Rolley's experience in advising and operating corporate Agricultural Investment and Management roles.

1.2 Purpose of report

The purpose of this report is to improve WDA's and other regional agencies' understanding of the objectives and information requirements of agricultural investors, in order for the WDA to meet those needs.

It is anticipated that agricultural investors will approach the WDA to seek information on various investment opportunities that the region provides. This investment and development will then promote economic activity, employment and flow on regional benefits.

The background information that investors will seek must be supplied in a timely and efficient manner. In many situations, providing the entire suite of information is not practical or not required, as investors will complete their own due diligence on opportunities. It is anticipated that the WDA will simply need to provide the 'headline' of the story and then provide contacts so that investors can complete their own analysis of the investment opportunity.

The output of this report is a 'checklist' of information requirements that agricultural investors seek. The team at WDA can assess the existing database of information and the information 'gaps' with the use of the checklist.

This will enable the WDA to more easily engage with both local investors and corporate or institutional investors by anticipating the information that they will require to make investment decisions in the Wimmera.

2 Investment objectives

2.1 Rationale

An improved understanding of the objectives of agricultural investors will enable the WDA to better engage with and present information to investors in order to meet their objectives.

Thus, this section examines the objectives of agricultural investors from both the macro and micro perspective.

2.2 Macro perspective

The common view often peddled is that the world is running out of food as population grows. However, the ongoing efficiency gains especially in developing nations have not seen widespread famine. In fact, even in developing nations the recent droughts (2011 East Africa) have been more severe than those earlier in history yet the human casualties have been far less.

The more accurate observation is that as the world becomes wealthier, it demands better quality food. This improvement in diet can be in the form of introduction of meat products in diets that are traditionally grain or rice based or the introduction of protein through dairy consumption. Thus the long-term increase in wealth and economic activity across the world is driving agricultural investment.

Institutional investors, sovereign funds and trading houses tend to have a global perspective on the opportunities in agriculture, or any resource for that matter. It does not matter whether the investment occurs in Australia, Algeria or Argentina. The decision making process is very clinical and based on a range of criteria that we rarely consider from our domestic perspective.

Investors that take a macro and long-term perspective considering future markets and production systems carefully consider where strategic investments ought to occur.

The following list outlines some of the considerations when considering an agricultural investment around the globe:

- **Political Stability:** An investment should occur in a country with a stable political system. Insurrections, coups and difficult changes of government make it difficult to run a business and trade agricultural products.
- **Judiciary:** Countries where there is a functioning judicial system mean that contracts, supply arrangements, and interactions with contractors are enforceable. This means that infrastructure can be built and timely operations can occur.
- **Infrastructure:** Some infrastructure is required to enable the processing and trade of agricultural produce, for example a country without a port will have difficulty exporting wheat into the global market.
- **Financial System:** Stability of economic systems and currency impacts on trading are considerations as they dramatically impact the ability to trade. Highly inflationary economies are particularly difficult.

- **Capital entry & exit:** Global traders consider entry and exit points of capital investments. Where there are difficulties in acquiring or selling capital assets this is problematic, especially if there is a chance that an agricultural asset (farmland) may not be able to be sold and funds extracted.
- **Supply Chain:** Functioning supply chains are integral to business success, where crops cannot be processed, transported or exported expediently then profit is lost, especially for perishable crops.
- **Food surplus:** Countries that have a 'food surplus' are preferred, as they tend to already have export infrastructure and systems in place, plus they can easily trade into global commodity markets. An example of this is Australia and our wheat production where we export much more than domestic consumption requires. The food surplus also indicated that the country is an efficient producer of food and able to compete on price against other countries.

These criteria¹ that larger investors apply to their agricultural investment portfolio see Australia score very highly compared to other countries around the globe. This is evidenced by the amount of activity that is occurring in the agricultural investment space at present.

2.3 Micro perspective

Once Australia is identified as a target location, then more focus is applied to the merits of a specific investment. These 'micro perspective' criteria also apply to smaller investors, such as family farms, smaller superannuation funds and private foreign investors.

This list has been constructed in priority order to reflect the most important aspects of investment through to the least important aspects.

