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UK Rural
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Spotlight | 2018

GB Agricultural Land

Foreword

Brexit-related developments continue to dominate market discussion. While Secretary of State Michael Gove provided some comfort to the farming community at the Oxford Farming Conference in January, lingering uncertainty is keeping supply constrained and average pricing marginally subdued.

Despite the prevalence of downside risk, we note strong pockets of resilient demand from lifestyle/amenity purchasers as residential farms and trophy estates have performed well when priced at fair value.

While some farmland values across Britain continue to be hampered, we believe the trend initially spurred by weakness in commodity pricing during 2014 is slowing. Our most recent *Farmland Value Survey* revealed an average fall of around only 2% year on year across all land types and geographies. Disparity is evident, with some more commercial areas and lesser quality properties seeing greater falls than others. Yet, in certain circumstances, excellent sale results are and will continue to be achieved.

We are confident on the market's longer-term fundamentals and expect dynamics to firm up as the outcome of Brexit further materialises. GB farmland remains an attractive investment proposition, buoyant against inflation with realisable upside from a return to capital uplift and further enhancement from diversification and/or development windfall.

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Market update

Short-term uncertainty lingers, but markets are likely to strengthen over the next five years. Holdings with a range of income streams will be sought after, while commercial units with little scope to diversify could encounter further downside risk

Farmland supply

Just over 151,000 acres of farmland were publicly marketed in Great Britain during 2017, down 16% from 2016 and 8% below the 10-year average of 164,000 acres.

The greatest fall in volume was recorded in Wales, down 40% year on year. Markets in England and Scotland proved more resilient, down 16% to 102,900 acres and 11% to 39,700 acres respectively.

The number of holdings marketed fell by 20% year on year to 725, in 2017, which is 5% below the 10-year long-run average. The falling supply levels suggest some caution among sellers following the decision to leave the EU.

These trends (see top right) reflect a similarity between the 2007/08 global financial crisis (GFC) and the reaction to the EU Referendum result in 2016. Both events prompted an initial uptick in activity as some chose to leave the asset class (197,000 acres in 2008 and 181,000 acres in 2016). Similarly, the GFC was followed by a lull in new launches, leading to annual supply remaining below the long-run average until 2015.

Reasons for sale

Personal circumstances, such as retirement and death, account for a significant number of sales – around 40% during the past three years. However, the number of sellers citing debt as their principal motivation has increased from about 8% at the time of the GFC to around 20% since 2015.

As interest rates have been at historic lows over the period, we believe that weaknesses in commodity pricing is the main factor driving debt levels up and, in some cases, to unsustainable levels. Although pressure on farm earnings has been in part alleviated by a comparatively weak pound against the euro.

Despite the farming sector's comparatively low gearing, the balance between the cost of debt and return on working capital employed is tight. For some, it would be negative if subsidy and diversification income is excluded.

With future farm income potentially under pressure, and the cost of serving loans set to increase, we believe debt will continue to be one of the material factors driving supply and could also temper demand.

Buyer types

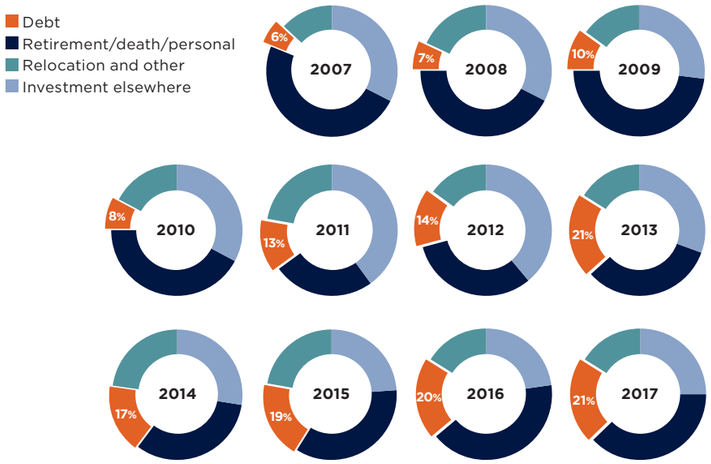
The scale and profile of demand has remained largely unchanged over the past three years, with farmers accounting for around 40% of purchases where Savills acted for either the buyer or seller. In 2017, there was increased interest from institutions, while the return of the lifestyle buyer has continued.

