

SHEEP & BEEF EQUITY FARMING

An Opportunity



Eggleton, Robin (2001)

Sheep and beef equity farming - an opportunity



KELLOGG RURAL LEADERSHIP PROGRAMME 2001

R.G. EGGLETON

ACKNOWLEDGMENTS

Special thanks to all those who helped in the production of this report, especially...

Andy MacFarlane – MacFarlane Rural Business Ltd

Peter Bradley – Consultant

Gina Miller – Typing/Printing

And my wife Kim

REFERENCES

1. Meat & Wool Economic Service
2. National Bank
3. Naploen Hills – Positive Action Plan – Quotes
4. The E-Myth

TABLE OF CONTENTS

SHEEP & BEEF EQUITY FARMING - AN OPPORTUNITY

1.0	Executive Summary	4
2.0	Introduction	5
3.0	Sensitivity Analysis for Earnings	8
4.0	Farming as a Business	17
5.0	The Quick Calculator	22
6.0	So How Does it Look?	23
7.0	Equity Structures	26
8.0	The Challenge	29
9.0	What's in it for an Investor	30
10.0	Conclusion	31

EXECUTIVE SUMMARY

Many New Zealand sheep and beef farmers are operating marginally viable farms. These people often justify remaining. In farming by quoting that farming is not so much for the money but the lifestyle.

When the financial situation of these farms is explored it concludes that after taking reasonable returns in real terms the farm is stagnant or slowly losing ground.

There is an opportunity however through equity farming to increase size. So long as care is taken through use of sound business practices to achieve top end performance the result is attractive. Equity farming would appeal to marginally viable farmers achieving good production results, or experienced farm managers wishing to take the next step.

Equity farming on farms with scale is also attractive for investors. Returns equate around 5% - 6% coupled with an inflating land value making equity farming comparable with other investment. Rural investment is also attractive to overseas investors wanting a slice of New Zealand "paradise". Rural investment is also appealing to ex farmers keeping an active involvement in an industry they have spent so much of their life.

By using expert advice and combining all skills the owner/manager would benefit from the board room approach to farm management and target driven production returns. Expert advice is available and should be used by anyone exploring the equity farming option.



INTRODUCTION

How often have we heard sheep/beef farmers say “we don’t farm for the money we farm for the lifestyle”? **Rubbish.** It’s nothing more than an excuse for the position farmers have found themselves in.

During this report I intend to dispel this myth. Farming is in fact a serious business and needs to have a business approach. Lets explore what makes farming a business and not a lifestyle.

What’s the Question?

Productivity

What’s the Answer?

Productivity

In order to get the necessary productivity there needs to be an emphasis on top end management, high performance at optimal cost. This will give you the ability to turn excellence of management into profit. To best achieve this, there needs to be a level of critical mass or scale.

We must shift our thoughts from farm succession of unviable farms through the use of cheap family labour and finance and focus on sustainability of the business itself.

A viable option to achieve the critical mass required is equity partnerships. Many sheep/beef farmers who have been sole traders will have difficulty focusing at first on what this will mean to them as it will be a big lifestyle change being accountable to others and not having sole responsibility stop with themselves. However board type approaches to management frequently add strength and give better results.

POINTS WHICH MUST BE CONSIDERED:

- An ageing farming population.
- Younger farmers entering farming with limited funds.
- Smaller farms that are marginally economic
- Being able to accumulate reasonable scale whilst still at young enough age to use it.
- The need for competitive returns comparable with other investments (shares, property etc).

Clearly the opportunities in the sheep/beef sector for equity farming are huge. Equity farming has the ability to give a marginal land owner the quantum leap to secure income as well as real dividend returns. Returning the BUSINESS to farming and attracting future generations to the business of farming and not the lifestyle.

“ARE YOU WAITING FOR SUCCESS TO ARRIVE, OR ARE YOU GOING OUT TO FIND WHERE IT IS HIDING?”

Avenues to farm ownership are changing. Many farmers used to gain ownership through well paid jobs such as the freezing worker or shearing. Then through a series of steps of owning smaller blocks of land and working into larger farms. Leasing was also used with ownership built up through livestock ownership.

Farm ownership schemes are now a product of a bygone era, and farm finance is a competitive business which treats everyone on their merits regardless of age or background.

Many farmers have of course succeeded into the family farm regardless of size or productivity.

To fully appreciate what we are dealing with we need to understand the business that people perceive to be a good lifestyle.

