EXPLORING THE CASE OF FARM REITS IN PAKISTAN

This piece is based on Pakistan's two main sectors: Agriculture/Farming and Real Estate with both these sectors contributing significantly to employment and GDP.

Agriculture in Pakistan

Pakistan is the 6th most populous country in the world with population exceeding 220 million as of 2017 Census, growing at an average rate of 2% annually. As per data from Pakistan Economic Survey 2022, Agriculture sector contributes 23% to GDP and constitutes 37% of the labour force (Females 67%, Males 28%). The important crops contribute 19.44 % to value addition in agriculture sector and 4.41 % to GDP while other crops account for 13.86 % in value addition of agriculture sector and 3.14 % in GDP. Due to its solid forward and backward linkages with both industrial and services sectors and resultant multiplier effect, Pakistan's economic growth is a direct function of agriculture sector. Figure 1 summarizes agriculture sector growth.

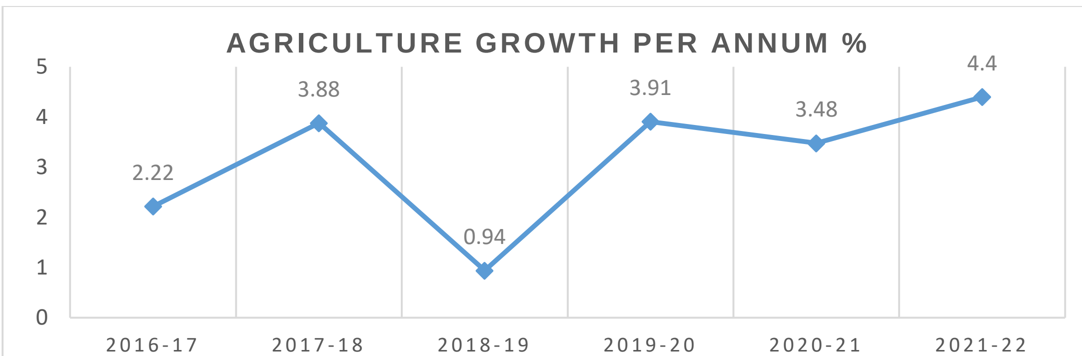

Figure 1

Farm Land and its Issues in Pakistan:

Agriculture sector derives its strength from its core input, farmland or agricultural land[1]. The agricultural land is 44% of the total land of Pakistan which has an irrigation coverage of 80%. Out of the total area of 79.61 million hectares, 22.74 million is cultivated area as rest is forest, rugged landscape and not fit for cultivation. As per Agricultural census of 2010, there are 8.26 million farms in Pakistan with the following breakdown:

Table 1

(Number in Million & Area in Million Acres)	No. of Farms				Farm Area			
	Total	Owner	Owner Cum Tenant	Tenant	Total	Owner	Owner Cum Tenant	Tenant
Pakistan	8.26	6.74	0.6	0.92	52.91	39.43	7.58	5.89
KPK	1.54	1.34	0.09	0.11	5.57	4.35	0.80	0.42
Punjab	5.25	4.32	0.45	0.47	29.33	20.60	5.37	3.36
Sindh	1.11	0.78	0.04	0.29	9.87	7.83	0.74	1.29
Baluchistan	0.36	0.32	0.01	0.05	8.14	6.65	0.67	0.82[2]

[1] Farmland and agricultural land have been used interchangeably in this document.

[2] Pakistan Bureau of Statistics

Further details of the Agricultural/Farm Land in Pakistan is as follows:

Million Hectares	Total Area	Total Cropped Area	Arable Land	Agriculture Land
Pakistan - 2019/2020	79.61	24.16	30.93	34.85

Table 2

(AREA IN HECTARES)

