Variable rate herd owning sharemilking agreement

Description

The concept uses the existing herd owning sharemilking agreement (HOSM), and existing clauses within the standard agreement. However, the key difference is that the percentage sharing of income and expenditure is varied, rather than the traditional 50:50 split.

Background

The standard Federated Farmers herd owning sharemilker (HOSM) contract allows for the percentage share of the milk income to be negotiated. Herd owning sharemilkers have historically made a greater return on equity invested than farm owners, albeit also accepting a higher degree of risk. Between 2013 and 2015, HOSMs achieved average returns of 12.3% compared to 3.2% for a farm owner with HOSM. This higher return reflects the greater risk HOSMs carry with a higher proportion of farm working costs to revenue, less capital as security and significant shifts in asset value from year to year. The comparatively low returns for farm owners may make HOSM positions unviable for some farms. By comparison, owner-operators achieved a return of 4.6% over the same period which is 1.4% higher.

Relatively minor adjustments to the share in milk income may make a HOSM agreement feasible for farm owners, which will ultimately create more herd owning positions.

It is important to note that no two HOSM positions are equal. Some farms have excellent infrastructure, good contour and productive pasture resulting in a much lower cost of production for the sharemilker. Other farms can be more challenging with a higher labour demand and greater supplement use resulting in higher farm working costs for the sharemilker. In many cases, receiving a lower milk income percentage on a well set up farm will still be more profitable to the sharemilker than receiving 50% of the income on a more challenging farm. A detailed budget is required to assess a fair and reasonable percentage share for each party.

An example of a variable rate agreement might result in the farm owner receiving 55% of milk income compared to 45% to the sharemilker. Costs may be split 50% each between the parties.

Advantages and considerations

Advantages

- Will allow more farms to benefit from the HOSM structure**.**

Variable Rate HOSM

- Can increase the financial returns for a well set-up and productive dairy farm owner.
- Sharemilker may be able to increase stock numbers

Farm owner

- May allow a herd owning sharemilking position to be created or maintained when it would otherwise not have been viable, e.g. for those with high debt.
- Can give more certainty that the business will be profitable
- Allows the farm environment, contour etc. to be taken in to account to ensure a fairer division of costs and **income.**

Considerations

- It is very important that a detailed budget is completed by both parties to understand the viability before making a decision on percentage share.
- Farm owners must understand that not all farms are equal, it may not be viable for a sharemilker to receive a reduced milk income share on more challenging farms or those with higher farm working expenses.
- Higher equity percentage required (than for land) from the sharemilker and bigger swings in profit volatility.
- Need clear agreement on who will cover what costs, especially feed, regrassing and improvements or maintenance.
- The 50:50 sharemilking contract has a long history in New Zealand and any adjustment to this traditional share on milk income will have to overcome the perception that all contracts must be 50:50. This can be achieved through budgeting and informed and balanced negotiations.

Keys to success

- Each party knowing their obligations and responsibilities will enable the relationship to run as smoothly as possible.
- A detailed budget is required to assess a fair and reasonable percentage share for each party, getting professional advice on this is recommended.
- When deciding the percentage shares both parties should have a clear understanding of what the net financial result will be for their business rather than focusing on the share of milk income as a measure of success.
- Following a process of due diligence before signing agreements will help improve likelihood of success for both parties.
- A thriving business relationship between two parties is likely to be one where goals and values have been shared and are fairly well aligned.

Skills required

A herd owning sharemilker will need the following skills:

- Farm management
- Financial management
- Contract understanding, negotiation skills
- Health & Safety and environmental knowledge and policies

Financial

Drivers

The key drivers for the herd owning sharemilker are the cash returns from their business, and the ability to build equity through herd ownership.

Equity required

Equity requirements for purchasing livestock are higher than those for farm land. Livestock assets averaged $814,000 between 2011 and 2016 for an average NZ HOSM. Equity of a minimum of $500,000 is likely.

Financial returns

The following comparison highlights the difference in returns between a 50:50 and a 45:55 herd owning sharemilking contract.

Example	
Production	150,000 kgMS
Milk price	$6/kgMS
Milk income	$900,000
Stock income	$80,000

50:50	
Sharemilker receives	$ 530,000
Farm operating expenses	$390,000 ($2.60/kgMS)
Operating profit	**$140,000** (after all labour incl. WOM, i.e. DairyBase)
Farm owner receives	$450,000
Farm operating expenses	$300,000 ($2.00/kgMS)
Operating profit	**$150,000**

45:55	
Sharemilker receives (45%)	$ 485,000
Farm operating expenses	$375,000 ($2.50/kgMS)
Operating profit	**$110,000**
Farm owner receives (55%)	$495,000
Farm operating expenses	$315,000 ($2.10/kgMS)
Operating profit	**$180,000**

How easy is it to enter/exit agreements

Contracts are for a given term with a simple, easy and proven entry and exit process.

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