1. **Return to Capital:** Identification of and entry into appropriately priced assets remain one of the key drivers of return to capital. There are many opportunities for agricultural investment across Australia however the net returns of both cash return and capital growth against the initial entry price is a key criterion for investment. A property, region or state that provides improved return to capital will be favoured over other regions.
2. **Efficient Cost of Production:** Agriculture predominantly produces commodity products. These commodities are produced around the globe and traded regularly with many commodities now able to be traded in futures markets. Looking forward, each commodity produced will have to compete on price against another region of the world. Therefore the best place to produce a commodity is where it can be most cheaply grown and processed. In Victoria for example, an assessment on the most cost efficient production of wheat based on land price, rainfall ability, operating costs and yield would determine the appropriate location to make an acquisition as this would provide the cheapest net cost of production.
3. **Contractual agreements:** Beneficial medium and long term purchase and sell agreements are highly valuable as they allow management of market risk both on the cost of production side (input supply agreements) and sale side (product offtake agreements). One example may be where back-to-back contracts for the supply of piglets and purchase of grown out pigs at fixed prices that enable profit to producers. The impact

¹ B. Gill – Asia Pacific Consulting Group

is that long-term reliable profits are available, providing the investor can achieve efficient production.

4. **Market Access:** Marketing and sale of quality produce at profitable prices is critical to investment success. Producing perishable product too far from the market or difficulties with quarantine, transport and timeliness can be factors that make an investment too risky even when all other factors suggest a profitable investment.
5. **Distressed Capital:** Most people like a bargain, whether a cheap house, car or white goods for use domestically. The same applies to investors. Distressed capital or land and other assets that have to be sold due to financial difficulty can often be purchased very cheaply, for example some of the Great Southern land (failed MIS) was purchased at 10% of its book value by a Canadian fund (New Forests) after it went into administration and receivership.
6. **Family and Personal Benefits:** Some of the foreign private high net wealth individuals purchase agricultural land, similar to residential real estate. The land may be inconsequential to the prime objectives. The prime objectives for investing may be access to education or university facilities, opportunity to emigrate to Australia or simply to have a property with quality accommodation to visit and take clients or friends to have an Australian experience.
7. **Capital Growth:** Similar to purchasing a house in a suburb that is going to achieve some capital growth over its life, the same approach applies to farmland. Land will be sought where there are capital growth opportunities; this is generally related to profitability. Some regions do have better capital growth prospects than others and factors such as proximity to towns or capital cities, or new crop types and technology can impact capital values.
8. **People:** Investors (the good ones) will align themselves with competent technicians and operational staff or contractors who have the experience, capability and capacity to provide the analysis, management and efficient production. This is especially true for investors who are external to regions and do not understand the local production issues. The utilisation of good people is critical to success.
9. **Vertical Integration Play:** Larger investors can focus on vertical integration opportunities. This may be where land, stock, processing packaging and export facilities are all purchased to service an existing market that the company may already have. Agricultural production alone may be an unattractive proposition, however a controlled supply chain can be very attractive, especially where sales occur into high value markets.
10. **Land Banking:** Some agricultural investors actually have very little regard to production and cash profits. In some locations, such as urban growth corridors, investors purchase agricultural land and hold it over a long period of time simply to capture any capital gains that may be available in the future due to urban sprawl.
11. **Climate Risk:** If all other production and market factors are similar between two sites in say South Australia and Victoria then the risk of production will be considered. This risk may be associated with drought, water allocations, frost, hail or flood depending on the crop grown and production sensitivities. A site with a lower climatic risk will be favoured over a climate that is subject to interrupted or high cost production.
12. **Resource Availability:** Access to inputs, contractors, employees, technicians and infrastructure can make one site more favourable over another site. If one property was

only 4klm from a major town and another property 65klm from the major town, then the closer property would be selected if all other aspects were equal.

This list describes a broad range of objectives that investors into agriculture possess. It is important to clearly identify the objectives in order to match an opportunity to the objective. There are some important common themes that underpin investment criteria and these are explored in the following section.

3 Profitable and sustainable agriculture

3.1 Long term sustainable investment

Successful, profitable and sustainable agriculture investment provides a long term stable improvement in economic and social conditions for the surrounding communities.

