50/50 Sharemilking

Where are we in 2013?

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EXECUTIVE SUMMARY

The purpose of this report is to have a better understanding of the 50/50 sharemilking industry in 2013.

The perception within the dairy industry is that the 50/50 sharemilking business structure is on the decline and not enabling sharemilkers to progress to purchasing their own properties or enter other business investments.

Having been a 50/50 sharemilker for seven years, from the late 1980's to mid 1990's and having gained significant benefit from the system, I identified the need to ensure this unique pathway endures. Due to this interest in the succession of our industry, I investigated where the 50/50 sharemilking system stands today and provided some solutions for how it may develop in the future.

The body of the report looks at the actual numbers today and the trends over the last decade. I also decided very early on in my research that there appeared to be, as I have termed it, a "natural progression bottleneck". This in itself was having a significant effect on how the 50/50 sharemilking system was functioning. To illustrate this more clearly; I chose to survey 10 long term 50/50 sharemilkers from around the country.

My findings were conclusive in that the industry needs to look seriously at its 50/50 sharemilking contract to more closely align itself with the current economic landscape, market changes and farm demographics.

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INTRODUCTION

It is recognised that one of the key drivers for the dairy industry being regarded as innovative and progressive, is the constant stream of new, enthusiastic young farmers entering the 50/50 sharemilking business.

The questions that, I believe, need to be answered are:

- What are the numbers today?
- What has been the trend of these statistics?
- What are some of the reasons for the position; the 50/50 sharemilking structure finds itself in?
- Where do I see the 50/50 sharemilking industry heading in coming years?

From the outcome of my investigation I hope to be able to come to some conclusions as to what the industry may need to do to nurture the future of this valuable pathway, or to look to other avenues which will allow succession within the dairy industry.

PART 1...THE ORIGINS AND FEATURES OF 50/50 SHAREMILKING

Sharemilking has a long history in the New Zealand Dairy Industry. The concept is believed to have had its origins in Scotland. The first known contract was recorded in 1884 by The Henley Land Company on the Taieri Plains.[1]

The idea took hold quickly and soon spread to the dairy dominant regions of the North Island, namely Taranaki and Waikato. Since these times, sharemilking, has become an important institutional structure in the New Zealand Dairy Industry.

The crux of the 50/50 sharemilking agreement is that the land owner relinquishes the day to day management of the farm to the sharemilker, who has, in essence, put some capital into the business by purchasing the herd, herd replacements and all other sundry equipment needed to operate the farm. He is rewarded for his labour, financial investment and ability through receiving 50% of the milk income for the farm.

This is a very simplistic view of the operation and this is all brought together in a contractual arrangement. In some ways it is this contractual arrangement that has led to an effect on the industry sharemilking numbers, I will explore this more in Part 3 of this report.

Some of the benefits of this 50/50 arrangement, for the owner, may be:

- To free up capital through the sale of the herd and sundry plant and equipment.
- To free up the daily tie to operating the dairy farm.
- Suits absentee owners, investors, estates, trusts, corporates etc.
- Potential benefit from new, innovative and enthusiastic operator with fresh perspective and willingness to drive higher returns.
- Potential benefit over time as there is a steady number of people moving through the system to look to buy their farm as they wish to exit the industry.

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[1] http://www.ifmaonline.org/pdf/congress/11_NPR_Gardner

Some of the benefits of this 50/50 Agreement for the sharemilker, may be:

- Opportunity to operate a property with limited input from owners.
- A natural fit to progress through the industry i.e. farm assistant- farm manager- variable order sharemilker- 50/50 sharemilker- possible land ownership.
- Opportunity to prove ability by improving both production and economic returns for the farm owner.
- Opportunity to benchmark yourself and your operation against other sharemilkers.
- Excellent vehicle to increase capital base to allow further investment in either larger sharemiking operation or other non-farming investment.

Sharemilking exists today for much the same reasons as it was originally set up:

- A need for the owners to exit the day to day tasks and commitment.
- An incentive for the sharemilker to grow their capital base.
- To provide stability and security of a job as all sharemilking contracts are for at least one season more often three seasons.
- It is also a great way for parties to drive maximum benefits from the dairy operation, through the sharing of risk and costs for their mutual benefit.

An outcome of all of this is often the ability for succession and an opportunity for the farm to be purchased by the sharemilker.

Whilst my report will focus solely on the 50/50 sharemilker, it is important, to point out that the other significant legal contract between a farm owner and sharemilker is the ‘variable order’ sharemilker. Unlike the 50/50 agreement, where the farm owner may have little to do with the farm management, a ‘variable order’ sharemilking contract, will often see the owner heavily involved in management.

