Equity partnerships

Description

An equity partnership is a joint venture between two or more parties who pool their capital, resources and often skills together in business. The actual business structure of the partnership will vary.

Background

The ultimate goal of an equity partnership is to utilise the joint venture to gain a greater return on investment through scale and sharing skills than each party could achieve alone.

There are many ways in which equity partnerships can be set up to suit the individuals involved. This factsheet discusses the general principles of an equity partnership.

Advantages and considerations

Advantages

- Skills from individual parties can be pooled to create a business with expertise in different areas. For example, there may be one equity partner that is employed to run the day-to-day operations that have the skills in farm management, another party may provide greater expertise in financial management and another party around the governance and strategic planning of the business.
- Enables parties to pool capital and gain benefits of scale.
- Enables parties to invest in the agricultural sector without having to be involved in the management of the property.
- A method of succession within a family operation.
- A method of releasing equity within the business for retirement planning.

Considerations

- Undertaking sufficient due diligence on the business/farm and potential equity partners is critical to success.
- Being in business with other parties does introduce the risk of the financial security of the other investment parties.
- Equity partnerships are still exposed to the risks of running a business in the dairy sector, e.g. the milk price, climatic events, regulatory risk etc.
- Over the years there have been some successful and some failed equity partnerships. A common differentiator between success and failure is people having shared goals, values, philosophies, and expectations in successful EPs.
- In the past many equity partnerships managed to earn significant capital gains on investments by purchasing underperforming properties and carrying out some development and/or improved productivity through better management and then selling the property. However, in many regions environmental regulations may impact this potential. A clear understanding of the impact of environmental regulation is important prior to purchase.

Keys to success

Strategy

- Equity partnerships should generally focus on agreed profit and cashflow objectives, rather than relying on the potential for capital gain.

Due diligence

- Undertake due diligence on both the potential business/farm and the potential partners.

People

- Having the right people with similar farming philosophies and values.
- Good communication and governance throughout the duration of the agreement.
- Clear understanding of the business goals, management plan and measures of success for the business.
- Recommended if an equity partnership is formed to purchase a new block of land that the 'people' side of the equity partnership is clear and sorted (governance, philosophies, operating structures) and only then start looking at blocks of land.

Entry/exit

- Clear business timeframe with the entry and exit process specifically outlined, this needs to include the exit process if one party needs to exit before the end of the timeframe.
- A clear policy around the valuation of the business at the start and end of the agreement.

Agreement

- Universal agreement around the payment of dividends. Is the expectation that dividends are paid out each year or reinvested for development etc? Additionally, if there are some years in which the profitability is low/negative due to low milk price, adverse climatic season etc., is the expectation that the company pays a shareholder dividend or not? 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. This employment/sharemilker agreement should be separate from the equity partnership.

Financial

The returns from an Equity Partnership would reflect any standard owner operator model divided between shareholders (e.g. 20% of profit plus 20% of capital growth).

