Equity partnerships with separate investment in the farm trading company and the land company

Description

An equity partnership, where the land owning and the farm trading business entities are separated.

How it works

In this situation the farm business would be structured into two entities, hypothetically called Land Co and Trade Co. Land Co owns the land and buildings and receives an annual lease for this business. Trade Co is the farming operation entity that owns all the operating assets including cows, plant and equipment and dairy company shares.

The progressing farmer would operate the farm via a manager, contract milker (CM) or variable order sharemilker (VOSM) position, and would be expected to have a shareholding in Trade Co. The size of that shareholding would be negotiated between the parties.

Land Co would typically lease the land assets to the Trade Co.

There may also exist an opportunity for the farm/operating manager to purchase a stake in Land Co. This would be a separate business arrangement and could continue even if the progressing farmer leaves the farm.

This model has been successfully used in farm succession plans. In some instances the agreement is structured once Trade Co is 100% owned by the progressing farmer, they agree to progressively purchase shares in Land Co.

Advantages and considerations

Advantages

Progressing Farmer

- From a farmer progressing perspective the investment in Trade Co is reasonably liquid and allows the farm manager to benefit from increasing the farm profitability.
- This model moves the financial driver from solely milk production, such as under a CM agreement, to farm profitability, which helps aligns financial motives between all parties. Having the progressing farmer better understand the business and its expenses can assist with better farm management and skill development.
- The investment required to invest in a Trade Co is significantly less than if land is included, which makes entry and exit easier.
- As the equity position of the progressing farmer improves, they may have an opportunity to also invest in the Land Co.

Farm owner

- From the farm owner's perspective having another party provide equity may improve an individual land owner's balance sheet.
- May suit farm owners looking to exit from the day-to-day running of the property or looking for a succession model.

Considerations

- As with all equity arrangements it is important that the core farming philosophies of all parties are understood and are aligned.
- If the progressing farmer leaves the Trade Co partnership they must realise any capital gains or losses in stock values at that point in time, and as such are susceptible to fluctuations in livestock values.
- Setting a fair lease rate, with transparent methodology is critical. There should also be a market based relationship between both Trade Co and Land Co to satisfy all parties.

Keys to success

- Equity partnerships should generally focus on agreed profit and cashflow objectives, rather than relying on the potential for capital gain.
- Undertake due diligence on both the potential business/farm and the potential partners.
- Good communication and governance throughout the duration of the agreement
- Universal agreement around the payment of dividends. Is the expectation that dividends are paid out each year or reinvested for development? Additionally, are shareholders required to invest further capital if there is a deficit?
- If one equity partner is to run the day-to-day aspects of the business as a manager/contract milker or sharemilker, a separate employment/sharemilker agreement is required with a very clear process of reporting and performance review process to address any performance issues.

Financial

The returns to Trade Co will be influenced strongly by the agreed rental. In areas with high land values, calculating the lease rate using productive potential may be more appropriate to ensure Trade Co remains a viable business. Investors will need to be clear in understanding this relationship between the lease price and Trade Co's profitability.

Trade Co

Drivers:

A low land lease rate. Milk price, milk production, stock income, dairy company dividend and farm working costs.

Example of equity required:

For a 20% share in a Trade co with 500 cows producing 175,000 kgMS

Trade Co Assets	
500 cows x $1800	$900,000
Young stock 100 R2s	$120,000
Young stock 100 R1s	$90,000
Farm machinery	$160,000
Fonterra shares ($5.50/share)	$962,000
Total assets	**$2,232,000**
Less assumed borrowings, at 50% of asset value	$1,116,000
Total equity required for Trade Co	**$1,116,000**
Equity required for a 20% share in Trade Co	**$223,200**

Financial returns:

This will depend on many variables, particularly the lease rate used. Trade Co can be expected to offer returns similar to, although slightly lower than, a HOSM business in an average milk price year (10% - 15%). This is due to the proportionally large investment in lower yielding dairy company shares (if required) compared to that of a traditional HOSM where the farm owner would retain the dairy company shares.

With a fixed lease rate, Trade Co could be significantly more profitable than a HOSM business in a high payout year as it will retain 100% of the benefit of this increased milk price.

In a low pay out year, the dividends from dairy company shares can provide some income security.

Land Co

Drivers:

A high land lease rate. Capital gains.

Example of equity required:

For a 20% share in a Land Co with 160 ha producing 175,000 kgMS

Total farm asset value ($45,000/ha)	$7,200,000
Less assumed borrowings, at 60% of asset value	$4,320,000
Total equity required for Trade Co	**$2,880,000**
Equity required for a 20% share in Land Co	**$576,000**

Financial returns:

These are very dependent on the lease rate negotiated. A simple return such as 4% of land value can be used to set the lease

i.e. 4% of $45,000/ha = $1,800/ha
Alternatively, the lease is decided from the productive potential of the land.

i.e. 1100 kgMS produced x $5.50/kgMS milk price x 23% share of milk income = $1,392/ha (3.1% return)

How easy is it to enter and exit agreements?

The ability to invest in Trade Co will involve more modest sums, and the entry and exit into this arrangement with a clear contract agreement should be no more difficult than a conventional HOSM agreement.

The main financial issue around entry and exit will be the volatility of livestock prices, the timing of which can have a big influence on the success or otherwise of the entry and exit process.

Any investment in Land Co is likely a more significant investment and will be less liquid. It is possible that this arrangement could be conducted outside an investment in Trade Co and a progressing farmer may be able to leave an investment in Land Co ongoing or until such time as another suitable investor is found.