Expansion of existing farm businesses remained the primary reason for buyers and accounted for just over half of transactions.

While Secretary of State Michael Gove provided some comfort to the farming community at the Oxford Farming Conference in January, there is a long way to go.

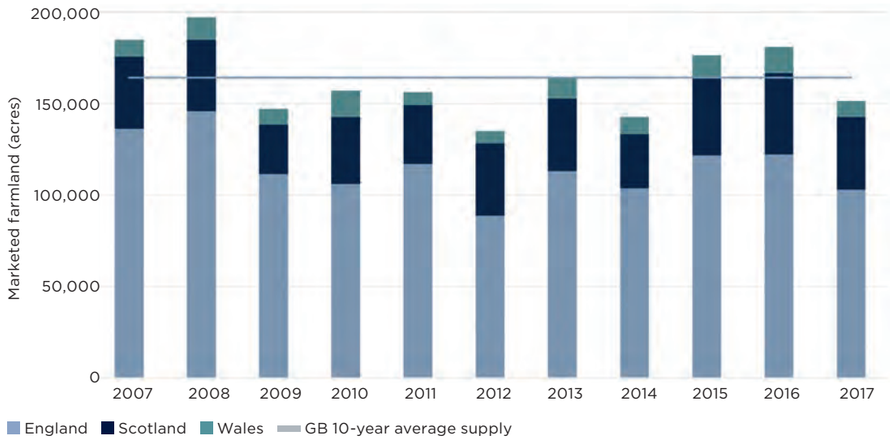
Uncertainty may impact on demand for commercial holdings, so realistic pricing is essential. However, interest in land with high amenity value and scope to diversify into alternative sources of income should stay strong.

Seller motivation Increasingly, debt is the principal reason for a sale



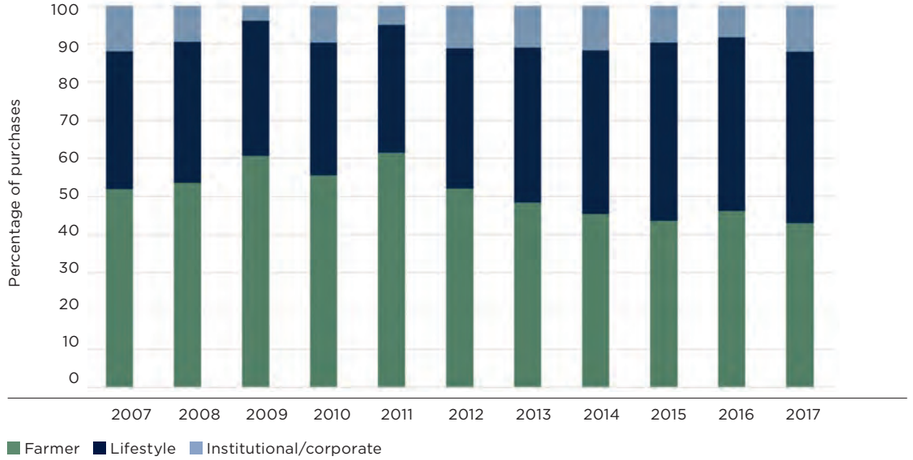
Source Savills Research

Farmland supply* Markets in England and Scotland proved more resilient than Wales



Source Savills Research **Note** *Of more than 50 acres

Buyer types Change in demand, driven by increased interest from lifestyle purchasers



Source Savills Research

EU FARMLAND

How UK farmland sizes up

With a large area of farmland and high domestic demand, the UK has the means post-Brexit to boost production and reduce dependency on imports

With more than 65 million people, the UK has one of the largest and most densely concentrated populations in Europe. Of the 11 countries analysed here, it has the third largest area of agricultural land, equating to 71% of total land mass. This is the highest of this group of countries, and well above the average of around 55%.