PART 2...SHAREMILKING STATISTICS

KEY FIGURES[2]

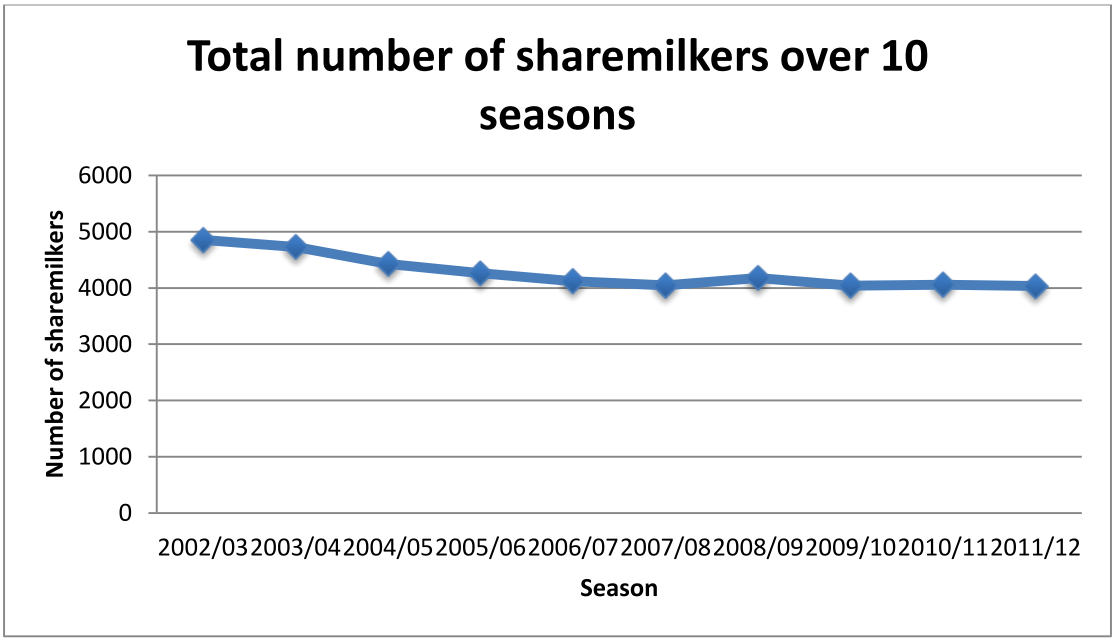
- 34% of all herds are operated by sharemilkers (4034 Herds).
- 55% of all sharemilkers are 50/50 sharemilkers (2218 Herds).
- 18.8% of all New Zealand herds are operated in a 50/50 sharemilking arrangement.
- Average herd size in 2013 was372 cows.

Sharemilking trends in the last decade (in a 50/50 arrangement):

Figure 1:

Year	2002-03	2011-12
Herd Numbers	3064	2218
% of all herds	23 %	18.8%

Figure 2: The total number of sharemilkers from the 2002/2003 season to the 2011/2012 season.



[2] http://www.dairynz.co.nz/file/fileid/45159

LAND PRICES AND COW VALUES

The number of cows required to purchase a hectare of dairy land basically doubled between 1992 and 2010. Adding in the purchase of dairy company shares further increases the number of animals required.

Figure 3: Cow numbers to buy one hectare of land[3]