SIZE OF FARM (HECTARES)	NUMBER OF FARMS		FARM AREA		CULTIVATED AREA		CULTIVATED AREA AS % OF FARM AREA	AVERAGE SIZE OF FARM	
	TOTAL	PERCENT	TOTAL	PERCENT	TOTAL	PERCENT		FARM AREA	CULTIVATED AREA
1	2	3	4	5	6	7	8	9	10
PAKISTAN									
PRIVATE FARMS-TOTAL	**8264480**	**100**	**21412545**		17249078	100	81	2.6	2.1
UNDER 0.5	2071227	25	545774	3	498109	3	91	0.3	0.2
0.5 TO UNDER 1.0	1525698	18	1143737	5	1065793	6	93	0.7	0.7
1.0 TO UNDER 2.0	1753985	21	2431810	11	2267232	13	93	1.4	1.3
2.0 TO UNDER 3.0	1131938	14	2627856	12	2446192	14	93	2.3	2.2
3.0 TO UNDER 5.0	915252	11	3531175	16	3221065	19	91	3.9	3.5
5.0 TO UNDER 10.0	562206	7	3793730	18	3352054	19	88	6.7	6.0
10.0 TO UNDER 20.0	211198	3	2723748	13	2181719	13	80	12.9	10.3
20.0 TO UNDER 40.0	66927	1	1678093	8	1213582	7	72	25.1	18.1
40.0 TO UNDER 60.0	12643	*	568075	3	382018	2	67	44.9	30.2
60.0 AND ABOVE....................	13457	*	2368524	11	621336	4	26	176.0	46.2

Figure 2

The data in Figure 2 and Table 1-2 shows the issue of farmland fragmentation and shrinkage in Pakistan as the root cause of many challenges in agriculture sector. Farmland being passed on from one generation to another and rapid surge in population have led to a decline in farm sizes globally. The average farm size has been on a decline from 5.3 hectares in 1971 to 2.6 hectares in 2010 as per the last agricultural census in 2010. Resultantly, over 90% of the farms in Pakistan are small sized of average 5 hectares with majority of these below 2 hectares as shown in detail in Figure 2. If we compare the Private Farm Data from 1990 to 2010, the private farms increased by 63% in number overall mostly driven by small size farm growth. From 1990-2000, total number of farms increased by 30% to 6.6 million followed by 25% growth to 8.26 million in 2010. The growth in farms is due to fragmentation of the large and medium sized farms as the number of farms have grown by 64% between 1990-2010.

This shrinkage of farm size in Pakistan is a cause of many fundamental issues pertaining to agricultural sector growth and development such as extending credit services, training, access to modern machinery and technology, developing storage and cold chain facilities, lack of economies of scale in marketing goods and services, capex for seed development and other development. All these activities require significant long term capital commitment and monitoring but sub-optimal farm size is inherently less competitive with diseconomies of scale blocking out any investment.

Although research studies have proven that there is an inverse relationship between yield and farm size, new research by Aragon (2022)[3] has asserted, based on evidence from 4,000 farms in Uganda, that crop yields are higher for small farms but productivity is higher for larger size farms.

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[3] Fernando M. Aragón, Diego Restuccia, Juan Pablo Rud, Are small farms really more productive than large farms? Food Policy, Volume 106, 2022, 102168, ISSN 0306-9192, https://doi.org/10.1016/j.foodpol.2021.102168.

It is because yield as a measure only focuses on land size as the denominator whereas productivity is a better measure as it incorporates a farm's ability to transform inputs into outputs based on a farmer's technology or expertise. Small farms have higher yields but they require greater amount of inputs at a higher cost.

Real Estate Sector and REITs in Pakistan:
The real estate sector encompasses housing, construction, retailing, hoteling, and renting of spaces for official or trading purposes. As per a report by PACRA and Pakistan Economic Survey 2021, combined direct contribution of construction and housing sectors to the country's GDP has remained more than 9% over the past decade. Real Estate itself has a contribution of 6% to GDP. The sector supports several other vertically integrated industries such as cement, steel, wood, cables, ceramics, etc. thus adding significantly to employment.

Real Estate Investment Trusts (REITs) are a subset of the real estate sector that has recently seen gained traction in Pakistan. During FY23, SECP has introduced several reforms to promote Real Estate Investment Trusts (REITs) in Pakistan by allowing several new categories including i)Agriculture; ii) Healthcare; iii) Transport; iv) Power; v) Energy; vi) Telecommunication; vii) water and sanitation; viii) social, cultural and commercial segment; This is a major positive development as it is the first time that new categories have been introduced in REITs that will allow better variety of options for investors, particularly retail. Several other policy initiatives include:

- Tax exemptions on payment of 90% dividends
- Reduction in REIT Dividends Tax to 15%
- Mandatory listing in 3 years of launch
- Exemption from property tax & CGT – till June 2023
- REIT investments to count towards mandatory housing targets for Banks with up to 15% equity stake
- Capital adequacy for REIT reduced to 100% from 200%
- SPV Structure for REITs and Customer Advance collection allowed.
- Banks can participate as investors