Large agriculture investments impact local communities. It is critical that any agricultural development is both profitable and sustainable in the long term. If these conditions are not met, then the impacts to industry and community are detrimental.

As the WDA and local government agencies seek to attract investment and development in the Wimmera, the questions that must be asked are:

1. Do we want these investments?
2. Are they profitable?
3. Are they sustainable?

If the investments and businesses are unprofitable or unsustainable, there will come a point in time where they will no longer exist. This process can cause significant damage to employment and communities. In fact, when large businesses and investments collapse the economic and social outcomes can be worse than where a number of smaller farms existed prior to any development or consolidation.

3.2 Case Study - Olives

The Boort-Charlton region experienced a massive investment in olive groves during the early 2000's that saw many sheep/wheat farms converted to large scale olive production for three different businesses.

This period of development and expansion was perceived as a fantastic example of rural development resulting from agricultural investment. Shops in local towns were opening, house prices nearly doubled, new people moved into these communities for employment, and rental properties were hard to find. There were real benefits and wealth was created.

The initial difficulties arose in the wake of the Managed Investment Scheme (MIS) collapse that witnessed a number of unsustainable agricultural investments collapse. The underlying issue is that the olive oil production in the region had a high cost structure compared to international competitors and world production of oil was increasing.

The impact of these investments on these communities has been somewhat of a 'roller coaster'. Initially the investment, employment and benefits to the community were exceptional. However, since the restructuring and consolidation of these large operations in the region (and other impacts such as the closure of the lucerne mills) the symptoms are numerous: shops vacant, many staff losing their jobs and leaving the region and declining house prices.

The land area in this region supported many farm families prior to the large agricultural investments. However, the smaller number of large enterprises have to compete on global

commodity markets and have to achieve acceptable profits for their investors. Thus, they cannot simply tighten the purse strings and hold on, and when they do go, they leave an enormous gap in the local economy.

There is no blame being apportioned towards large agri-developments. They can create efficiencies of production that small farmers cannot achieve, however the scale of the business means that a lack of success can result in a bumpy ride for local communities. These communities would have experienced the bumpy ride sooner or later anyway, however consolidation and investment speed up these processes.

3.3 The cost-price squeeze in agriculture

RMCG see the financial position of many agricultural businesses and the ability to make profit in agriculture is more difficult than imagined. Most agricultural businesses run at a low profit and do not properly value labour inputs or the opportunity cost of capital, hence they are unprofitable.

There are a small proportion of businesses in agriculture (the top 20%) that are dynamic, understand their markets and produce efficiently to specification. These businesses make good profits.

One of the main drivers of this challenge is the 'cost-price squeeze' in agriculture. The cost price squeeze means that in developed economies (e.g. Western World) the price achieved for agricultural commodities either remains flat or decreases in real (inflation adjusted) dollar terms over time. Whilst the reverse occurs with input costs, as other sectors of the economy bid up their cost, e.g. fuel, chemicals, labour and electricity. Thus, agriculture operates in an environment of increasing costs and decreasing prices, which is why increasing scale is such an important driver of profitability.

One example of this is the Victorian Dairy Industry, a recent detailed analysis of the historical drivers of milk production² revealed that the profit margin decreases in the industry by 1% each and every year, despite farms increasing scale and improving efficiencies.

The challenge to investing in agriculture is that it is not a static system, but rather a process of continuously improving efficiency of production to maintain profit margins over time. New entrants to agriculture need to comprehensively understand and build a production model based on continuous improvement, remembering that there are no easy profits.

Any investors that approach agriculture as a static model and do not factor in ongoing efficiency requirements are likely to become unsustainable and unprofitable at some point in time.

3.4 Conclusion

It is difficult for an external investor to agriculture to create a profitable business without a clear understanding of the technical aspects of production, the ability to manage risk and a clear understanding and knowledge of the marketplace.

² RMCG, 2012, table 4-4 page 32, WestVic Dairy – An impact study of growth in the Western Victorian and south east South Australian dairy industry.

Any agricultural investor has a mandate to maintain efficiency, profitability and sustainability. This mandate occurs in a difficult environment over time as the cost-price squeeze directly impacts agricultural businesses.

