

WHAT IS THE BEST CAREER PROGRESSION OPTION – EQUITY MANAGER OR 50/50 SHAREMILKING?

Understanding Equity Partnerships - An Equity Manager's Perspective

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Career progression has been a strength of the NZ dairy industry. The traditional pathway to farm ownership still exists, but it is becoming increasingly difficult to achieve ownership through this pathway. Therefore, in recent years there has been an increase in the number of, and interest in, equity partnerships as a form of career progression to ownership.

This paper will cover:

- critical success factors of Equity Partnerships
- case study of equity managers' progress from a personal development and financial perspective
- key points from a simulation comparing an actual Equity Partnership growth against a theoretical sharemilking opportunity.

Background

A case study which involved interviewing seven equity managers was undertaken. The objective of the project was two-fold: 1) to chart the progress both from a financial growth and personal development perspective; and 2) to develop key principles around supporting farmers through change into equity partnerships.

The two main drivers for carrying out this project were: 1) that entry as an equity partnership may become a more common form of dairy farm ownership going into the future; and 2) that highlighting the many and varied issues involved in the formation and running a successful equity partnership may provide valuable assistance to those investigating the feasibility of an equity partnership proposition.

What is an equity partnership?

The term 'Equity Partnership' has been coined, but the preferred ownership structure for an equity partnership is usually not a 'partnership' at all but almost always a company. Out of the seven entities involved in this study, six were companies and the seventh was a partnership. The term equity partnership ultimately describes a 'partnership of people' who pool their financial and personal skill resources together for the common good of the partnership.

Probably a more correct terminology for this concept would be 'Equity Share-farming' or 'Syndicate Farming'.

Critical success factors of an equity partnership

When existing equity managers were interviewed, factors they felt were critical to the success of an Equity Partnership were documented.

Decision making, agreements and processes

- Decision making between the parties must be fair and equitable
- There must be a robust and thorough shareholders/partnership agreement in place, but there should also be the ability to cover off shareholders' issues at regular meetings
- Regular communication between the parties following a formal or semi-formal process
- Shared and common goals for the business, with the expectations of shareholders being clearly set out at the start
- There should be a commitment from all parties to lock into a fixed period initially (from three to five years as a minimum). Investment in an equity partnership is a long-term investment.

People

- There must be a high level of trust between the parties
- The people involved must have similar values and integrity. The overall relationship is built on *Trust*
- As well as trust, there also needs to be honesty. Trust is earned and usually takes time.

Returns

- It is important that the equity partnership is not over-gearred. A debt to asset ratio of around 50% is comfortable
- Although not expected immediately, regular cash dividends after an initial 3-year development period are necessary for the ongoing success of the enterprise.

Notes:

Support

- Reliance on professionals. Seek outside expertise if it is required.

Leadership

- It is important that the equity manager enjoys a challenge and is willing to take some risks
- It is important that all shareholders have confidence in the ability and respect for the equity manager
- Equity managers must recognise that they are in the driving seat and should take responsibility for day-to-day financial and farm management.

Case study of equity managers' progress

An interview was conducted with seven equity managers to chart their progress both from a personal development and financial growth perspective. Selection of the equity managers was Southland (4), Canterbury (1) and Waikato (2). Selection was predominately made with assistance from Phil Handford (National Bank – Farm Equity Partnerships Specialist).

Financial progress

All respondents have made positive gains in equity since their involvement in the equity partnership. In most cases, little if any return came from cash dividends, indicating there was a heavy reliance on capital appreciation to form the major part of growth.

The average rate of annual capital appreciation in land over the period 1978 to 2005 has been 8.7% per annum (calculated from LIC Dairy Statistics). However, the rate of capital appreciation in land over the five years from 2000 to 2005 has been in excess of 13% per annum.