To briefly describe, a Real Estate Investment Trusts (REITs) are companies that own, finance, and develop income-producing real estate across a range of property sectors. Most REITs are required to distribute 90%–100% of their taxable income to shareholders and invest at least 75% of their assets in real estate. There are several categories of REITs such as public or private REITs, Debt/Mortgage or Equity REITs, Rental or Developmental REITs or Hybrid Structures[4]. [Refer to CFA Institute Refresher Readings on REITs for more details]

Globally, REITs have been growing in popularity and in size as reported by NAREIT, the world's largest platform for REITs. There are a total of 865 listed REITs with a combined equity market capitalization of approximately $2.5 trillion (as of December 2021) with US being the market leader. One of the most significant growth has emerged from Asia with India and China leading the way. Current countries and regions with REITs represent 85% of 2020 global GDP, increasing from 28% of global GDP in 1990 as per NAREIT[5].

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[4] CFA Institute Refresher Readings – Public REITs – 2019
[5] https://www.reit.com/data-research/reit-indexes/real-time-index-returns/enhgeur-ftx

In Pakistan, however, REIT market has been on the back burner for a long time due to limited investor awareness and product range availability for investors despite a robust policy framework. Currently, there is only one listed rental REIT scheme available in Pakistan at a market cap of PKR 30 billion as of now; Pakistan listed its first developmental REIT as of December 2022 with an initial size of PKR 2.8 billion. Two new schemes have been approved while several others are in process by large conglomerate groups following new favorable policies. It is pertinent to mention that countries like India (3 major listed REITs) and China started adopting REITs only in 2021 and 2014 respectively while Bangladesh is still working on its policy framework.

For Pakistan, real estate as an asset class, remains one of the most prominent investment choices for investors, both short term and long term. Relatively, real estate has remained less taxed and regulated over the years than other assets, making its returns more attractive for investors. Investors have banked on the real estate as a key hedge against inflation over other asset classes.

Furthermore, surging business costs, regulatory requirements and tough macro-environment over the last 10 years diverted funds from the industrial sector as well towards real estate, causing a boom with volatility in property prices, with some speculative activity also. Data by State Bank of Pakistan shows that average return from industrial sectors between 2011-2016 has remained lower than property market. Table 3 shows price movement in Real Estate between 2013-2018.

Percent	Karachi	Lahore	Islamabad
Plots	129	85	53
Houses	86	63	33

Table 3[6]

Due to this, real estate market has remained informal, non-fractionalized thus shutting the door for retail investors to diversify their investment and having a share of the pie. However, as regulations have improved recently to document the activity in Real Estate and offer new products, prices and returns have started to normalize and become more consistent.

FARM REITs in Pakistan and its application

In this backdrop, a case is being made for launching Farm REITs in Pakistan as it offers the best combination of the two most significant sectors of Pakistan economy i.e agriculture and Real Estate. Institutional investors can work with farm land/agricultural land which is not being used efficiently at present to introduce farm REITs in Pakistan.

As an investment avenue, farm REITs are more beneficial than direct real estate on the basis of: lower obsolescence risk, lower capex requirement (other than irrigation and drainage) and vacancy risk. In addition, farmlands are easier to adapt to changing food habits of population, more flexibility for best crop choices as compared to traditional real estate where CAPEX and switching costs can go as high as 20-30% of NOI[7]. Although initial returns might be on the lower side than traditional real estate in Pakistan, but over time the returns improve as land costs diminish, increased farm output and steady growth due to less correlation with economic cycles. Plus, Farm REITs offer income + capital appreciation both, making it an effective inflation hedge.

When compared to other investment tools for agricultural sector, Farm REITs rank better in terms of liquidity as well as capital appreciation opportunities, especially for passive retail investors. A

[6] Zameen.com as reported by State Bank of Pakistan
[7] Research Primer by Farm Land Partners - 2019

detailed comparison from the investor's point of view is shown in Table 4. In Pakistan, unfortunately, capital markets remain underdeveloped to offer multiple investment options other than direct real estate.

