Equity partnership in herd owning sharemilking position

Description

An equity partnership in an entity that owns a herd and enters a herd owning sharemilking agreement (HOSM).

How it works

Two or more parties create a business partnership that enters a herd owning sharemilking business in partnership. Generally, one of these parties will be running the day-to-day aspects of the business and the other(s) will act as investors.

This equity partnership can also be constructed whereby the farm owner is also an investor in the herd owning sharemilker business. In this situation, the cows may remain on the farm and the herd owning sharemilking agreement set up as a three or five-year term. The incoming 'sharemilker' purchases shares in the herd owning sharemilking business, and at the end of the agreement sells their share in the business to the next incoming 'sharemilker' or back to the farm owner.

Advantages and considerations

Advantages

Sharemilker perspective

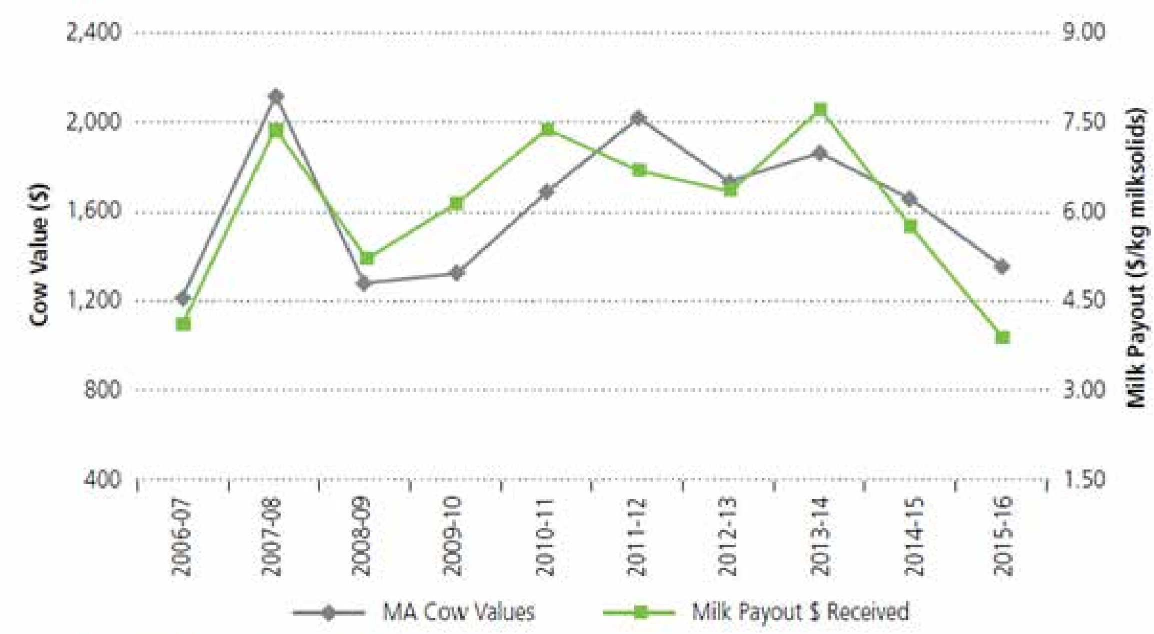
- Individuals not required to have 100% of the equity for the sharemilking business so can run a larger scale business with less equity
- If in partnership with the farm owner, and at the end of the term they cannot find another herd owning sharemilking position, they are not left having to sell their cows on the open market, i.e. there is a guaranteed buyer.
- Have the benefits of the high cash returns of a sharemilking business

Farm owner perspective

- Have someone running the day-to-day aspects of the business with 'skin in the game' and similar drivers for profitability and efficiency due to sharing of the costs and profits
- Can maintain the cows on the property ensuring continuity of cow quality
- Relatively easy to revalue business at beginning and end of timeframe compared to an equity partnership in the entire business
- Land assets are kept separate
- In a situation where the farm owner is required to re-purchase the shares of the managing sharemilker at the termination of the sharemilking agreement, the farm owner is open to the change in value of the herd. May end up having to purchase the shares back at a significantly higher value to when the managing sharemilker paid for them at the start of the agreement.

Considerations

- The equity partner who is managing the herd is liaising/reporting to their equity partner as well as the farm owner.
- The incoming sharemilker is vulnerable to the change in value of the cows as they are buying into the business and selling out again at the end of the agreement. Potential to lose equity if the cow value drops during this time, equally have the potential to gain equity if cow values increase. A graph depicting the relationship between cow price and milk payout is included below, highlighting the volatility in the main asset in a herd owning equity partnership.