THE FARM – often perceived a good lifestyle

**180 ha (450 ac)
11 su/ha**

2000 su	Farm Value @ 360 su	\$720,000
	Stock @ 80 su	\$160,000
	Plant	\$ 70,000
	Working Capital	\$ 36,000

	Total Asset	\$986,000

	Less debt @ 120 su	\$240,000

	Net Equity	\$746,000

- W/Capital @ 60 of F.W.E



WHAT'S REQUIRED FOR A GOOD STANDARD OF LIVING?

\$40,000 plus?

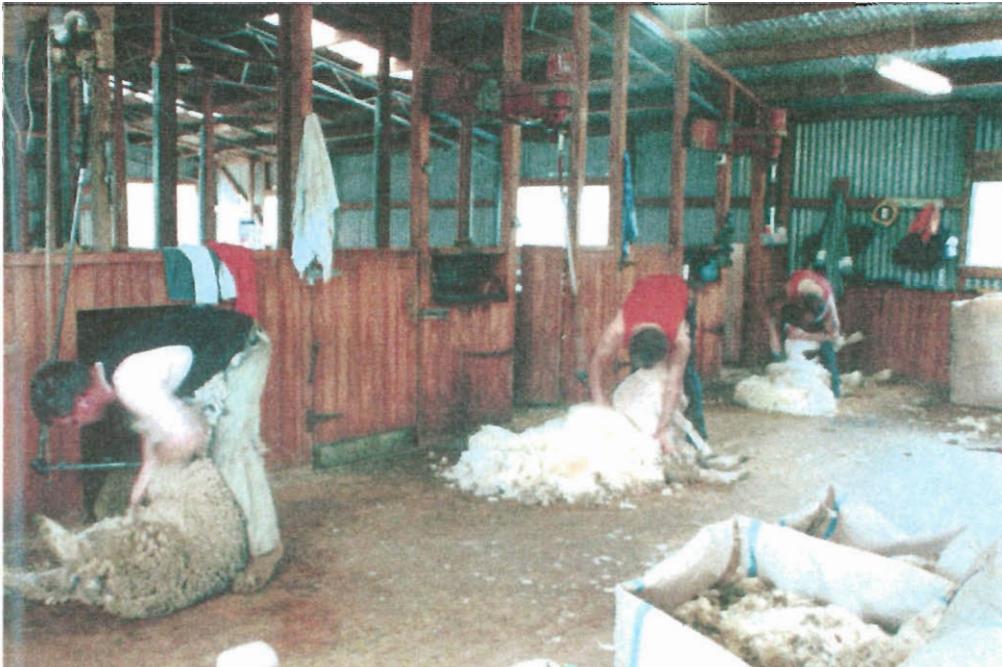
WHAT WOULD A FARM'S E.B.I.T.* REQUIREMENTS BE IF THIS WAS TO BE GAINED?

Requirement	\$95,000	
-	\$15,000	Plant Replacement*
-	\$26,000	Tax
-	\$12,000	Debt Reduction
Leaves	\$42,000	Drawings

With some room for movement we can assume that we need \$100,000 E.B.I.T.

* E.B.I.T. Earning Before, Interest, Rent and Tax - The point where drawings, interest payments and capital items are made.

* Given depreciation at the same level tax implications would be neutral.



SENSITIVITY ANALYSIS FOR EARNINGS FROM 2000 SU'S.

E.B.I.T. per su	\$25	Average \$27	\$30	Top \$38
E.B.I.T.	\$48,000	\$54,000	\$60,000	\$76,000
Interest on 240,000 @ 9%	\$21,600	\$21,600	\$21,600	\$21,600
Seasonal 10% on 50,000 – 6 months	\$2,500	\$2,500	\$2,500	\$2,500
Residual for personal, tax, capital and debt reduction	\$23,000	\$30,000	\$36,000	\$51,900

All figures rounded to the nearest (000)

- * \$27 is New Zealand's National average for Downlands sheep beef farming (av size 3800 su) yr 2000.
- * \$38 is New Zealand's Benchmark group having 80% higher scale lower F.W.E. to G.F.I.

E.B.I. T. Earning before interest and tax

- * F.W.E. – Farm Working Expenses
- * G.F.I. – Gross Farm Income



If we analyse these figures we see.

AV @	\$30,000	
	\$3,500	Tax
	\$30,000	Personal Drawings
	\$10,000	Plant Replacement

Results - \$13,500 Deficit

Top @	\$51,900	
	\$10,000	Tax
	\$30,000	Personal Drawings
	\$10,000	Plant Replacement

Result - \$1,900 Profit

So we need to see if we can get the \$720,000 they will clear after farm sale after sales commission lawyers fees etc to work better for this farmer.