	Direct Property	**Farm REITs**	**Mutual Funds/ETFs**	**Commodities**
Investment Nature	Land + Operations	Land	Operations	Commodity
Investment Ticket Size	Large	Small	Small	Small
Exposure	Direct	Direct – Indirect for retail investors	Indirect	Indirect
Diversification	Very Low	High	High	Low
Liquidity	None	High	High	High

Table 4

Farm REITs, though similar to rental REITs, need to account for certain factors that affect their viability and success, especially in Pakistan. Firstly, the selection of tenants or farmers is a serious issue as it directly impacts the farm income. Similar to screening and selection of tenants in Rental REITs, stringent criteria must be in place to ensure stability in income from farmland encompassing factors like previous track record, credit score, understanding of business and eco-system, reputation and financial strength. However, In Pakistan, most of the farmers are small scale and lack advanced training and skills. Therefore, a mix of well informed, large scale farmers + small scale farmers needs to be included in this model. This is because it will make it easier to transfer technology and tools from one farmer to another, provide synergies as well for all tenants.

Another factor which is significant is the lease structure. In traditional REITs, it is common to have long term, fixed lease rentals with an annual appreciation factor whereas in Farm REITs, shorter – medium term rentals are preferred depending on crop nature with a variable component. This is a risk/return pay off in term of type of lease offered with fixed rentals being least risky and partnership/join venture bearing highest risk. [Figure 3]. Shariah compliant leasing options can be introduced as well.

In Pakistan, Farm REITs are recommended to include a variable component based on higher yields and productivity to act as an incentive for improved farm operations. This is strongly suggested as the greater purpose of farm REITs should be mutual benefit of investors and farmers. There are case studies of companies including Farm Land Partners and Gladstone Land Corporation that are listed Farm REITs in US that attempt to not only lease the land to farmers but to partner with them. Such REIT structures can support farmers in the form of better access to inputs, resources, modern farming knowledge and practices that will in turn boost the yields/productivity. Given the limited space for land extension and crippling challenges of inefficient use of farm land, such partnerships are vital for Pakistan economy. Some other benefits include less tied up capital for farmers due to de-risking of operations by REIT and partnership with their tenants for training, development and shared prosperity.

From the perspective of investors, Farm REITs, once listed can prove to allow participation from retail market and a share in the agricultural sector growth. Currently, there are limited diversification avenues available for investors in Pakistan and direct real estate remains a difficult choice due to large ticket size of investment for majority plus challenges of a relatively unregulated market. Promoting Farm REITs helps to achieve multiple objectives including improved transparency and documentation in real estate sector, broadening of equity market with new avenues for investors as well as improved yields, food production and farming practices for agriculture sector.

Structure of Farm REITs:
Farm REITs offer a unique opportunity for corporate farming and farmer producer companies (FPCs[8]) to join hands for the betterment of agriculture sector in Pakistan. Aggregation of land and resources with this combination can promote investment in seed development, adoption of technology and mechanization on a larger scale and other areas. Using legally registered entities on both sides can help to overcome various challenges including having a formal framework and organization structure that supports reform implementation. FPCs have been successful in mainstreaming of reforms in countries like India, Europe and USA where they have been at the forefront of key initiatives like seed reforms, water conservation and branding of produce. Since Pakistan is an agricultural economy with demand of food outpacing supply due to high population growth and other issues, agricultural sector has immense potential for offering lucrative returns, growth and sustainable revenues for REIT investors.[9]

The institutional investors will act as REIT managers and owners who would lease the land to farmers. Similar to Rental REITs, the responsibility of providing repairs, development work and other operational tasks would be carried out by REIT managers for a fee. Both parties will be co-dependent for the successful performance of Farm REIT.