Agricultural investment brings many benefits to individuals and communities, however it must be profitable and sustainable and continually strive for ongoing efficiencies if it is to be of long term economic and social benefit to the local community.

4 Why come to the Wimmera?

The Wimmera Development Association and other regional agencies are actively promoting investment, economic development and resilient communities. One mechanism to do this is to increase the investment in agriculture. The Wimmera is essentially competing with every other agricultural region in Australia to secure investment, development and stable long-term profitable production.

Where a natural advantage in the Wimmera exists for agricultural production, it also should be able to be validated and measured. For example, in a cropping situation where more reliable rainfall and competitive land prices may occur in the Wimmera, then high profit should be achieved and able to be measured as \$ return per mm of rainfall per cost of land.

While the Wimmera has many positive aspects that relate to agriculture, so do many other regions in Victoria and Australia. The sunshine, land, water, soils and climate are all available to purchase for a prospective investor. Thus, the question must be asked 'Why come to the Wimmera?' or what significant advantage does the Wimmera give to agricultural production, for example:

- Can the Wimmera achieve a higher return to capital than other regions?
- Can the Wimmera offer supply and offtake agreements not available to other locations?
- Is the climate risk in the Wimmera lower than other locations?

These questions are beyond the scope of this paper. It is important that the WDA and associated regional agencies be able to identify the 'Unique Selling Point' or a message that can be communicated to a prospective investor in 30 seconds that demonstrates a robust reason for coming to the Wimmera. This must also be within the context of a profitable and sustainable investment opportunity.

5 Types of agricultural investors

5.1 A diverse range

Stereotyping investors is dangerous, especially in agriculture. Some common themes prevail amongst all investors, however caution against a 'one size fits all' approach is required. It is not that simple.

However, at the risk of providing generalised insight to a diverse range of participants, the following section attempts to provide an overview of the 'types' of investors in agriculture to demonstrate the diverse range of opportunities that they will seek.

5.2 Family farm businesses

Historically the family farm business has underpinned the agricultural landscape in the region. Early in Australia's European history, land was allocated to soldiers, migrants and settlers to produce crops and income from the land. Throughout history and in each generation some of the businesses have failed or been sold to neighbouring properties. These more successful neighbours have grown in scale to take over additional assets to increase efficiencies of production though achieving improved economies of scale.

Some family farm businesses have increased in scale significantly in the last generation and now command significant land and water holdings. These businesses can have very strong balance sheets (low debt compared to assets) and be constantly looking for acquisition opportunities to increase scale and improve production efficiencies, or alternatively to diversify into different agricultural or commercial investments.

Typically, farm family businesses are funded through historical trading profits, changes in land valuations and some bank debt. Therefore, investment and expansion is linked to return to capital and profitable opportunities. For example, increased production efficiency through using the same tractors and harvesting equipment across a large area results in more profit as average overhead costs per hectare are reduced.

5.3 Individuals and small superannuation funds

In addition to the traditional family farm businesses, there are individuals and small self managed superannuation funds that invest in agricultural land and assets. These assets are then either actively managed by the individual or share-farmed or leased out to larger farmers.

There are significant taxation advantages to individuals who have off farm income and an affinity with owning and operating parcels of agricultural land. Larger lifestyle properties are used to provide a family residence, obtain some taxation advantages and generate additional income.

Acquisitions are often financed with off-farm income or wealth created from alternate ventures or salaries. Therefore, these investments can be less linked to profit and tend to be driven by emotional or lifestyle factors.

5.4 Foreign investors

The term 'foreign investor' is a strange term and there has been plenty of negative publicity about foreigners 'owning the farm'. Australia's food production supply chain has historically had significant foreign ownership, e.g. most of the dairy companies operating in Australia are actually foreign owned by large multi national companies. It is not likely that our food production sector will ever be locally owned.

Agricultural production has seen a range of small and large foreign investors coming to directly purchase assets to rent out to third parties or to adopt management structures and actively manage the assets.

These investors typically have one of two objectives:

1. Commercial – they might have a trading business overseas and are looking to secure supply of commodity for their market and increase margin through the supply chain.
2. Personal – to achieve migration, university education for their children or divestment of assets from their country of origin.