Drivers

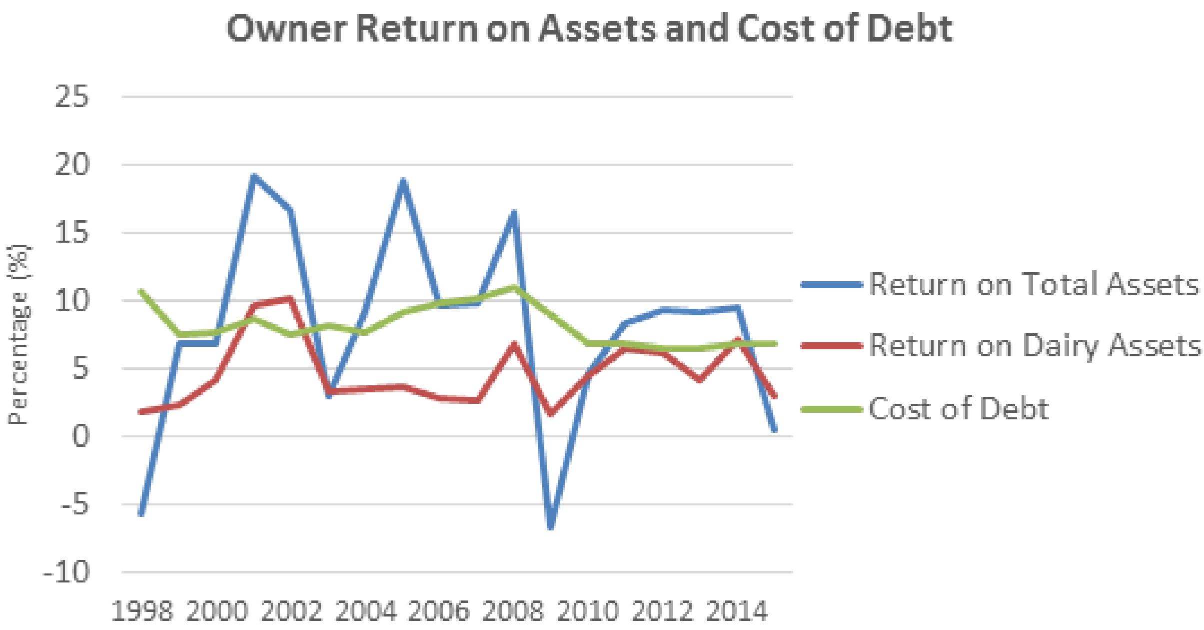
Typically, the key driver of the business is profitability leading to greater return on investment. This business structure does generally result in an alignment of drivers within the group. It is important that a clear policy around dividend payments is agreed upon.

Equity required

Dependent on the size of the business and number of parties within the equity partnership. There can be some significant challenges in cases where the equity manager/sharemilker only has a small percentage equity (<20%) in the business. The equity manager/sharemilker needs to be aware of the realistic cash returns on their investment and how easy it is to remove equity.

Financial returns

Return on investment can vary significantly depending on the farm management ability, timing of entry and exit, quality and value of the land asset purchased. The average return on total assets (including the change in value of the cows and capital value in land) over the 10-year period from 2005-2015 was 7.1%. However, the returns vary significantly from year to year as shown in the graph below.



Source: AgFirst (total assets includes cow values and change in capital value of the land)

How easy is it to enter/exit agreements?

Equity partnerships can be difficult to exit if not clearly defined. They should be set up with a clear timeframe, e.g. 3 years/5 years/10 years etc.

At the end of the agreement the parties can decide whether to extend the agreement, or if any party wants to exit, this is typically done through:

- purchase of shares by existing equity partners;
- purchase of shares by new investors;
- or dissolution of the agreement and selling the assets (cows, land etc).

It needs to be clearly understood that even at the end of the agreement it can take time to sell the property, particularly if the parties have differing views on asset values or how quickly they want their investment out. This can cause conflict particularly if the asset values have not increased at the expected rate.

Entry

Equity partnerships can be set up either with a group of people that know each other or between complete strangers. A binding Shareholders Agreement should be discussed and signed by all parties. This should include (but is not limited to) the following:

- The purpose of the joint venture
- Authority to make commitments on behalf of the business
- Banking arrangements
- Reporting and meeting structure
- Process of voting on major decisions such as capital investment
- Appointment of directors
- Share transfer and exit clauses

This can be drawn up with input from lawyers, accountants, bank managers, financial advisors and/or farm consultants

Exit

Exiting equity partnerships can be particularly difficult if the process is not clearly defined. It can also take time if shares are required to be sold to outside parties, or the property is required to be sold prior to the termination of the equity partnership. This can also mean the parties involved can be at the mercy of the markets at the end of the equity partnership and if some parties want their investment out quickly the property/shares will need to be sold at the current market conditions. One option suggested is that any partner wishing to sell their share before the end of the term, should offer their share at an agreed discount such as 5%, to provide an incentive to other shareholders to buy them out.

More Information

For more information on equity partnerships please refer to the other fact sheets looking at specific types of equity partnership and talk to your bank manager, chartered accountant, financial advisor, or farm management consultant.