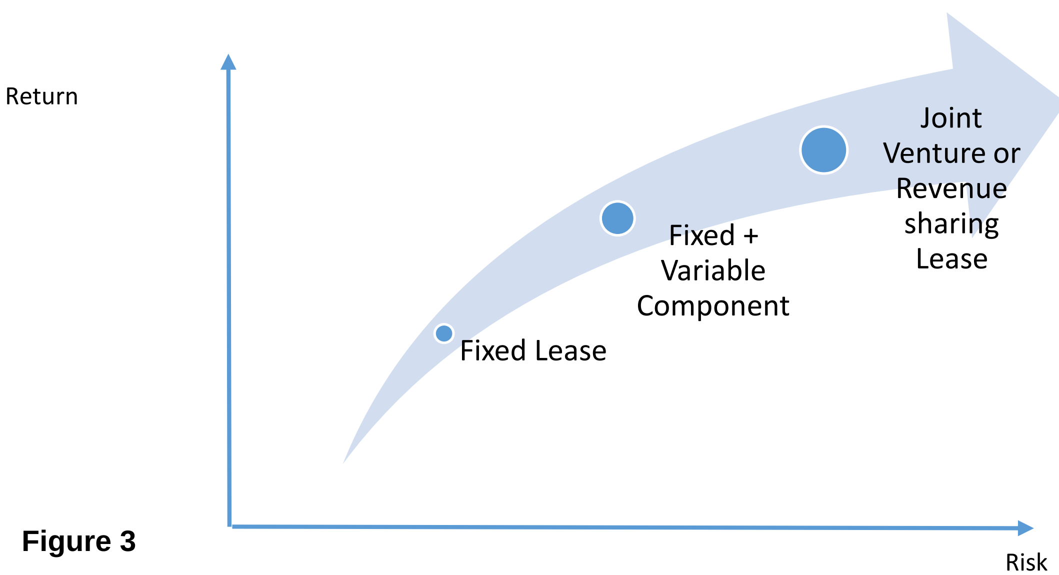
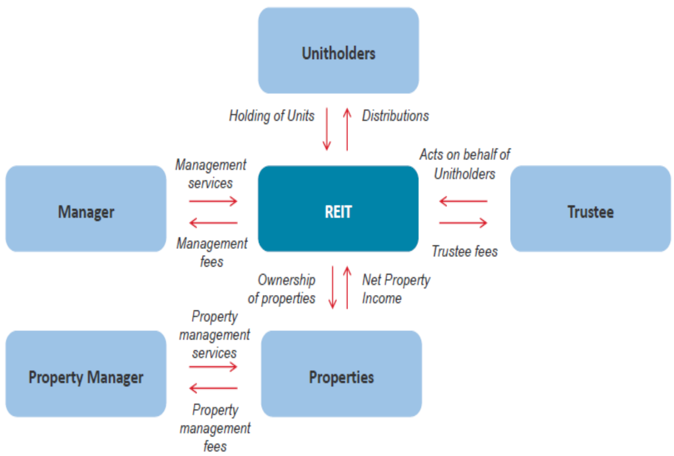


Figure 3

[8] Farmer Producer Companies are defined as Producer organizations registered under Section 581(C) of Indian Companies Act, 1956, as amended in 2013 are termed as Farmer Producer Company. Principally the structure, concept and philosophy of Co-operative Societies

[9] https://www.worldbank.org/en/news/press-release/2022/07/15/world-bank-supports-pakistan-to-increase-agricultural-resilience-and-protect-small-farmers-from-climate-change-impacts-i

Figure 4 shows a typical REIT structure. In case of Farm REITs, the properties will be leased to FPCs, consisting of a combination of subsistence + experienced farmers as tenants whereas the corporate sector will act as the REIT manager and property manager (could be single entity or consortium). Both legal entities will have a close working association based on mutual cooperation and partnership, underlining the farm REIT.



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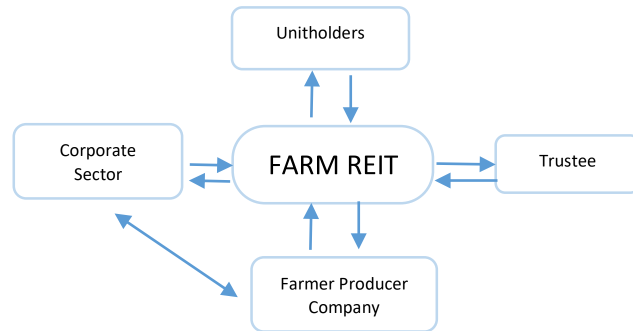

Figure 4

Key risks include natural calamities that hamper farm produce, lack of documentation and data about farmers and real estate sector, power imbalance in REIT and limited experience of FPCs locally.

Conclusion

Despite being an agricultural country, Pakistan is struggling to meet the domestic demand for food as food trade deficit stood at USD 3.6 billion in FY22[11]. This is expected to widen due to high population growth rate and serious problems of agriculture sector outlined in this article briefly. It has become imperative to look for innovative and breakthrough solutions to address the fundamental issues of agriculture sector.

Moreover, capital markets need to play an active role by offering relevant products that combine such vital sectors of Pakistan like Real Estate and Agriculture to make them more productive and documented. Not only this, capital markets have to strive for democratization of land and other assets by developing new avenues for much larger retail participation, diversification and better-quality depth of Pakistan markets.

[10] https://www.reitas.sg/singapore-reits/s-reit-structure/
[11] State Bank of Pakistan