These investors are typically funded through international businesses that are highly profitable and often have a link to agriculture or food production. Where an investor has a purely commercial focus the vertical integration and profitability are the major considerations.

5.5 Corporate entities, public companies and trading houses

Corporate investors (e.g. Warakirri³), Superannuation Funds (e.g. SAF⁴), Public Companies (e.g. Tandou⁵) or International Trading Houses (e.g. Westchester⁶) all have similar structures and objectives in agriculture.

Essentially, these companies are looking to invest significant volumes of capital into agriculture to diversify risk from equity markets and have exposure to a different asset class. Many of these funds have historically focussed on global equities (stock markets), however in the past ten years there has been interest in agriculture as 'hard assets' can be owned, capital gains can be achieved and a different risk profile can be adopted compared to global stock markets..

These investors are funded externally through a variety of capital raising, superannuation and institutional investors. Historically, the approach to investing in agriculture has been a little 'loose', however this has tightened up and now profit and capital growth are the major drivers of investment.

³ watag.com.au

⁴ www.sustainableag.com.au

⁵ www.tandou.com.au

⁶ wqimglobal.com

5.6 Sovereign funds

The sovereign funds are more difficult to understand. They are actively acquiring assets around the world, especially in developing countries, where there is bountiful labour and prime agricultural resources at a bargain price.

These funds tend to have slightly different criteria for agricultural (and other resources) investments than we typically would encounter, such as: long term food security, currency hedging, and diversification of assets and economic activity.

They are funded through taxes, profits (oil sales) and tend to make larger rather than smaller acquisitions. These funds can have both a mixed and long-term view to vertical integration. The real investment drivers and views of profit from these organisations are still difficult to understand in some situations.

5.7 Government agencies

Government agencies, water authorities and the crown are some of the larger owners of agricultural assets in different regions that tend to fly under the radar. While these agencies may not be typically be considered as 'active' investors in agriculture their influence certainly forms part of the landscape.

These agencies tend to outsource all operational activities to private landholders. From time to time they do make acquisitions such as occurred recently in Northern Victoria for flood-impacted landscapes. Investment in agricultural assets is linked to policy rather than economic opportunity.

5.8 Conclusion

Thus, there are vast differences between agricultural investors. Their objectives are highly diverse, scale is dramatically different and they respond differently to opportunities.

Common to all investors is the mandate of achieving a profit in the short or long term in agriculture. This is also coupled with long term sustainable operations.

6 Checklist

This section explores some of the data that the WDA may be able to collate for prospective investors. This data is some of the critical information that prospective investors will likely assess to determine if an opportunity can meet their objectives, in particular an examination of the profitability and sustainability of each opportunity.

It is impossible to collect sufficient information for a satisfactory business case around each investment opportunity. As such, it is suggested that WDA's approach should focus on the collection and collation of 'headline' information and the means of accessing further more detailed information for specific business cases...

In many instances, investors will want to and need to complete their own due diligence process on prospective investments. Thus, any work that WDA complete on the detailed analysis may be wasted.

The following table outlines the market, production and risk factors, in priority order, likely to be important to prospective investors making decisions on acquisitions.. **Items in bold or the first ten items** are those that the WDA should consider acting upon to prepare high level data for prospective investors.

Table 1 – Checklist of Information for Agricultural Investors

Item	Description	Specific Data
1 (RISK)	Return to Capital	<ul style="list-style-type: none"> ▪ What is the cash and total (including capital gains) return to capital? ▪ Given a poor outcome (low price and low yield) can the investments remain cash flow positive?
2 (PROD'N)	Costs of Production	<ul style="list-style-type: none"> ▪ Benchmark data for cost of production ▪ Access to other producers in the region willing to share information ▪ Key production parameters – yield averages & ranges.
3 (MARKET)	Offtake Agreements	<ul style="list-style-type: none"> ▪ Purchasers offering sales contracts ▪ Typical details of the contracts offered
4 (MARKET)	Price History	<ul style="list-style-type: none"> ▪ Historical Price Data ▪ Previous reports/data on price and quality differentials.
5 (MARKET)	Overview of Marketplace	<ul style="list-style-type: none"> ▪ Seasonal/Historical Supplies ▪ Broad description of market opportunities available ▪ Key players in the market ▪ Export volume and price data
6 (RISK)	Acquisition Price	<ul style="list-style-type: none"> ▪ Are current prices for assets high or low? ▪ What discount to entry is available now or in the future?
7 (RISK)	Capital Gain	<ul style="list-style-type: none"> ▪ Historical evidence of asset prices ▪ Research or data suggesting future trends.
8 (PROD'N)	People	<ul style="list-style-type: none"> ▪ Soils Experts ▪ Technician for specific industry