UK agriculture benefits from strong domestic demand and a large volume of farmland. However, the sector has comparatively lower production. The UK's aggregate output volume per acre of agricultural land ranks as third quartile (due to a high portion of marginal grazing ground) in comparison with the other countries, despite second-quartile ranking for the unit value of output.

The UK also has the lowest per capita of production and is the most reliant on imports, with 70 to 75% of the food supply serviced by domestic output. For most countries, production exceeds domestic demand needs.

Increasing efficiency to make post-Brexit margins competitive will be key to closing the productivity gap with top-quartile countries. The UK's reliance on imports, coupled with below average food consumption per capita, presents the sector with an opportunity to better align output with domestic food demand.

Key

- Percentage of land used for cropping
- Percentage of land used for grazing
- Percentage of land (non-agricultural)
- Agricultural area (million acres)
- People per acre of agricultural area
- Production per agricultural acre (tonne)

Source Food and Agriculture Organization of the United Nations, World Bank, United Nations Population Division and Eurostat
Note The map is a graphical representation of the percentage split in agricultural and non-agricultural land. It is not a guide to where each land-type is located

Farmland values
UK farmland is second only to the Netherlands in terms of value. Over the past 10 years, Eastern Europe recorded the strongest capital growth, averaging just under 20% (compound annual growth).

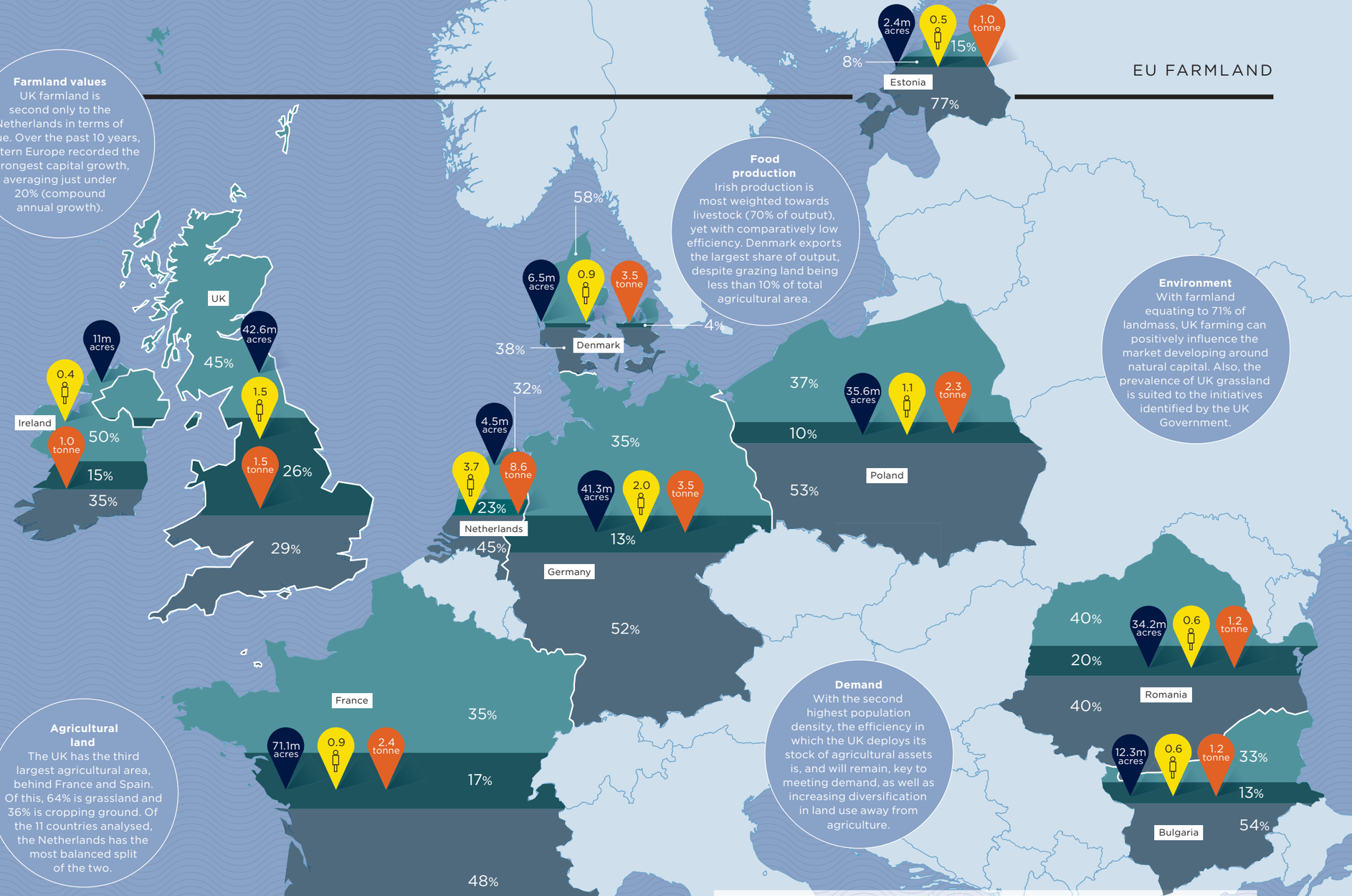
Food production
Irish production is most weighted towards livestock (70% of output), yet with comparatively low efficiency. Denmark exports the largest share of output, despite grazing land being less than 10% of total agricultural area.