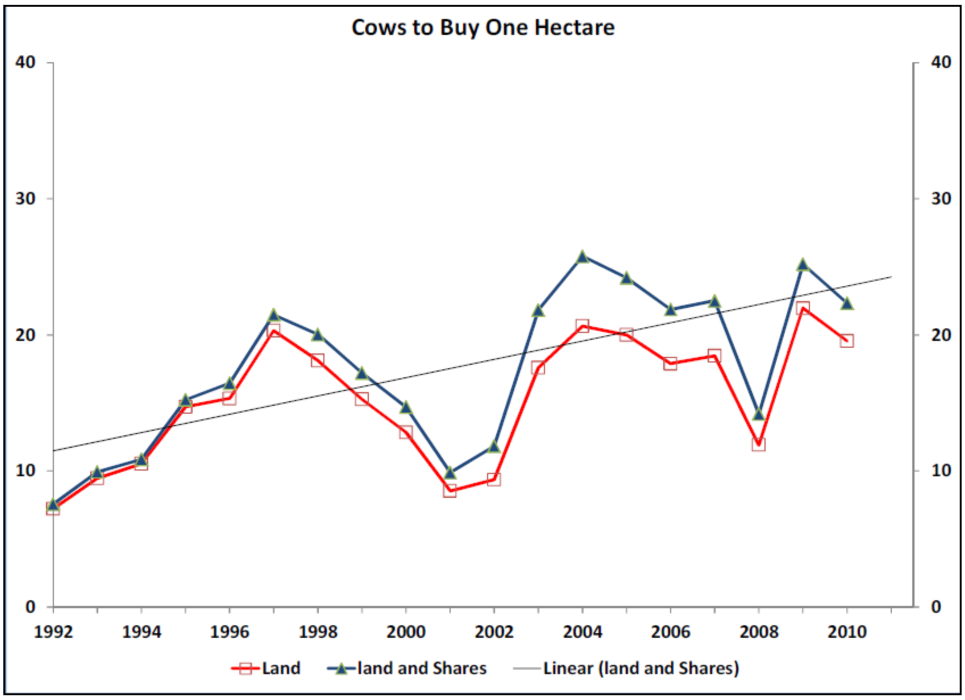


Figure 3 highlights the classic issue of timing of entry (and exit) for an investment. The ratio in the years 2001 and 2002 were not far from 1992. Livestock values escalated faster than land at these points in time[4].

NB: In my own business, we required eight cows, at a value of $1250 to purchase one hectare of land in 1994, this compares with 17.5 cows, at a value of $2000 to purchase 1 hectare of land in 2012.

[3] http://www.fedfarm.org.nz/files/Sharemilking-Study---June-2012---AgFirst.pdf

[4] http://www.dairynz.co.nz/file/fileid/45159

PART 3...STATISTIC REASONING AND IMPLICATIONS

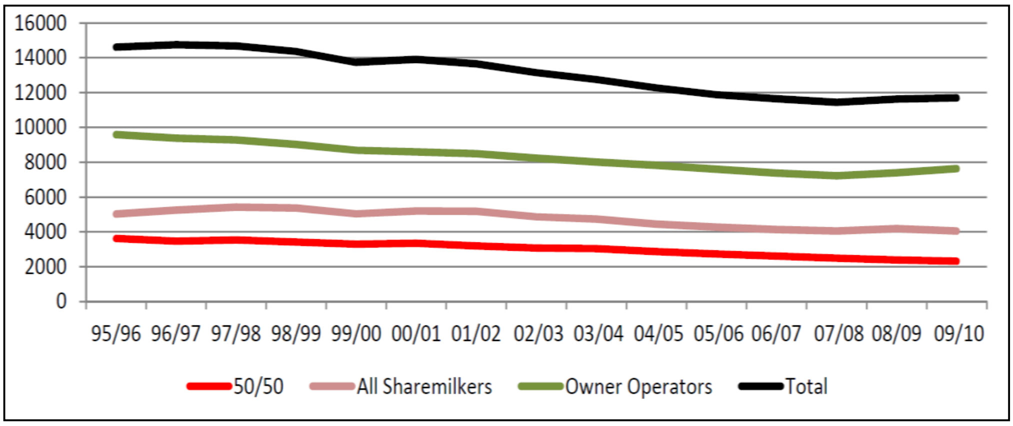
What are some of the significant reasons that we have seen a decline in the total number of 50/50 positions over the past 10 years?

The numbers have declined by 846 positions in 10 years[5]. Why?

Factors contributing:

- Actual farm demographics, dairy farm numbers have reduced by 16% over the last 10 years.

Figure 4: Farm Numbers Grouped by operating structure[6]



- Corporate ownership of farms and equity partnerships (particularly in the South Island) has also contributed to the decline in 50/50 agreements. These structures usually involved multiple owners who sit as investors whilst the operator is typically an equity manager who has also invested into the business.
- The average size herd in New Zealand has increased in the last 10 years from 250 cows to just fewer than 400 cows[7]. This has had a significant effect on the total capital required by a sharemilker.
- Owners who want to exit the daily routine of milking are more often opting for a variable order sharemilker over a 50/50 sharemilker due in a big part to economics and debt loading,(refer figure 5.)

[5] http://www.fedfarm.org.nz/files/Sharemilking-Study---June-2012---AgFirst.pdf

[6] http://www.fedfarm.org.nz/files/Sharemilking-Study---June-2012---AgFirst.pdf

[7] http://www.dairynz.co.nz/file/fileid/45159

Figure 5: Debt registered to New Zealand banks[8].

