Agcapita Agriculture Update
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AGCAPITA

Summary

In this month's newsletter we examine the often asked question *"What are farmland's financial characteristics"*? Agcapita's research indicates that Western Canadian farmland, particularly Saskatchewan farmland:

- has characteristics of an Inflation Indexed or Real Return Bond;
- is a high return asset class with historic, compounded real returns in excess of 8.0% per year;
- generates agriculture commodity linked returns with much lower volatility than direct agriculture commodity investments; and
- has the potential for material capital gains due to asset mispricing.

Given the current economic and monetary climate, it may be a good time to consider an asset allocation to farmland due to the financial characteristics mentioned above.

Kind Regards

Stephen Johnston - Partner

CONTENTS

Agriculture Update

FARMLAND'S RELATIONSHIP TO INFLATION – REAL RETURN, INFLATION INDEXED BOND

Farmland has a high positive correlation to inflation – this appears to hold true in most jurisdictions where historic pricing data is available. US research shows a correlation of positive 0.54 between US farmland and the Consumer Price index ("CPI"). Farmland's correlation to CPI exceeds that of stocks, bonds and non-farm real estate. Farmland shares this correlation attribute with gold, however unlike gold, farmland also produces stable income streams – as a consequence it has been described as "gold with yield". According to Bank of Canada, Canadian inflation has averaged 4.2% annually over the last 50 years[1] compared to annual compounded farmland returns of approximately 12.7%[2] - producing an annual real return of about 8.5%. For these reasons (high positive inflation correlation and consistent real returns) we view the farmland asset class as having many of the characteristics of an indexed bond.

In addition, by investing in Saskatchewan farmland it appears possible to get these real return bond qualities with a material capital gain potential created by Saskatchewan land prices that Agcapita believes have been artificially suppressed by regulations limiting the flow of capital – regulations which have recently been liberalized. Agcapita's research shows that the passage of the Saskatchewan Farmland Security Act in 1988 then the repeal of key provisions in 2003[3] is highly correlated to the low Saskatchewan farmland prices. The compounded annual growth rate ("CAGR") of Saskatchewan farmland prices in three key periods is supportive of this conclusion:

CHART 1: SK FARMLAND RETURNS

Period	Years	CAGR (per annum)
Pre-legislation	1938 to 1988	6.4%
Legislation in force	1989 to 2003	1.2%
Post-legislation	2004 to date	6.1%

Assuming that the Farmland Security legislation caused Saskatchewan farmland to underperform compared to its long-term appreciation trend by approximately 5% per annum then Saskatchewan land would need to double just to return to trend value. This analysis discounts any gains driven by changing agricultural commodity demand or accelerated inflation.

FARMLAND'S DIVERSIFICATION BENEFITS

Farmland can bring diversification benefits to a portfolio composed of stocks, bonds and non-farm real estate.

CHART 2: ASSET CROSS CORRELATIONS[4]

	CPI	Bonds	Stocks	REstate	Farmland
CPI	1.00				
Bonds	-0.34	1.00			
Stocks	-0.23	0.33	1.00		
REstate	0.38	-0.20	0.06	1.00	
Farmland	**0.54**	-0.52	-0.13	0.11	1.00

Agriculture Update (continued)

Due to these correlation characteristics and absolute returns that have historically been higher than equities and bonds, farmland may improve portfolio risk adjusted returns as well.[5]

FARMLAND'S RISK AND RETURN CHARACTERISTICS

Direct investments in Canadian farmland have been less volatile than investments in stocks historically with higher absolute returns. Over the last 50 years the S&P 500 had a compounded annual return of 9.2% (including dividends) with a standard deviation (the indicator for volatility/risk) of 17.3%[6] while Canadian farmland had compounded annual returns of 12.7% (including cash rental income[7]) with a standard deviation of 8.7%.[8] In general farmland returns have volatility similar to bonds but yet historically average higher total returns than bonds.

It may be useful to discuss a concept called the Sharpe ratio. The Sharpe ratio is used to characterize how well the return of an asset compensates the investor for the risk taken. When comparing two assets, in general the asset with the higher Sharpe ratio gives more return for the same risk. Investors are generally advised to pick investments with higher Sharpe ratios. The Sharpe ratio[9] of western Canadian farmland has averaged over 4 times higher than the Sharpe ratio for the S&P 500 over the last 50 years:

- S&P 500 – Sharpe ratio = 0.2
- Western Canadian farmland – Sharpe ratio = 0.9

FARMLAND COMPARED TO SOME TRADITIONAL ASSET CLASSES

The following table is an attempt to put the size of the western Canadian farmland market into perspective. Farmland as an asset class has a very small "market capitalization" when compared to stocks and is a small fraction of the size of the ongoing bailouts and government deficits.