Environment
With farmland equating to 71% of landmass, UK farming can positively influence the market developing around natural capital. Also, the prevalence of UK grassland is suited to the initiatives identified by the UK Government.

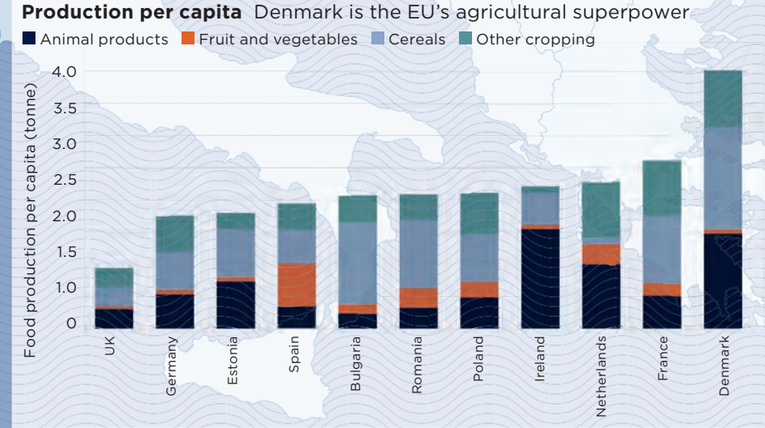
Demand
With the second highest population density, the efficiency in which the UK deploys its stock of agricultural assets is, and will remain, key to meeting demand, as well as increasing diversification in land use away from agriculture.

Agricultural land
The UK has the third largest agricultural area, behind France and Spain. Of this, 64% is grassland and 36% is cropping ground. Of the 11 countries analysed, the Netherlands has the most balanced split of the two.

UK food production
Although the UK's aggregate production is in line with the peer group average, it has the lowest level of agricultural output per capita and hence the highest reliance on food imports.



Production per capita Denmark is the EU's agricultural superpower



Source Food and Agriculture Organization of the United Nations

GB FARMLAND VALUES

Outlook and historical context

While pure commercial holdings are at risk from any reduction in farm earnings, we forecast rising values for those with options to diversify. Is there anything we can learn from historic trends? We examine the events that shaped farmland values

Farmland values continued to be muted during 2017, with a significant price difference across both land type and geography. Grazing land proved most resilient, falling around 1.5% year on year compared with the average 2.5% drop for prime arable land.