Source: DairyNZ Economics Group, IRD

- Need to have clarity around who makes decisions within the sharemilking business such as breeding and culling decisions.
- Although the managing sharemilker has ‘skin in the game’, if the herd stays with the farm owner at the end of the agreement there may not be the same feeling of ownership in some aspects of management such as reproductive performance.

Keys to success

- Clear areas of decision-making between parties. E.g. Clarity around who makes decisions within the sharemilking business such as breeding and culling decisions.
- Having the right people with similar farming philosophies and values.
- Clear understanding of the business plan.
- Good communication throughout the duration of the agreement.
- A clear policy around the valuation of the business at the start and end of the agreement. For instance; is it one valuer agreed at the commencement of the agreement or does each party bring a valuer and agree to the average value?
- Clear timeframe for the partnership with clarity around exit strategy and what happens if the partnership needs to be terminated prior to the end of the timeframe.

Financial

Drivers

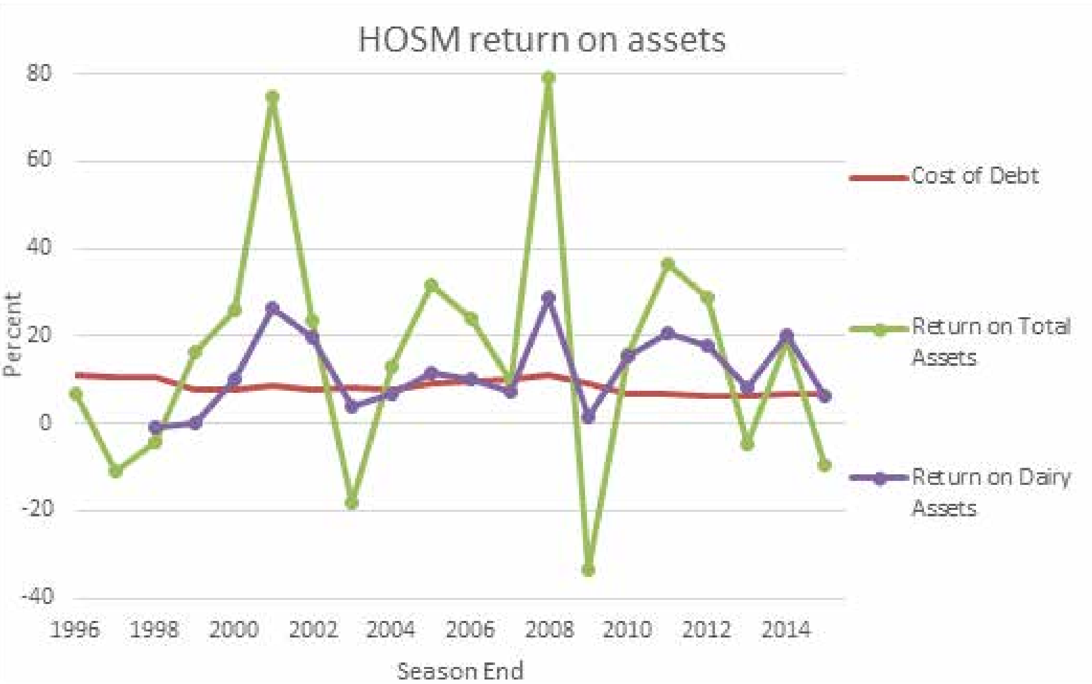
Key driver for the herd owning sharemilking business is profitability.

Equity required

Dependent on the size of the sharemilking business and cow values which can vary significantly from year to year.

Financial returns

Average returns of a herd owning sharemilking business are around 15% return on asset, although the range can be significant due to the large fluctuations in cow values. The variation is shown below where the return on dairy assets indicates the cash return on the business and the return on total assets represents the return when including the change in cow values from year to year.



Source: AgFirst Alternative Business Progression Pathways Report 2017

How easy is it to enter/exit agreements?

Entry and exit is relatively easy compared to other equity partnership agreements that involve the land.

The sharemilking aspect of the business (i.e., cows and machinery) would be valued at the beginning and the end of the agreement.

There would need to be an agreement around what happens at the end of the agreement if there is not an incoming farmer willing to purchase the progressing farmers shares in the business.