For Alpha in a Real Asset Portfolio, Look Up the Value Chain

Private equity investments in these "value chains" offer the real asset manager a way to extract more value from existing holdings while also diversifying revenue and reducing exposure to commodity prices.

By Jose Minaya, Senior Managing Director and Head of Private Markets Asset Management, TIAA-CREF

Interest in, and experience with, real assets among institutional investors has never been higher. The package they offer of potentially attractive total returns, portfolio diversification, and protection against inflation is garnering more and more attention in today's environment of near record low interest rates and historically steep equity valuations.

It is well known that a portfolio of core real assets – farmland, timberland, energy resources and infrastructure – can provide beta diversification to a traditional portfolio through steady income, capital appreciation, and the intrinsic value of the holdings. What is not widely known is that real assets also confer some advantages to their owners that are not available to holders of financial assets.

By virtue of their close relationship with adjacent companies in the value chain, the owners of real assets are able to identify and act on investment opportunities that would not be known or available to others. Private equity investments in processing and distribution companies that lie further up the value chain can bring real asset managers important benefits, including more efficient capital deployment, potentially attractive total returns, and meaningful diversification. This is a large market that is under penetrated by institutional investors and a source of potential alpha for real asset portfolios.

Obviously, real assets do not exist in an economic vacuum. Once they are produced in raw form, they enter a processing stream in which they are transformed into finished products ready for sale to consumers. Private equity investments in these "value chains" offer the real asset manager a way to extract more value from existing holdings while also diversifying revenue and reducing exposure to commodity prices. They help real asset owners capture more of the full retail value by removing an intermediary and provide market knowledge that helps producers adjust to changing trends in demand. In some instances, the operating asset may also act as an internal hedge to land investments, since profitability is often based on volumes processed rather than crop prices; if excess production pushes crop prices down, part of that loss can be offset through the increased revenue from processing higher volumes.

The rationale for investing in businesses adjacent to real assets in the value chain is much the same as for investing in real assets themselves, as they both benefit from the same growth drivers. For example, increased protein consumption, the growing interest in healthy living and rising demand from emerging markets benefit agricultural processors just as they do farmers and farmland owners. These businesses also provide the investors with same benefits as real assets: the potential for current income, long-term capital appreciation, and low correlations with traditional equity or fixed income investments.

To get the most from our real assets portfolio, TIAA-CREF began looking for private equity investments in 2010 that would complement our farmland holdings. As an almond producer – one of the world's top five, actually – we have detailed knowledge of how almonds are purchased, processed and marketed, and the amount of value added at each stage of the production chain. We also have relationships with the businesses that perform those tasks and knowledge of prevailing market conditions. As investors, we quickly recognized that controlling some of the stages of production, marketing and delivery — the vertical integration that exists at the intersection of agriculture and infrastructure — would help us to derive additional value while at the same time mitigating some risks.

So, in 2011 TIAA-CREF acquired a minority equity stake in a privately held almond processer in California in order to capture the potentially attractive risk-adjusted returns it generates and to invest as long-term partners with one of the leading owner-operator management teams in the industry. This investment has allowed TIAA-CREF to improve our overall almond sector risk-return profile and helps us to better coordinate production and processing, thereby improving returns at each stage.

Not only do we benefit from their profitability, our investment with this almond processer also helps us understand the market and customize the product for our customers' varying demands. In Japan, for instance, most buyers want to buy almonds that have been sorted and graded so that they get only small, perfect nuts. In India, by contrast, we sell almonds in the shell so that participants in the country's employment program can add value processing them by hand.

Almonds are part of our farmland portfolio that is managed by our Illinois-based affiliate Westchester Group. Westchester invests in farmland and provides services to farmers that help maximize their returns. Our private equity investments are predominately made through California-based AGR Partners, which provides investment management, sources minority equity transactions and conducts due diligence in the agribusiness space. Both Westchester and AGR Partners leverage the broad infrastructure and institutional knowledge of TIAA-CREF's asset management team.

Overall, our strategy is to use the industry knowledge we gain from owning the key factor in the production stream to make opportunistic investments further up the value chain. Usually, we are interested in taking a minority stake. That gives us a larger universe of investment opportunities from which to choose – many businesses are owned by families that need capital but do not wish to give up operational control – as well as strong operating partners with aligned interests. We put particular emphasis on margins: we look for companies engaged in volume and value-added activities that let us be commodity price agnostic. We have a long-term focus, using dividends for current income and allowing the long-term capital appreciation to accumulate. ■

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