Flexi-Rate Sharemilking agreement (concept)

Description

A variable milk price sharemilking agreement whereby the percentage paid out to the sharemilker and landowners varies according to the milk price.

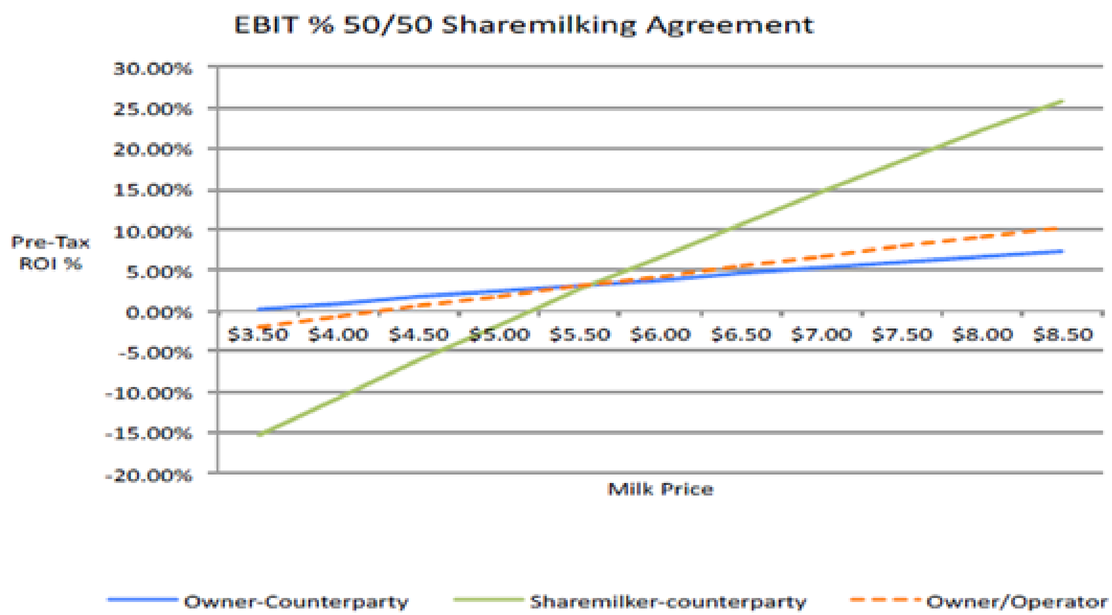
Background

The objective is to reduce the variability in the profit range for the sharemilker. This is achieved by sharemilkers receiving a higher percentage of the milk cheque in low payout years but receiving a lower percentage of the milk cheque in higher payout years.

The aim is for a fair return on asset to land owner (5.8%) and sharemilker (9%). It involves full disclosure by both parties of the farm budget to determine the farm working expenses.

The Flexi-rate HOSM agreement is currently a concept developed by MyFarm, a farm investment and consultancy business. The financial examples here and in the associated fact sheet are therefore modelled and not based on real farms.

The graph below highlights the relative EBIT under the existing HOSM agreement at a range of milk prices.



A Flexi-rate agreement gives flexibility about who pays what share of operating costs, and how much capital is contributed. This means that a herd-owning agreement becomes an option for a greater number of sharemilkers, i.e. those who may not be able to afford to buy an entire herd. It also means that farms that could not otherwise support a herd-owning sharemilker, may be able to do so i.e. by the owner meeting a greater share of operating costs.

How it works

A full farm budget is prepared for the farm business prior to the start of the season. The value of assets being contributed by both parties would also be agreed.

A table of each party's share of the milk revenue is built based on the initial milk price forecast.

As the milk price forecast is altered through the season there is a requirement for a retrospective adjustment for the season to date milk revenue. The final adjustment will not be known until September of the following financial year for Fonterra suppliers.

The system recognises sharemilkers typically have a higher cost of funds because due to a higher risk profile (compared to farm owners). MyFarm has estimated the weighted average cost of capital for landowners to be 5.8% and for sharemilkers 9%.

It is recognised that sharemilkers typically pay for about 65% of the farm working expenses, and contribute about 14% of the capital.

The overarching principal is the percentage milk revenue share is based on agreed contributions in terms of budgeted costs and farm capital.

Advantages and considerations

Advantages

- The flexibility to alter the rate based on agreed contributions to farm working expenses and capital contribution means this arrangement has the potential to succeed where the existing HOSM agreement makes the proposition unviable.

Sharemilker

- Receive greater protection (and share of revenue) in low payout years. However, in the high payout years they will receive a slightly lower percentage of the milk revenue.
- Possible to buy part of the herd, not necessarily the whole herd, when starting out.
- Grow stock numbers or purchase more cows over time.
- As a result of reduction in profit volatility, sharemilker financial risk is likely lower with a Flexi-rate agreement. A lower risk profile would make debt funding easier.