WHEN YOU CLOSE THE DOOR OF YOUR MIND TO NEGATIVE THOUGHTS THE DOOR OF OPPORTUNITY OPENS TO YOU.



How much is \$720,000?

If we visit the Retirement Commissions Internet Site. It will tell you that

- 35 yr Male
- 33 yr Female

Retiring at age 60 giving a retirement income of:

- Male 21,000
- Female 10,500

Combined \$31,500 Retirement Income

This equates to an earning ability at their current age of combined \$60,000 before tax.

To achieve this they will require \$500,000

Let's work through the farm sale

Farm Sale clear commission, fees etc	\$720,000
Less a house in town	\$200,000
Update car	\$20,000
Incidentals	\$20,000

	\$480,000

\$480,000 available for retirement.

This does not take into account that in real terms this farmer is in fact going backwards during some years. Reality would dictate that the \$480,000 will be less as the deficits will effect the balance.

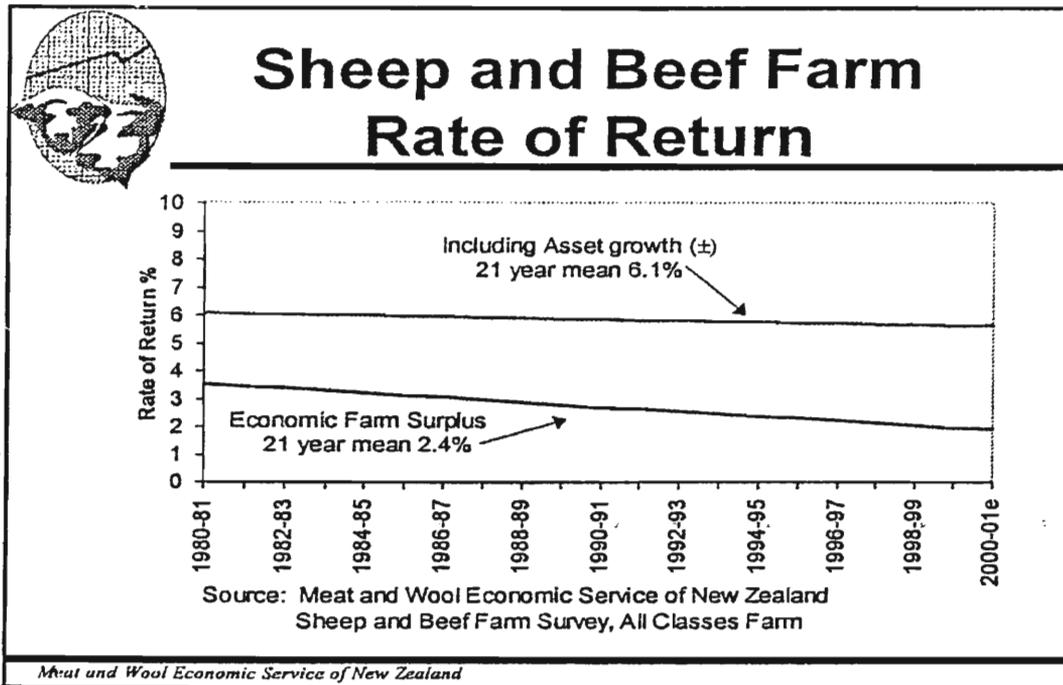
So lets analyse what people call a good lifestyle.

- Earnings \$30,000. Sometimes causing a deficit.
- Compared with average taxable personal income in NZ 38 year Male \$38,000.
- Farm can't afford labour.
- Family frequently doing the work for no reward.
- Would you call this a lifestyle?