Agriculture credit by registered banks - detailed industry breakdown ($million)

As at June	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total loans dairy farms	11,177	12,295	13,845	15,956	18,577	23,995	28,626	29,268	29,621	30,549

Average farm debt has grown exponentially over the last 10 years. Dairy industry debt, at just short of 31 Billion in 2012, is at an average of $18.39 per/kg/ms, this compares to $8.77 per/kg/ms in 2003/04 season. This is an increase of 120%.

- This economic data highlights that a large number of farms that, 10 years ago may have put on a 50/50 sharemilker, now find this option is not economically viable.
- Return on assets is another key factor in owners opting to not put on a 50/50 sharemilker. Many owners identify that the 50/50 sharemilker is achieving a higher return than them when they have significantly more risk and capital at stake.

Figure 6: Return on assets, owner operator vs 50/50 sharemilker.[9]

	Operating profit/ha	ROA
Owner/operator	$1942	4.5%
Owner with 50/50	$1105	3.1%
50/50 sharemilker	$924	16.9%

- There is also, what I believe, a ‘natural progression bottleneck’ in the industry. Whilst this hasn’t so much impacted on the numbers of 50/50 positions in the industry, it has slowed down the traditional movement or added to a change of focus by sharemilkers to one of wanting to own their own farm.

  To understand this concept I chose to survey a group of 50/50 sharemilkers, this survey will provide a better understanding of what motivates 50/50 sharemilkers to move through or stay in the system.

[8] Source: Reserve Bank of New Zealand updated 31.8.2012

[9] Dairy Base stats 2007-2010

SURVEY

Ten sharemilkers were surveyed; they were from several geographies in New Zealand and were from varying sized operations.

The questions were:

1. How long have you been 50/50 sharemilking?
2. How long do you intend on staying in your current position?
3. What is the main reason you have stayed in your current position?
4. Have you used your 50/50 position to enable you to grow your business beyond the farm gate?
5. Do you intend to own and operate your own dairy farm in the next five years?

Figure 7: Survey Results.

1. Average time for sharemilkers to have been 50/50 sharemilking was nine years.

2. Four participants were looking at staying in their current position for at least another five to 10 years.

   Three were unsure on how much longer they would stay in their position.

   Three were looking to make this their final season in their current position.

3. All participants gave their number one reason for staying in their current position as that of equity growth and cash flow.

   Five also added that this was followed closely by excellent owners, farm location and family needs.

4. Eight participants have used their 50/50 position to expand their business beyond the farm gate, two have not. The various investments were housing, land for run offs/dairy farms and orchards.
5. Five participants did say they would purchase a dairy farm and operate it within the next five years; Five said they would not.

Whilst the survey number was only a small sample of 50/50 sharemilkers, the results gave some quite defining insights into what sharemilkers are planning and currently doing.

The strongest of these relates to Q3 where the reasons given were emphatically those of equity growth and good cash flow. This was reinforced in the results of Q4 where 80% of the participants had then used this equity growth to expand their business beyond their current position. The fact that in Q5 50% said they would like to buy a farm whilst 50% said they would not, left the question, Is there really a “bottleneck”? I would argue “yes” as the answer in Q1 showed there was a real correlation between the sharemilkers who had been sharemilking the longest and the desire to own a farm (the longer term sharemilkers had less desire).

SOME GENERAL COMMENTS

"We have excellent owners who do not live on the farm and allow us to operate the farm as if we owned it..."

"Our return is too good to want to own a farm..."

"Our reputation with the owners is of a high standard which has encouraged them to choose 50/50 sharemilkers over other sharemilking options..."

"We are not tied to milking the cows each day as we have staff, I believe that we would have to go back in the shed full time if we brought a farm, this would impact on our lifestyle..."

"We often get frustrated at times as not all decisions are ours to make and these are often fraught with process and time lines which sometimes compromise the

"Whilst equity growth and cash flows are our big drivers
we really enjoy operating and running the farm as if it was our own..."

PART 4...HOW THE FUTURE MAY LOOK

This may be crystal ball gazing, to a certain extent, but it is worth taking a look at what structures maybe enduring 10 years from now.

For 50/50 sharemilking to survive it will need to evolve and adapt to the powers of market forces. The market for 50/50 sharemilkers will evolve and change as the dairy industry changes. History shows that there will be times where there will not be enough good quality people to 50/50 sharemilk, or those who do not have the economic clout to operate.
There will also be those that do not have the foresight and commitment to work hard and commit time and energy to what is a long term goal. There may continue to be rationalisation in the size of the average dairy farm, but with this comes a new set of problems around scale.

There will also be, as is the current situation, times where owners will have the power to really be selective in their choice of a sharemilker and the terms and arrangements that will sit within their agreement.