Farm owner

- Release capital by selling herd or part of herd to a sharemilker.
- Work with an experienced sharemilker who has a stake in the profitability of the farm.
- Landowners will receive in most years a slightly higher percentage of the milk cheque, which more adequately reflects the large capital contribution that they do make. This has the effect of improving landowner profitability in most years.

Considerations

- The process is reliant on full disclosure by both parties of their farm working and capital positions.
- The process requires recalculating and reconciliation payments during the season if the forecast milk price changes.
- Both parties need to be are aware of the financial impact of the variation in the milk price.
- Setting up for the season, monitoring and reconciliation payments require input from an advisor.
- Sharemilkers are exposed to a higher proportion of the farm working expenses and do have a higher cost of funds. However, division of expenses is agreed at start of contract.
- The total milk income has not been increased but rather the method of distribution has been changed.

Keys to success

- Each party knowing their obligations and responsibilities will enable the relationship to run as smoothly as possible.
- Openness and transparency by both parties' with sharing farm budgets and capital positions
- Having a third party manage the calculations is likely to be important.
- Following a process of due diligence before signing agreements will help improve likelihood of success for both parties.

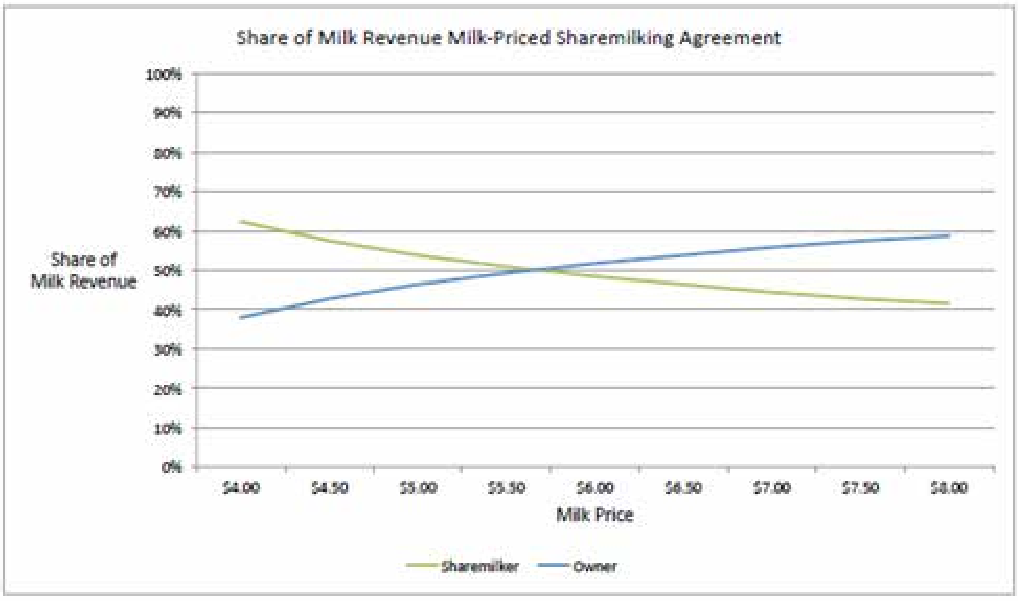
Skills required

There are no additional skillsets required over and above those expected in a herd owning sharemilking agreement partnership. However, use of trusted advisors is recommended before entering a novel agreement, and advice and management of the agreement during the season is also required.

Financial

In examples provided by MyFarm the sharemilker revenue split could range from a 62:38 split in favour of the sharemilker at low milk prices, in the order of $4.00/kgMS, to a split of 41:59 in favour of the landowner at milk prices approaching $8.00/kgMS.

Share of milk revenue graph below gives an overview of the potential share of milk revenue at a range of milk prices under a flexi-rate agreement.



In terms of profitability, examples provided by MyFarm under the flexi price scheme sharemilker profitability ranged between - 0.3% to 13% over a range of milk prices from $4.00 to $8.00/kgMS. Under the standard 50/50 herd owning sharemilking agreement the sharemilker profitability varied from -8.7% to 23.1%.

Farm owner profitability ranges between minus 0.2% and 8.8% at payouts between $4.00 and $8.00/kgMS relative to 1.2% to 6.9% with the traditional 50/50 agreement.

The approach is essentially removing some of the downside risk for sharemilkers, and as a trade-off removing some of the extreme upside rewards sharemilkers receive in high payout years.

How easy is it to enter and exit agreements?

In principle this arrangement will have no material impact on the ability of sharemilkers to enter and exit agreements. In longer-term agreements there may be a requirement for re-evaluations of both livestock and land to ensure the cost of capital is being accurately reflected in the calculations.

Timing of entry and exit is critical for HOSM due to fluctuating livestock values. This can seriously erode equity for the HOSM.

More information

The Flexi-rate HOSM agreement is currently a concept developed by MyFarm, a farm investment and consultancy business. This information is a summary of a fact sheet located here.

For more information on the Flexi-rate agreement please contact MyFarm Business, Angie Fisher at DairyNZ (0800 4 DairyNZ), or your own farm consultant.