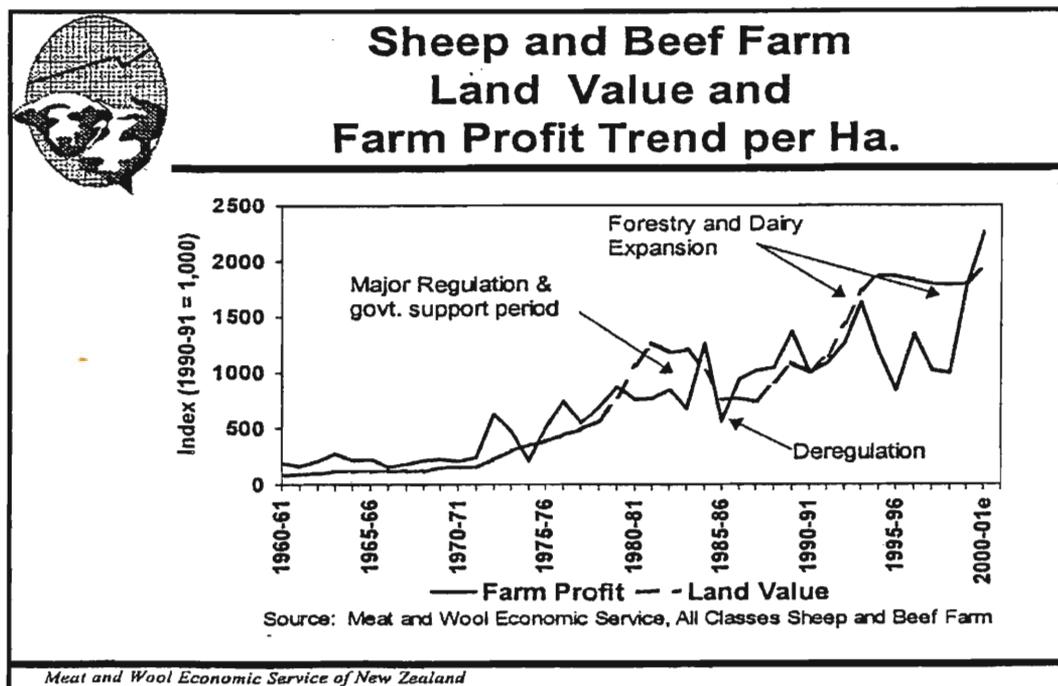
It appears that at best a lifetime struggle for enough income at the point of farm sale for retirement.

“WHERE WILL YOU BE IN TEN YEARS FROM NOW IF YOU KEEP GOING THE WAY YOU ARE GOING?”

3. SHEEP AND BEEF FARM RATE OF RETURN



4. FARM PROFIT LAND VALUE AND FARM PROFIT TREND PER HA.



5. LAND USE CHANGE

LAND USE CHANGE

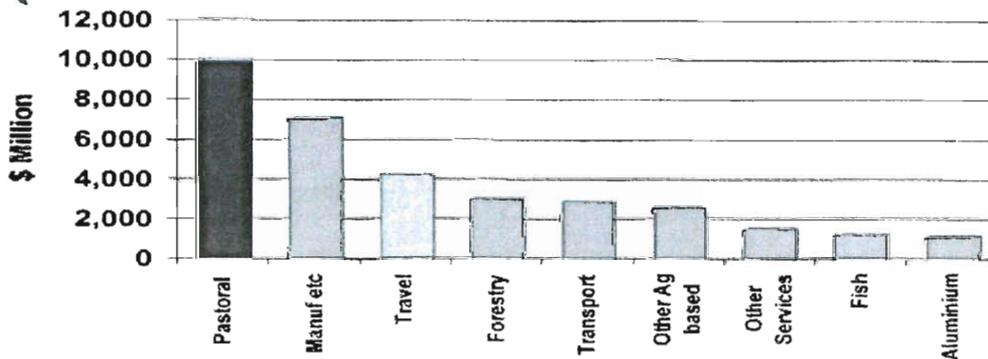
- 1986 to 1996
- Sheep & Beef Land
- Decreased 18%
- Reflected in lower sheep numbers
- With the loss to dairy, blanket forestry, small holdings and reversion.

Meat and Wool Economic Service of New Zealand

6. EXPORTS, GOODS AND SERVICES YEAR TO JUNE 2000



Exports, Goods and Services year to June 2000



Source: Statistics New Zealand
Meat and Wool Economic Service of New Zealand

Meat and Wool Economic Service of New Zealand

7. LAND USE CHANGE TO DAIRY

LAND USE CHANGE TO DAIRY

- Sheep and Beef Farm Conversions to Dairy last 8 years
- 11,511 new dairy farms to Spring 2001 displaced 3.3 sheep and beef su.
- 2001 Spring, 171 conversions, 10 in N.Isl that will displace 0.7m sheep and beef su.

Meat and Wool Economic Service of New Zealand

8. AG. PORTFOLIO CHANGING

AG. PORTFOLIO CHANGED

* Since 1990-1991

- | | |
|--------------------|-----------------|
| - More Dairy | + 75% volume |
| - More Export Wine | \$24m to \$201m |
| - More Beef & Veal | + 9% volume |
| - More Lamb | + 11% volume |

but from 22% fewer sheep!