Table 1: Summary of Results

| Respondent | Personal Equity at beginning | Personal Equity 31st May 2005 | Increase in Net Worth over period | Annual Growth Compounding % p.a. |
|-------------------|-------------------------------------|---|--|---|
| 1 Southland | \$200,000 | \$987,195 | \$787,195 5 years | 38% |
| 2 Waikato | \$0 | \$178,888 | \$178,888 3 years | N/A From \$0 |
| 3 Waikato | \$1,284,000 | \$3,807,323 | \$2,523,323 5 years | 24% |
| 4 Southland | \$1,055,000 | \$1,362,406 | \$307,406 3 years | 9% |
| 5 Canterbury | \$507,000 | \$918,864 | \$411,864 5 years | 16% |
| 6 Southland | \$100,000 | \$371,243 | \$271,243 4 years | 39% |
| 7 Southland | \$1,300,000 | \$1,318,477 | N/A Only 1 year | N/A |

Note: The calculation of net worth excludes any allowance for tax liabilities that could arise on the exit from an equity partnership.

Personal development

Decision-making process and reporting to ensure success and smooth running

For all of those surveyed, everyone had some sort of a formal or semi-formal monthly reporting process in place and ran a meeting at least once (AGM) and up to four times annually to carry out governance and make major policy decisions. In most cases, shareholders had a Director representative on the board, and voting rights were allocated one director one vote.

Notes:

This system of decision-making seems to work well, with most equity managers accepting that they honed their communication skills and their ability to work with others to reach common objectives.

Importance of the shareholders agreement and what it contains

The shareholders agreement is an integral document, with robust preparation vital to the long-term success of an equity partnership. All respondents noted how crucial the preparation of this document was.

Sense of ownership by Equity Manager

It was interesting to note that there were differing opinions on this issue. About half of the respondents felt that the farm provided them with a sense of ownership (that they “called it their own”), which included the dwelling, whereas the other half felt that ownership within an equity partnership did not give them the same sense of ownership as if they had owned the farm themselves outright.

Equity partnership and 50/50 sharemilking comparison

A simulation was carried out comparing the actual Equity Partnership growth against a theoretical 50/50 sharemilking opportunity.

Key Points

The analysis indicated that the final increase in net worth with the sharemilking opportunity was still impressive, yet not up to the level achieved in the investment in equity partnership. *However* points to note:

- The actual cash operating return in sharemilking would be much higher than produced by the equity partnership (including level of tax paid!)
- There was also a return from an increase in livestock values - there is a positive margin between livestock purchased at the commencement of the period and sold at the end of the five year term, due to the increase in livestock values between purchase date and sale date (this is very much reliant on timing in and out of the market)
- Increase in National Dairy Land Values over the same five years (2001 to 2005) has been around 13.75% pa – well above the average annual increase in dairy land recorded between 1978 and 2005 of 8.65% pa. This begs the question, “How sustainable in the long term is this rate of increase, and would you rely on this level when calculating future returns from the investment?”

The conclusion that can be gained from this analysis is that an investment in 50/50 sharemilking and in an equity partnership could be comparable – this will change on a case-by-case basis and will depend on capital and operating returns achieved during the period and timing in and out of the market.

Conclusion

There are many pathways to make progress in the dairy industry. Key conclusions from this study on Equity Partnerships were:

- The *mix* of people involved in an equity partnership is vitally important
- Getting things right at the start – choice of people, preparation of shareholders agreement, level of gearing, involvement of proven and experienced rural professionals, well prepared feasibility studies – will be strongly beneficial in the long run
- Each opportunity has to be assessed on its merits. To identify strengths and weaknesses of a proposal, seek proven professional help
- The returns made from equity partnerships over the last few years have been greatly assisted by the above average capital gains in land. To base future investment decisions on the assumption that these gains will continue at recent levels would be optimistic
- Entering into an equity partnership doesn't guarantee personal and financial success. Despite the fact that all seven equity managers surveyed were successful, there are many who have failed, and for one main reason – the *people mix* was not right
- The long-term cash dividend flows from an equity partnership are important. There seems to be too much reliance on the capital appreciation side of the business to bolster returns, and a far lower expectation from the cash operating side of the business. This attitude needs to change
- 50/50 sharemilking could be an alternative to investing in an equity partnership as an equity manager. Each case should be decided on its merits.

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