Poorer-quality arable land recorded the largest fall, reflecting the lower productive capacity coupled with uncertainty over the sector's future prosperity (trade and subsidy). Conversely, despite exposure to post-Brexit trade arrangements, lower-quality grazing land remains insulated, falling by only 1% as demand remained strong for lifestyle holdings with higher amenity value.

At the close of 2017, Savills *GB Farmland Value Survey* shows average prime arable commanded close to £9,000 per acre, with average grade 3 farmland trading at £7,500 per acre. Grazing land was trading at between £4,400 and £5,500 per acre, reflecting the variation in quality and geography across the holdings marketed.

While the spread between prime and average arable land is at a 10-year high, the difference between average and less productive grazing land has fallen from a 2012/13 high, although it is still well below the levels recorded in the late 1990s and early 2000s, where the premium was almost 50%.

On average, the decline in capital values has persisted since the downturn in commodity prices during 2014. We calculate an average cumulative drop of 6% across the market for all arable farmland over the past three years, with a 3% fall for grazing land. But the results of our quarterly *Farmland Value Survey* indicate this decline is slowing, with an increase in Brexit-related clarity likely to bring more certainty to the marketplace.

Five-year outlook

Our outlook for the next five years shows an overall recovery to positive growth, albeit at a pace below historic trends. However, much will depend on the outcome of trade negotiations and revisions to agricultural subsidy.

On the supply side, unless the national political and economic picture materially worsens, we believe annual volumes will increase over the near-to-medium term and return to long-run average levels.

Interest from lifestyle buyers is likely to continue, particularly for holdings with scope for diversification away from agriculture.

Over the medium term, a weakened trade position and reduced subsidy, coupled with any further softening in commodity pricing, could put pressure on earnings for lower-performing commercial arable and livestock businesses. This is priced into our forecast, with an average decline of 2 to 3% per annum expected for pure commercial farmland, but rising values of around 2% per annum for amenity holdings which have options to diversify away from agriculture (see table right).

Values in an historic context

Over the past 100 years, the value of GB farmland has, on average, increased by 6% per annum (see pages 8 and 9). Yet, when adjusted for inflation, real-term growth equates to just over 1% (compound annual growth). While the lion's share of nominal growth has occurred over the past 15 years, real-term values indicate higher volatility.

Despite the sector-specific and macro-economic factors which influenced values, we also note that the fundamental shape of land ownership has shifted. At the turn of the 20th century, the bulk of farmland was held by a comparatively small number of owners, with more than 90% of land let. Over the period of our research, this has fallen to around 35%. Today, annual supply equates to around 0.5% of total GB farmland.