Meat and Wool Economic Service of New Zealand

9. TOP 20% OF FARMS

TOP 20% OF FARMS
Rate of Return from
Farming activities averaged around
6.5% over 21 years
<i>Meat and Wool Economic Service of New Zealand</i>

10. CONCLUDE

CONCLUDE
Agriculture is where our “Knowledge” Industries will build on our global.
- Comparative and
- Competitive advantages, and
- New industries will clip-on to this
<i>“Agriculture to NZ is what Silicon Valley is to California.”</i>
<i>Meat and Wool Economic Service of New Zealand</i>

CONCLUDE

In 15 years nothing has replaced our National Resources industries centred on –

- Pastoral Farming
- Forestry
- Fishing
- And Tourism to view our Natural Resource Base.

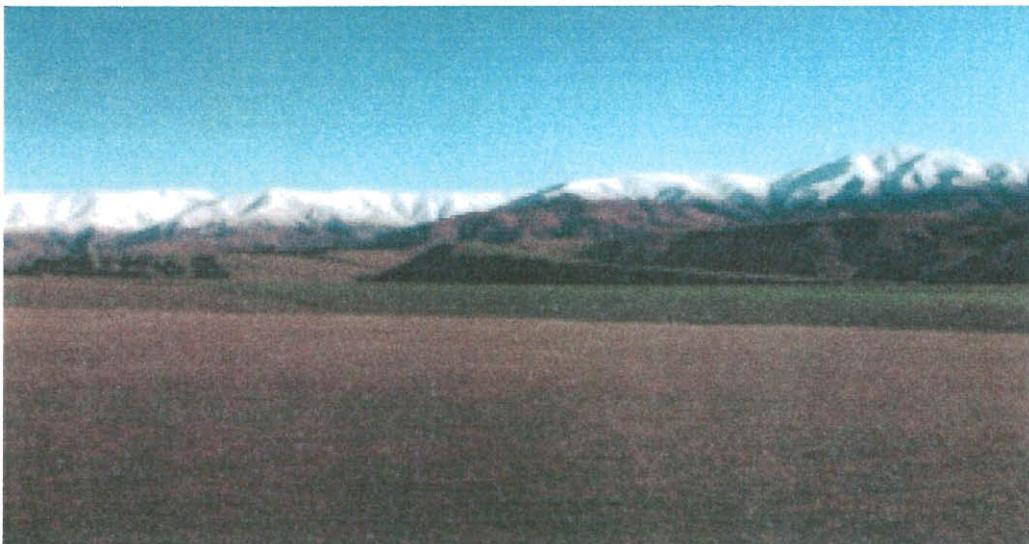
“This is our Future.”

Meat and Wool Economic Service of New Zealand

This would give weight to the fact that sheep/beef farming in New Zealand is in fact a sunrise industry – not a sunset industry.
Farming sheep/beef needs to take on a business approach.

OUTPUT, PROFITABILITY need to be key drivers.

Farming for a lifestyle no longer is acceptable when individuals can take the lifestyle opportunity couple it with a real wage or salary.



FARMING AS A BUSINESS

The focus needs to change from survival to a full business approach.

Based on

- Return on capital
- Productivity driven
- Use of outside expertise
- Supply chain links
- Knowing strengths and weaknesses



A good farming business structure may look like this.

