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Kilter's charted waters

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Climate change was front and center in global political discourse last year and continues to dominate headlines into 2020.

Teenage Swedish environmental activist, Greta Thunberg, notably named Times Person of the Year rallied at the 2019 UN Climate Action Summit: "…Entire ecosystems are collapsing. We are in the beginning of a mass extinction. And all you can talk about is money and fairytales of eternal economic growth. How dare you!"

Yet, Kilter Rural, an Australia-based farmland and water investment manager, does not think that economic growth and positive environmental action are always at odds. And nowhere has felt the impact of climate change so acutely as Australia, which has been ravaged by some of the worst wildfires in decades, with large swathes of the country devastated since the fire season began late July.

Kilter, which is 50% owned by Australian hedge fund powerhouse Regal Funds Management, was established in 2004 and took capital from a large Superannuation fund, Vic Super, with the aim of delivering profit with positive environmental impact.

"It took us two years to come up with the regenerative agriculture model that appealed to a big super," Cullen Gunn, CEO of Kilter, tells *AsiaHedge*. "I think there really is a significant opportunity for investors to get in and transform farmland so that it is climate resilient."

Gunn has been working in the farmland and water management sector since 1993 with both active, hands on land management, as well as experience in the development of priorities for investment at both catchment and state levels in Victoria.

For its farmland strategy Kilter has acquired 38 farms between Lake Boga and Kerang in northern Victoria, totalling 9000 hectares. The firm has also spent almost $40m remediating soil, installing irrigation infrastructure, and developing technically advanced irrigation operations. The firm's water assets are valued at almost $400m, making it one of the largest water managers in

Australia. In addition to the water used for its own farmland operations, Kilter leases and sells water to other large irrigators, to generate long-term returns for its investors.

Gunn says that water is the world's most vital tradeable commodity. He points to a strong – and rising – demand amid increasing population and high value food production, falling supply due to climate change, and a lack of a substitute.

Water works

Investment in water occurs via two types of assets: permanent entitlements, which hold features similar to land titles, and seasonal allocations, which are a right to use a specified amount of real water.

Water entitlements are underpinned by strong property rights and are perpetual, transferable, mortgageable and can be divided and amalgamated. Water allocation can be used by the irrigator or can be traded in active markets.

Water allocation prices are primarily determined by supply, the product of seasonal rainfall and inflows into storages, with increased scarcity leading to increased prices. According to data from the Murray Darling Basin Authority, where Kilter operates, 2018-2019 inflows were only 2,800GL, which was 69% below the long-term average inflows, while the last 20 years average inflows is 35% lower than the long-term average inflows.

Gunn also says a current demand for water from high value crops is driving a significant increase in water allocation prices, particularly when water is scarce.

"The water price has jumped significantly over the last couple of years. With a drying outlook driven by climate change and reduced water driven by environmental buyback, as well as significantly escalating demand from permanent tree crops, we still think the water values has a good little way to run," he says.

These forces of supply and demand have driven water allocation prices from around A$100 per megalitre in early January 2018 to A$950 per megalitre in October 2019.

Kilter invests in the Southern Murray Darling Basin (sMDB), an area roughly the size of Germany and Australia's largest irrigation system. It facilitates the growing of a diverse range of crops and industries including fruit, nuts, grains, fodder, dairy, cotton and grapes. The total value of sMDB irrigated agriculture in 2017-18 was more than $6bn.

"We can trade from New South Wales through Victoria down to South Australia quite readily. But it's not necessarily done through pipes. It's done through river systems," says Gunn. "So, the river system has a certain physical constraint. Sometimes you can't move water where you want to get it to at a given moment just because everybody else is doing it."

Adding to tradeable water scarcity is government intervention. In 2012 the Murray Darling Basin Plan was legislated requiring the recovery of 2,750GL of water for the environment by July 2019. The Basin Plan now requires a further 450GL to be recovered by July 2024 subject to socio-economic neutrality. And in 2015 the Government introduced legislation that capped the volume that could be recovered through direct buy-back at 1,500GL.

The corollary of increasing water prices is that water entitlement values have also ticked up. Yet, Kilter's Gunn suggests that longer-term structural changes are the true drivers of entitlement pricing.

He points to allocation prices between April 2016 and April 2017 falling by more than 80% in connection with the wet 2016 Winter/Spring, while the impact on entitlement priceswas negligible with prices underpinned by strong demand from investors and irrigators.

"Water entitlement values have historically increased at about 8 or 9% a year, and then you have somewhere between 5 and 7% yield on year-on-year allocation, whether you use it yourself or you sell. So, you're in that sort of 10 to 13% range for annualised returns," he says.

And with the world experiencing the fallout of climate change at unprecedent levels the potential for future growth is almost unforecastable.

"I think anybody that's working in agriculture thinking historical averages are applicable to the future is just kidding themselves," says Gunn.

Kilter has been an early mover in farmland and water investing, but with a market showing good returns and desire from institutional investors to fight climate change and make profit, they may well find themselves with increasing competition.

Cashing in on carbon

Kilter's farmland investing sequesters carbon – a positive for the environment and also a long-term return maker

For Kilter's farmland strategies an integral part of the work the firm does involves regenerating the acquired landscapes. This involves putting back in native trees, shrubs, protecting biodiversity, and also sequestering carbon.

Carbon sequestration is the process by which carbon dioxide is removed from the atmosphere and held in solid or liquid form. For Kilter the rationale is twofold: it helps protect the environment and may also create an additional revenue stream.

Kilter expects that over time the rewards for those who are willing to plant trees and receive payments for the carbon stored will become significant.

"In our view there should be a higher price on carbon. At the moment it is A$13 a tonne. So, any revegetation projects we put into our landscapes we don't build the payments for sequestration into our budgets as yet," says Gunn. "But we certainly model what might happen once we think that carbon price gets up to a point that's worth engaging in sales to a broader carbon market."

Gunn expects this to happen quickly as climate change continues to be at the top of mind for politicians globally.

"When it happens, it'll happen quickly. There is just so much pressure now that wasn't on even 18 months ago as half of New South Wales has been on fire," says Gunn. "I think the public expectation is that it will change, and while there is a program to pay to sequester carbon it's just a bit limited at the moment."