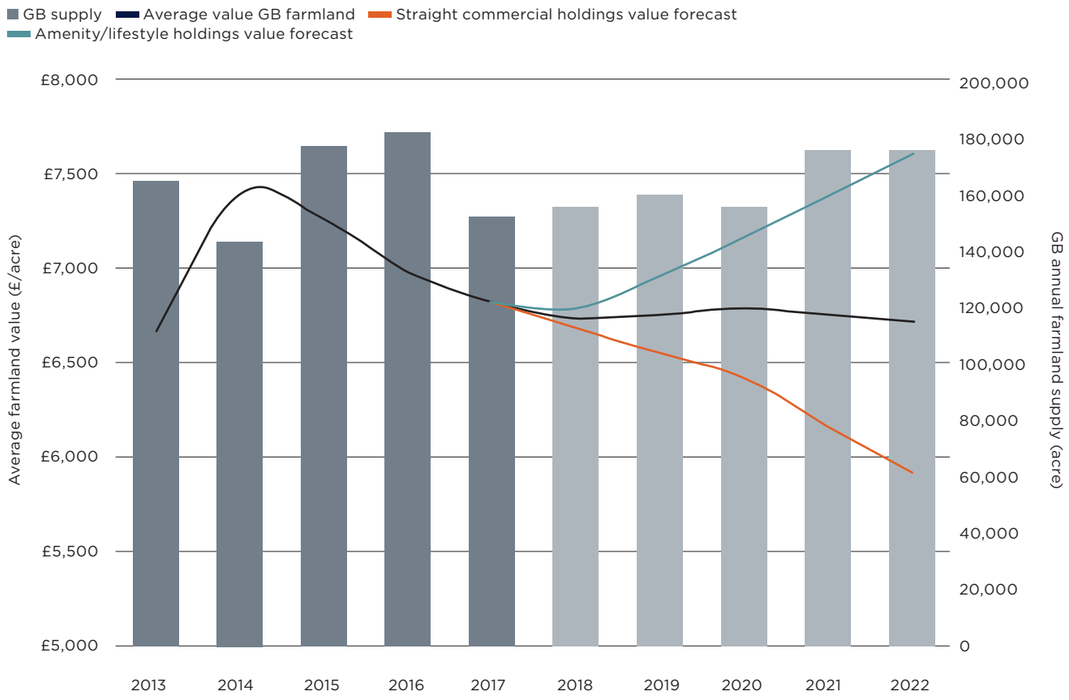
> The decline is slowing, with an increase in Brexit-related clarity likely to bring more certainty to the marketplace

Following the Second World War, growth was largely driven by a combination of market intervention by the British Government and inflationary pressures. The uptick in protectionism and initiatives to encourage domestic output bolstered the earning potential from agriculture while also reducing downside price risk. This, in turn, prompted increased interest from both domestic and foreign investors, who entered the market in search of stable and relatively low-risk cash flow.

The UK's entry into the European single market in the early 1970s, and, subsequently, the Common Agricultural Policy, further spurred demand-led growth, amplified by strength in commodity prices.

While the correlation between farm profitability and land values has become somewhat diluted with the emergence of non-farming lifestyle buyers, any reduction in farm subsidies and/or weakened trade position would likely exert downward pressure on the value of commercial holdings. Yet, we see no reason why farmland will not retain its status for long-term wealth preservation.

Five-year outlook



Source Savills Research **Note** The land value forecast uses Savills rural data and considers factors ranging from the macro-economic outlook, the performance of competing asset classes, through to the individual components influencing farm earnings

GB FARMLAND VALUES

11 key events that have shaped farmland values: 1900 to 2017

The impacts of historical events on farmland values inform our forecasts for the next five years. The detailed discussion can be found on pages 6 and 7

1 1900-1930
There's a material fall in land values as the sector opens up to international markets. The UK is inefficient compared with emerging markets – especially the US. The First World War prompts high inflation and causes a huge strain on the farming sector, which drives land values down further.

2 1930-1940
The establishment of UK marketing boards increase price certainty, and the introduction of farm subsidy brings a hardening of land values and a return to positive real-term growth.

3 1940-1950
The Second World War boosts demand for food and, with guaranteed prices, leads to a 50% increase in the area of arable farmland. Changes in attitude, innovation and financial support see the adoption of technology to aide production. This spurs capital growth until the early 1950s when demand settles and values retract.

4 1950-1970
The Common Agricultural Policy (CAP) comes into existence with the aim of collectively modernising the industry towards realising better economics of scale.

5 1970-1980
The UK joins the EU and, in turn, the CAP.

6 1992
CAP reforms lower subsidy payments for cereals and beef. It marks the start of a transition from incentivising per unit production with the introduction of Arable Area Payments, which lead to increased disparity between average arable and grassland values.

7 2003
Interest from lifestyle buyers peaks at around 45% of demand, a level not reached again until 2015.