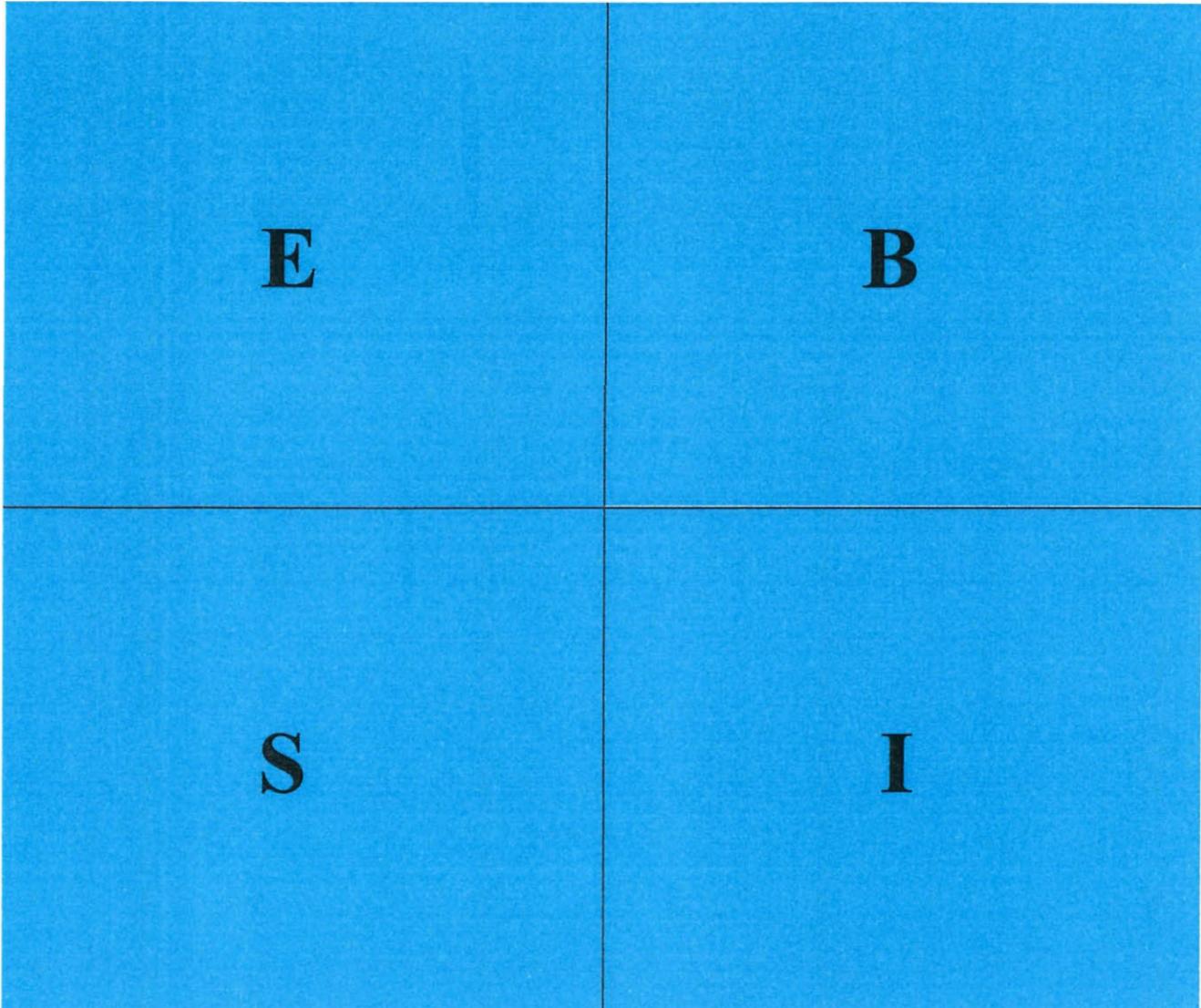


We now have a business

- The manager receives a salary commensurate with experience.
- Shareholders have a real return on investment.
- There exists a business structure.
- There is growth in the form of increasing land values.
- Productivity and profitability is the focus.

***“THE SUCCESSFUL PERSON KEEPS THEIR MIND SET ON WHAT THEY WANT IN LIFE
– NOT ON WHAT THEY DON’T WANT.”***

GERBERS QUADRANT



- | | | |
|----------|------------------------|---|
| E | Employee | Works for someone else |
| S | Self Employed | Have their own business. Often works harder and Harder but frequently having no better returns than being employed. (Many farmers are in this category). |
| B | Business Person | Someone who can leave a business for 12 months and when they return it is operating as well or better than when they left (few farmers in this category). |
| I | Investor | Potentially where the money is made. These people take the risk and profit accordingly. |

WHERE DO YOU CURRENTLY FIT IN?

Equity farming with scale would involve all 4 parts of the quadrant.

It's about taking control of the situation and expanding. After all you are the controller of your own destiny.

OPPORTUNITY OFTEN KNOCKS – ONLY TO FIND NO ONE IN.

So how could we make this persons \$720,000 work better for them. Let's explore the options of purchasing a larger unit.

THE ONE WHO TRIES TO GET SOMETHING FOR NOTHING GENERALLY WINDS UP GETTING NOTHING FOR SOMETHING



So what happens to our farmer if they decided to enter an equity farming deal with the 720,000 that was clear after farm sale.

	8,000 su	10,000 su	15,000 su
% Holding	25%	20%	13.7%
Net E.B.I.T. Earnings @ \$35	\$9000	\$10,300	\$13,800
Net Salary after Tax	\$40,000	\$42,000	\$44,000
Dividends/Income	\$9,000	\$10,300	\$13,800
Total Income	\$49,000	\$52,300	\$57,800
Less Current Income *	\$30,000	\$30,000	\$30,000
Better off After Tax	\$19,000	\$22,000	\$27,800
Return on Capital	5.6%	5.8%	6.2%

- **Remembering in the earlier figures that this was not sustainable.**

Return on capital being returns minus management and plant replacement as a return on total ingoing.