It is inevitable, in my view that sharemilkers will have to accept changes to the 50/50 agreement. This may be around the percentage shared or other clauses within the contract. This will require rebalancing and there will be more situations where, for instance, all of the Fonterra dividend will go to the owners and all of the cost of grazing or other farm working expenses may be paid by the sharemilker.

As previously shown in my report, the return on assets, by the sharemilker is significantly better than that of the owner and for this reason, sharemilkers may have to accept more variability in their agreements.

50/50 sharemilking will continue to be a part of the New Zealand Dairy Industry landscape for the next decade and beyond. For many of the reasons, I have previously outlined, it will also be that any alternative i.e. equity partnerships, will always require an element of significant capital to be invested. Many smaller farm owners (180-500 cows) will look to 50/50 sharemilkers to operate their farms as there will be better economic returns from an operator with ‘skin in the game’. Sharemilking will continue to be an integral part of our dairying landscape as it allows for significant equity growth. The larger farms (1000 cows plus) will inevitably look to other more varied arrangements to operate their farms as the amount of capital required for a 50/50 sharemilker to operate this size property is significant and owners of these sized properties will have a smaller pool of sharemilkers to choose from.

Due to the pressure in recent years that has been put on many equity partnerships (over geared with debt, and differing investor goals) coupled with the evidence that there is a reduction in the number of 50/50 operated farms, I believe over the next 10 years other arrangements will evolve.

An example of one such new arrangement has recently been put together by a Waikato based company ‘Rural Business Solutions’. Some of the key features of this new investment plan, known as, ‘Pathways For Progression’, are:[10]

- This investment pertains to land only. Under the new “**pathways for progression”** model the business is split into a land owning entity and an operating entity. The operator(s) provides a **constant return** on investment to investors **linked to milk price** through a lease to the operator(s) who takes all operational risk with running the dairy farm.
- Investment in the land is funded by **100% equity**.
- This investment is setup so that the **investor has a succession plan** through the progression of the operator.
- The operating entity will also own a manageable share in the land entity (ideally 10%) from the outset.
- The ownership of the operating company will be the people who are hands on working and leasing the farm.
- Strict selection criteria will determine only the “**cream of the crop**” will be selected as operator(s) for this investment.
- Based on a current projected milk price (August 2013), $7.50 / kg/MS, the gross return on investment in land only is projected to be approximately 5.82% per annum.

[10] Rural Business Solutions Investment Prospectus 2013

- Net lease rental with GST will be paid and **surpluses distributed monthly to the investors.**
- **No assumptions** have been made with respect to **capital growth** of the land has been accounted for. However historical information suggests there has been capital growth but investors need to make up their own minds as to the extent of which this will affect returns above and beyond the gross cash returns forecast.
- To hold true to the belief that issues pertaining to farm succession and progression exist in the New Zealand Dairy industry, the central objective of the model is that the operator(s) will over time progress to outright ownership of the property, land, stock, shares, plant etc. This goes some way to addressing this issue whilst providing an opportunity for investors to share in the success of the dairy industry through their investment.

The 'Pathways for Progression' is just one example of a new concept being developed that will encourage 50/50 sharemilkers to invest capital into a business with the ultimate goal being full ownership of the property. These types of schemes will encourage 50/50 sharemilkers to look to farm ownership as opposed to long term sharemilking.

CONCLUSION

- 50/50 sharemilking is still an excellent vehicle for rapid capital growth for any future investments.
- 50/50 sharemilker numbers have declined in the last decade. There are a number of reasons why this is the case but essentially it has been created through changing economic circumstances, an increasing difference between land price and cow prices along with an amalgamation of smaller dairy units.
- Farm size/structure will change but it will always be recognised that to maximise returns the best operators will need to have a financial interest in the operation.
- Progressive sharemilkers will acknowledge the requirement to view the whole business plan and realize that there may be a need to veer away from some of the traditions of the former 50/50 agreement.
- It is evident that for succession to happen, some owners may look at alternative ownership structures which will allow sharemilkers to grow into the ownership of the farm over time.
- There may be a role for the likes of Fonterra or Federated Farmers to drive the direction in which changes are required to the 50/50 agreement, as in the long run the industry will certainly benefit.

Fundamentally New Zealand's Dairy Industry has been built by enterprising people who have progressed through a structure or system that has encouraged innovation and a willingness to adapt, this will not change!

REFERENCES

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Source: Reserve Bank of New Zealand updated 31.8.2012

Dairy Base stats 2007-2010

Rural Business Solutions Investment Prospectus 2013