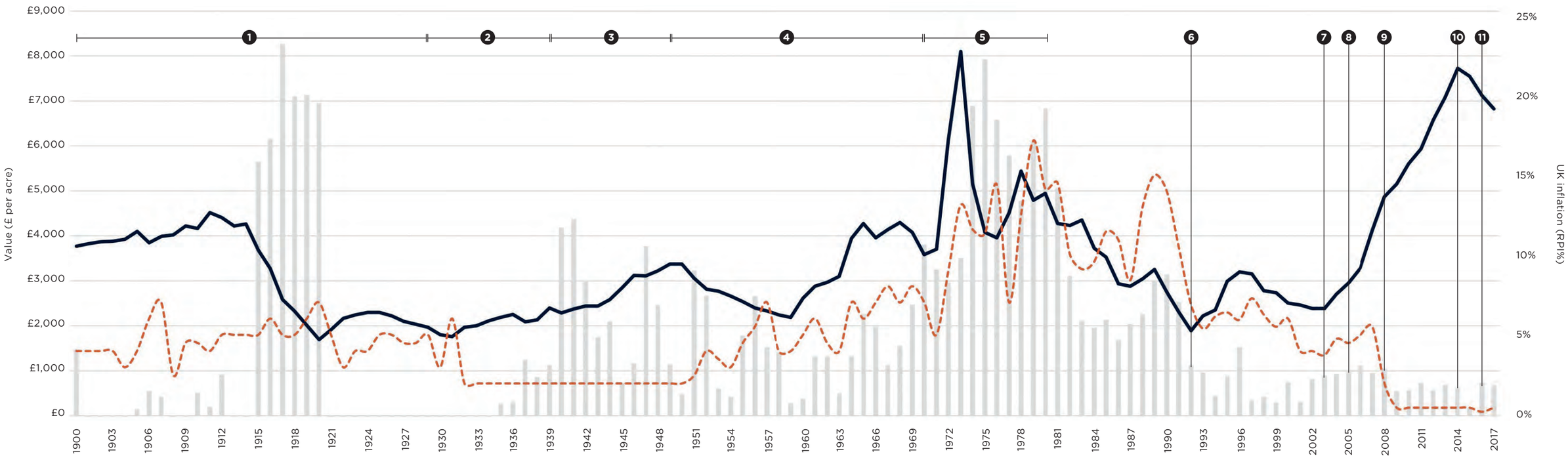
8 2005
CAP reforms with the introduction of the Single Farm Payment (SFP) mechanism.

9 2008
The global financial crash heralds a resurgence in demand for relative safe-haven assets.

10 2014
Weakness in commodity pricing drags average values down as farm earnings contract.

11 2016
The UK votes to leave the EU, casting material uncertainty over the future prosperity of UK agriculture.

Historical context Long-term average value of GB farmland compared with inflation and base rate: 1900-2017



Source Savills Research, Bank of England

Farmland rents

The rental market remained subdued during 2017, in keeping with the longer-term downtrend in the size and frequency of reviews undertaken

Driven by weakness in commodity prices since 2014, the average uplift in rents has fallen from just over 7% between 2013 and 2014 to around 4% during the last two years. We continue to note the reduced number of reviews taking place, as well as an increase in the number of no change and downward revisions.

During the past 10 years, our *Estate Benchmarking Survey* shows that average rents have increased by just over 4.5% per annum (compound annual growth). Farm business tenancies (FBTs) recorded closer to 5.5% growth, yet underperformed traditional tenancies (AHA) during 2016 and 2017.