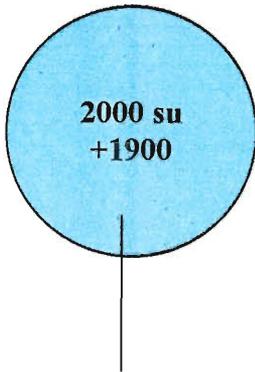
THE QUICK CALCULATOR

Insert your figures for your results

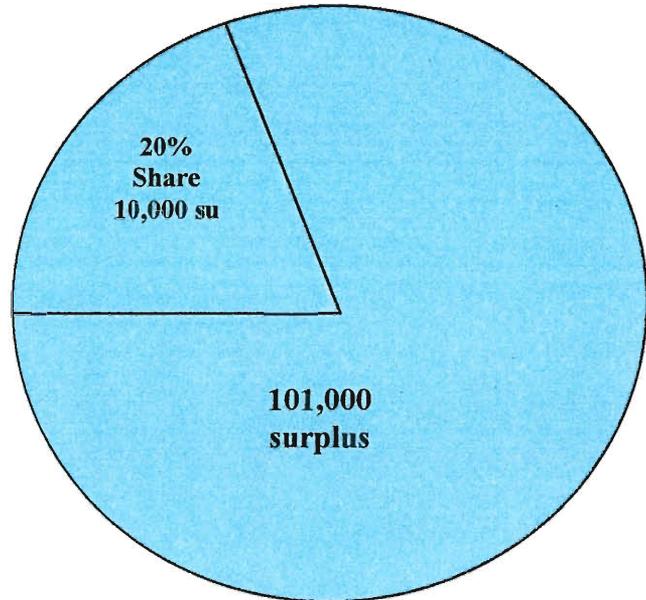
Size of Purchase farm su/	
@ 360 su	=
Stock @ 80 su	+
Plant	+
Working Capital @ 60% FWE	+
TOTAL	=
Debt @ 120 su	-
Total Equity	=
E.B.I.T @	
Manager's Salary	-
Interest term @ 9%	-
Seasonal @ 10%	-
Plant Replacement	-
Available for =	
Debt Reduction and Tax	

SO HOW DOES IT LOOK?

Top Producers



So this person has 720,000 equity, a top producer but slowly losing ground



This person has investment returning 5.8% on capital. If the 2000 su person invested his 720,000 in this venture he would receive an income of around 50,000 as a manager and a dividend return as well.

On an income of say \$52,000 + Dividend Returns the 2000 su farmer has new found wealth the possibilities are boundless.

- Savings
- Pay a mortgage on an investment property or house
- Live comfortably

All whilst being an investor in a growing asset, which could possibly be succeeded.

Incidentally \$15,000 compounded @ 4% net p/a for 20 year will return \$464,000 food for thought.

THE PURCHASE

	8,000 su	10,000 su	15,000 su
Purchase 360su	\$2.8 m	\$3.6 m	5.4 m
Stock @ \$80 /su	\$640,000	\$800,000	1.2 m
Plant	\$100,000	\$150,000	\$200,000
Working Capital @ 60% F.W..E. @ su. Inc.	\$140,000	\$180,000	\$270,000
Total Ingoing	\$3.76 m	\$4.73 m	\$7.07 m
Less debt @ 120 su	\$960,000	\$1.2 m	\$1.8 m
Equity	\$2.8 m	\$3.53 m	\$5.27 m

EARNING POTENTIAL

	8,000 su		10,000 su		15,000 su	
E.B.I.T.	27	35	27	35	27	35
E.B.I.T. Earnings	\$216,000	\$280,000	\$270,000	\$350,000	\$405,000	\$525,000
Less – Manager’s Salary	\$50,000	\$50,000	\$52,000	\$52,000	\$55,000	55,000
Interest on Mortgage @ 8% 960,000 1.2 m 1.8 m	\$77,000	\$77,000	\$96,000	\$96,000	\$144,000	144,000
Seasonal 6 month @ 10% 100,000 150,000 200,000	\$5,000	\$5,000	\$7,500	\$7,500	\$10,000	10,000
Tax @ 30%	\$25,000	\$44,000	\$34,000	\$58,000	\$59,000	95,000
Plant Replacement	\$20,000	\$20,000	\$25,000	\$25,000	\$30,000	30,000
Repayment @ 5% of Loan 960,000 1.2 m 1.8 m	\$48,000	\$48,000	\$60,000	\$60,000	\$90,000	90,000
Net Available Distribution	-\$ 9,000	\$36,000	-\$ 4,500	\$51,500	\$17,000	\$101,000

EQUITY STRUCTURES

Anyone entering on equity farming business must do so with an open mind. Advice is essential as it is easy to get into any relationship undoing it is much harder.