CHART 3: FARMLAND VALUE ("MARKET CAP") COMPARISONS (USD billions, November 2009)

Saskatchewan Farmland	30
Amazon	57
Suncor	57
Western Canadian Farmland	93
Wal-Mart	206
Louisiana Purchase	217
Microsoft	260
Korean War	450
The New Deal	500
Vietnam War	700
US Farmland	1,500
All Gold Above Ground	5,300
US MZM	9,500
US Bailouts	11,600
US Debt	12,000
US GDP	14,000
Global Bail-outs	19,000

Sources: Yahoo Finance, World Bank, Agcapita, RGE Monitor, Only Gold – all data adjusted for inflation

Agriculture Update (continued)

CARBON MARKET UPDATE

The global carbon market is a collection of sometimes disparate rules and systems – some mandatory, some voluntary. In simple terms, a carbon offset is a financial instrument aimed at a reduction in CO2 emissions. Carbon offsets are measured in metric tons of carbon dioxide-equivalent (CO2e). There are two markets for carbon offsets.

1) The compliance market where users buy carbon offsets in order to comply with regulatory caps on the total amount of carbon dioxide they are allowed to emit.
2) The voluntary market where users purchase carbon offsets to mitigate their own greenhouse gas emissions from transportation, electricity use, and other sources.

Both markets are growing rapidly. According to consulting firm New Carbon Finance, in 2008:

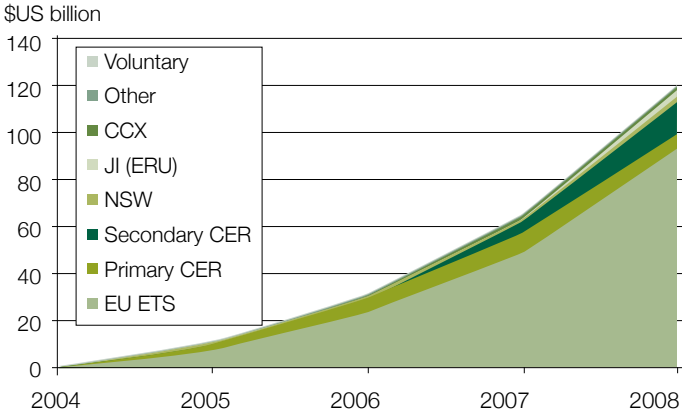
- the value of the global carbon market increased 84 percent to US$118 billion;
- transaction volume reached four billion tons, an increase of 42 percent from 2007; and
- the average transaction price rose to US$29 per ton in 2008 from US$23 per ton in 2007.

New Carbon Finance expects the carbon market to reach US$150 billion in 2009, despite the global economic slowdown.

At the next round of climate talks in Denmark participants will consider the inclusion of offsets that could be generated through reforestation, avoided deforestation, and the reducing emissions from deforestation. Presently such credits are limited to voluntary markets, which grew to $499 million in 2008 from $265 million in 2007. Forestry credits may prove to be of particular interest to prairie land investors as pastureland may be suited for low cost tree production.

Agcapita's view is that monetizing the carbon sequestering capabilities of prairie land has the potential to be a material revenue stream for parties

CHART 4: VALUE OF GLOBAL CARBON MARKETS



that can achieve the critical mass on both the aggregation and marketing sides of the business. The major challenge to date has been the embryonic nature of the Canadian compliance market and the lack of accepted protocols. This is changing with the introduction of the Alberta carbon market and the contemporaneous growth of the voluntary market across the prairies and in British Columbia.

The low land prices across the Canadian prairies, particularly pasture land, may provide a competitive advantage in generating carbon offsets. One of the key capital costs associated with agricultural offset projects is finding land for "change of use" at reasonable prices.

ENDNOTES

1 Bank of Canada data - http://www.bankofcanada.ca/en/rates/inflation_calc.html
2 See section on farmland risk and return characteristics
3 The 2003 revisions to the Saskatchewan Farmland Security Act repealed the prohibition against non-Saskatchewan Canadian residents from owning an interest in Saskatchewan farmland. Prohibitions against foreign residents and publicly traded companies from holding an interest in Saskatchewan farmland remain in place. The Saskatchewan rules have now been largely harmonized with its prairie neighbors in Alberta and Manitoba and the market has been opened to all Canadian citizens and residents.
4 Sources: CPI, NCREIF US farmland and US commercial real estate index, Lehman Bond index, S&P 500
5 "*Farmland investments significantly improve the risk-efficiency of mixed-asset portfolios.*" Portfolio Diversification Using Farmland Investments, Enrique Hennings, American Agricultural Economics Association, 2005.
6 Robert Schiller, Long-term stock (S&P 500) and bond data - www.econ.yale.edu/~shiller/data/chapt26.xls
7 Cash rental rates assumed to be 6% and not to be reinvested
8 Stats Canada Farmland Price Series, Agcapita estimate of annual cash rental yields
9 Assuming the risk free rate over the 50 year period averaged 5%

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