Item	Description	Specific Data
		▪ Irrigation Designers/Suppliers
9 (MARKET)	Vertical Integration	▪ Processors/Exports/Agents ▪ Volumes of production with processors
10 <u>Point of Difference</u>	<u>Point of Difference of producing it in Wimmera</u>	▪ <u>For any one enterprise – why should it occur in the Wimmera as opposed to another region?</u> ▪ <u>How can the Wimmera demonstrate a more profitable or less risky outcome than another region?</u>
11 (MARKET)	Global Supply & Demand for commodity	▪ Reference reports for various commodities eg Rabo & ANZ ▪ Future market signals that may provide opportunities
12 (MARKET)	Export Opportunity	▪ Contact details of existing exports and freight forwarders ▪ Quarantine and handling procedures
13 (PROD'N)	Soils & Geography information	▪ Local soils information ▪ Geographic factors impacting production
14 (PROD'N)	Climate	▪ Rainfall, solar radiation, temperature ranges and mean temperatures.
15 (MARKET)	Historical production in region	▪ ABS/ABARE data ▪ Market impacts on production cycles
16 (RISK)	Diversity of Marketplace	▪ Who are the buyers for the product? ▪ Are there multiple markets for the product? Are there numerous access points to the markets?
17 (RISK)	Climate Risk	▪ Variability of Climatic factors, what do the historical best and worst years look like ▪ Climate Change – is this a more risky site?
18 (PROD'N)	Development & Regulatory Approvals	▪ Locations that development can occur ▪ Local Government contacts to liaise with for understanding development restrictions and approvals.
19 (PROD'N)	Access to Resources	▪ Key suppliers of infrastructure, inputs and materials.
20 (RISK)	Production Variability	▪ What is the range of production that is typically experienced? ▪ What mitigation measures can be used to manage production variability?
21 (PROD'N)	Labour	▪ Local labour availability and cost. ▪ Mechanisation availability and back up service.
22 (PROD'N)	Waste Management	▪ Waste disposal for intensive production or manufacturing systems

This table has been constructed considering the 'types' of investors and also the 'objectives' of the various investors. The items in bold are generic – essentially the 'high level' information required to assess an opportunity. Once high level assessment occurs the detailed information will be required. It is not imperative to collect and collate this

information, however it is important to have the necessary contacts and be able to point an investor in the right direction in order to obtain the information.

Investors tend to be comfortable in the private sector and view government agencies as simply holding up progress or a 'necessary evil'. When collating and sourcing information or contacts that investors can use it is critical that the private sector be part of the equation rather than simply relying on government agencies and contacts.

7 Summary

There is a range of agricultural investors and no 'one size fits all' rules apply to their objectives.

There are some common and important objectives that agricultural investors do have, these include:

1. Return to Capital
2. Understanding the cost of production
3. Offtake agreements
4. Price history
5. Marketplace Overview
6. The total entry price
7. Capital Gain (loss) implications.
8. Access to good people/mangers
9. Vertical Integration

The key criteria of profitability and sustainability must be achieved across all types of investors even considering their objectives for initial entry of investment and then ongoing long-term operations,.

Investors will need to engage with the supply chain in the private sector and in many cases, if the WDA can facilitate these relationships, then the private investors will be able to manage their own process of obtaining, analysing and interpreting data.

It will be helpful for the WDA to collect and collate some 'high level' information on the opportunities in the region, which are outlined in the checklist.

The WDA and other regional agencies need to understand the key point of difference that the Wimmera offers agricultural investors. Investment can occur in many locations around Australia and there must be an identifiable reason to come to the Wimmera.