Emphasis must be on bringing together like minded people. They must have

- Similar goals
- A clear vision
- Detailed legal descriptions of requirements.
- Good management structures.

Clarity needs to be gained at the outset as to the length of time the partnership will operate. Also how the partnership will operate.

- Needs to initially operate for a period of 5 years.
- A good facilitator
- Detailed documentation of each individual role within the partnership.
- Business goals
- Plans for management
- Profit distribution plans
- Individual shareholding level/voting rights
- Plans for conflict management
- Reporting plans and frequency of meetings
- In and out clauses – in the case that partners may wish to be bought out who gets the first chance to purchase this share etc.
- Sunset clause – The length the partnership intends to run and how it would be settled etc at conclusion.

PITFALLS

As with anything there are pitfalls

- Less than ideal agreements
- How expenses are split incomes etc.
- No of partners and their background.
- Poor management results.
- Unforeseen seasonal challenges etc.

Facilities have to be made to allow for ongoing alteration to agreements.

Care has to be taken as to the property to be purchased. Advice from lawyers, accountants, consultants and bankers is essential after all this is a **business** decision.

REMEMBER SCALE WILL NOT ALWAYS MAKE YOU BETTER OFF ESPECIALLY IF THERE ARE INEFFICIENCIES.

Casting back to the earnings Potential Graph an average to below performer on 15,000 su. is worse off than a top producing 8000 su performer. Productivity is still the key driver must always be remembered.

WHO TO CONTACT?

- Accountants
- Lawyers
- Banks
- Farm Management Consultants
- Contact with people already involved

Some of the above specialise in such deals. Good advice is plentiful and worth pursuing. It is just a matter of asking and asking questions and soon the contact will arise.

THE CHALLENGE

A farmer used to farming a smaller block as a sole trader will discover many changes and will also need new skills. There will be a need to have time management skills with set targets for achieving goals.

Employment skills will be required as good relationships will be necessary with staff and management.

Being able to communicate with shareholders and being frank and open is also essential to overall production and well being.

Being answerable to others will be a new experience for many but often a board type approach brings good results. Use of a facilitator or consultant will initially help to bridge gaps.



WHAT'S IN IT FOR AN INVESTOR?

Return on capital is 5-6% which may seem low, but history repeatably shows that land values move up regularly with appreciating land value suddenly 5-6% becomes more attractive.

Queen Street farmers are less likely to be attracted than in the 1980's. The people more likely for targeting are – overseas investors, keen to purchase land with good location for their needs. Exchange rates also give these people favourable buying power. Also another group are those who want an investment in Agriculture without the hassles of leasing etc. These people often are those that have had land in a family for a long period but are not interested in farming it themselves.

A growing population is retiring farmers who retain a hand in an industry they know so well.

The opportunities are endless. If the manager is also a partner in the equity partnership they are more likely to go the extra mile. But a Manager outside the partnership is also a possibility.



CONCLUSION

Opportunities and knowing how to pursue them are important. An opportunity is seldom ever likely to knock on your door, it's about finding out what you want in life, setting ongoing goals and then setting about achieving them.

If you want to farm and be a farmer you are entitled to an income that is comparable to the real world. Believing that you are farming for lifestyle simply doesn't cut the mustard I'm afraid. Farming is a serious business. If you address your own farm or perspective farm purchase in a business light you will find from the findings in this report that:

- A smaller sheep/beef farm is no longer a viable **business** option.
- Productivity is a key driver
- Focus must be on profitability
- Scale is important

It is possible for individuals involved in the farming industry to make the quantum leap to farms with scale. So long as emphasis is put on production, farming as a business is viable. Equity farming partnerships have come along way from the 1980's when many started.

A farm farmed in an equity/partnership in the 21st Century will have need to have a good business structure showing real returns on invested capital. It's about getting what you have today working better for you. Wealth creation through sheep/beef farming is possible.

Equity farming is an excellent opportunity for smaller marginal farmers, prospective farm purchases with a good management history and for investors looking for an investment with real dividend returns and an inflating capital investment.

Equity farming is an opportunity for sheep/beef farming but not a panacea for poor performance. Remember scale only gives advantages if top production is gained. Equity farming is an excellent opportunity for the sheep/beef farmers of the 21st Century.