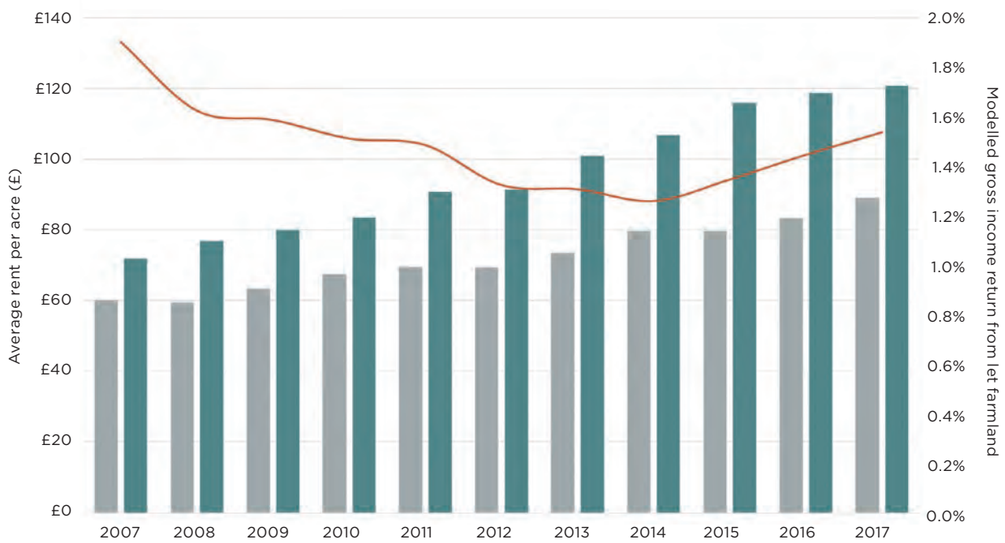
We estimate annual growth in AHA rents has averaged more than 6% in the last two years. The value gap between tenancy types has also narrowed since 2015, albeit remaining marginally above the long-run average of around 30% FBT premium to AHAs.

While returns appear modest in comparison with the heightened risk posed to agricultural earnings, long-term capital appreciation remains the prime attraction to the asset class. Although we remain bullish on farmland's role as an inflation hedge, income returns could come under pressure if cash flow from agriculture declines. This is particularly salient for farm businesses which have relied on direct subsidy payments to remain cash-flow positive during the downturn in commodity prices.

Should the agricultural sector's position weaken post Brexit, we see material benefit in landlords engaging with tenants to assess rents in relation to the realisable earning capacity of both the farming operation and the land utilised. While this could lead to rents commanding a larger share of cash flow, scarcity of supply should offer protection for newer, shorter terms tenancies.

Farm business tenancies recorded growth during 2016 and 2017 yet underperformed traditional tenancies

Average passing rents During the past 10 years, average rents have increased by just over 4.5% per annum



Source Savills Research, Bank of England

Four for the future

Given the uncertainty and associated risk over the next five years, land managers should assess their respective exposure to a decline in farm earnings. Our research has flagged four short- and long-term levers to protect investment returns

1.

Increasing operational efficiency would give the most immediate relief. This could be achieved either through raising output yields to boost aggregate revenue, or by implementing cost reductions to prevent margins from contracting. However, the extent to which gains could be made will be limited.

2.

Tighter capital discipline will ensure cash is conserved and not re-invested into a business where the future return is uncertain. We are likely to see an increase in the number of project deferrals until further clarity emerges on the impact of Brexit. Similarly, we are unlikely to see surplus cash being used to ease leverage, with reserves likely to be highly prized over the next few years to provide additional running room against lower cash flow.

3.

Diversifying revenue to lessen the reliance on agricultural earnings represents a longer-term undertaking. Our *Estate Benchmarking Survey* shows that rural businesses have reduced their exposure to farming over the past 15 years. Residential and leisure initiatives have increased in prevalence, often making use of surplus built infrastructure that is no longer required or not fit for modern agricultural purpose. The all-but-confirmed shift from direct subsidy payments towards incentivising environmental management also presents opportunities for future income streams.

4.

Value added investment into enterprises other than agriculture present the best, yet most capital-intensive, way to protect both income and capital value. These often require a complete change in land use across the area in question. Combined energy generation and storage, as well as woodland establishment, both present attractive options with plenty of benefit to be realised, although thorough due diligence is required to unlock maximum value.

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