Farming - 'a great means of wealth creation, but who's managing it'.

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Abstract

This paper identifies that modern farm businesses have three key aspects to consider in order to optimise business and farm capital performance. These three aspects comprise the need to continue to farm more efficiently, the need to increase farm scale and the need to consider investment outside the farm sector. Few farmers actively manage off-farm investment programs despite these having a capacity to enhance wealth creation and provide other tangible benefits to the farm sector.

Introduction

The Australian agribusiness sector is often depicted in negative terms particularly by the media given the variety of events which make good copy including droughts, floods, insect and pest attacks and the inevitable commodity price cycle downturns. For those in society removed from direct contact with agriculture, many could be forgiven for considering farm communities as an economic wasteland and a sector requiring ever increasing financial support at the hands of the taxpayer.

However from our perspective as agribusiness bankers we witness something very different because we see very few farm business failures, substantial levels of reinvestment by farmers back into their business to improve efficiency and wealth creation by asset accumulation often over generations. These positives have created new investment by the leading financial institutions into their agribusiness offerings resulting in improved understanding of farm financial cycles, increased flexibility and sophistication in farm lending packages and access to loans often at premium borrowing levels.

Clearly there is a disconnect between the public view of agriculture and the reality of agriculture from a business view point.

The challenge for the farmer is to firmly decide which camp they wish to be in; the cultural practice of farming as a life style where profit and conditions always seem to be against you, or the business of farming as a pathway to sustained wealth creation.

For those that decide they are in the business of farming and as such are committed to optimise the business performance of the operation, farming provides significant wealth creation opportunities but in order to capture these opportunities farmers need to actively concentrate on both the physical process of farming as well as managing the farm capital.

Key aspects of business performance

There are three key aspects that farmers should consider focusing on in order to derive optimum business performance.

These aspects comprise the need for farmers to:

- Farm better – to maximize operational efficiency and enhance economic returns and generate cashflow.
- Get more farm – benefits of economies of scale, ability to stay commercially relevant.
- Use the asset rich farm balance sheet to invest in other sectors – to diversify the asset and income base away from the farm, improve retirement and succession plan aspects and gain increased wealth and consistency in income returns whilst still farming.

In general, farmers have traditionally undertaken the first two aspects reasonably well. However the concept of using the farm assets to invest into other sectors is an area that not many have undertaken, despite the fact that farmers have significant capacity to invest into other sectors and that strong evidence exists to suggest that many positive benefits could be gained by farmers in doing so. The latent capacity is readily apparent when the neighbour's farm comes onto the market!

Farm better

Operational efficiency is vital in order for farmers to remain financially sustainable given the long term adverse trend in Australian farm sector terms of trade. Put simply this means every year, each dollar grossed from the farm will deliver less surplus given costs are increasing faster than returns. The only way to combat this trend in order to stay financially viable is to manage for increased operational efficiency either by increasing outputs off the same level of inputs or maintaining the same level of outputs but in doing so lower input costs (Figure 1).

Clearly concentration on aspects such as weed cost and controls plays an important part in farming better and as such your attendance at the Grasslands Society – Waging War on Weeds conference is a key indication that you are all in the business of farming in a professional manner.

Numerous studies and analysis of statistical data on the Australian farm sector have revealed that management plays an important part in achieving enhanced economic returns which ultimately contributes to increased wealth for farmers.

Segment analysis of the economic performance of farm management invariably reveals that the top performing segment out performs the average of the study group by often factors as high as 100%.

Enhanced economic performance leads to increased capacity to grow the business due to increased surplus cash being available to reinvest or being directed to debt service expenses enabling unused leveraged capital expenditure back into the farm business.

If I wear my land valuer hat for a moment, it is interesting to note that highly efficient and profitable farms may not have this benefit reflected fully in the value of the assets given most Australian farms do not involve analysis of trading figures as part of the asset sale process. Well presented farms would in most cases be likely to sell at upper valuation range levels however this is not always the case given the various factors that drive property values.

However poor management can have an adverse effect on capital values despite the current strong rural property markets. This is evidenced via a recent valuation which I have reviewed involving a property where pasture management had been poor. In essence the valuation of this property given the farm's lower carrying capacity has incurred a 30% discount compared to the potential value of the property if well managed.

The clear message under the heading of 'farm better' is that operational efficiency is important to farm economic wealth and can be managed for improved performance. It is likely to impact on future economic fortunes within farming and in particular cases can have a major impact on farm capital wealth.

Get more farm

The 'get big or get out' message has long prevailed in the agribusiness sector and culturally the sector is predisposed to growing the business via further farm land acquisition. ABARE statistics have revealed that record levels of farm land transactions have been in occurring in Australia since 2000 with consequent strong land value appreciation occurring.

Whilst a constant debate exists over the issue of what constitutes on economic farm size, considerable research exist to suggest that farm size is a critical factor to overall farm economic performance. An important component of economy of scale is the capacity to potentially lower a farm operations fixed cost ratio. Any lowering in cost ratio's potentially assists the farm business stay in front of its declining terms of trade resulting in enhanced economic performance.

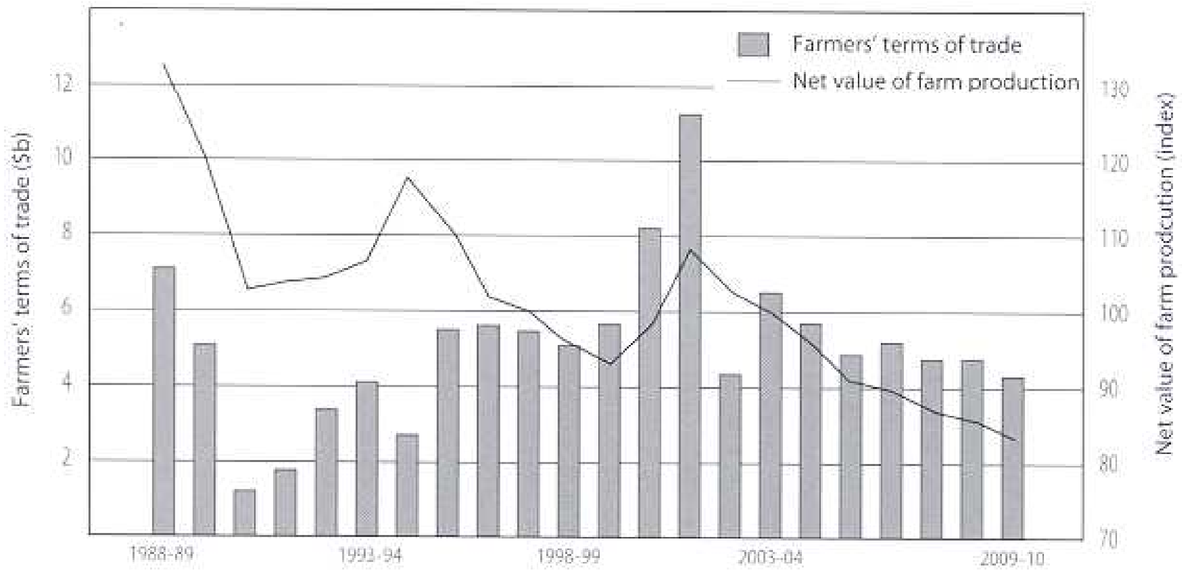

Figure 1 The value of Australian farm production and terms of trade expressed in 2004/05 dollars from 1988 and projected forecast to 2010. Source: Australian Commodities, Volume 12 No. 1 March quarter 2005. ABARE.

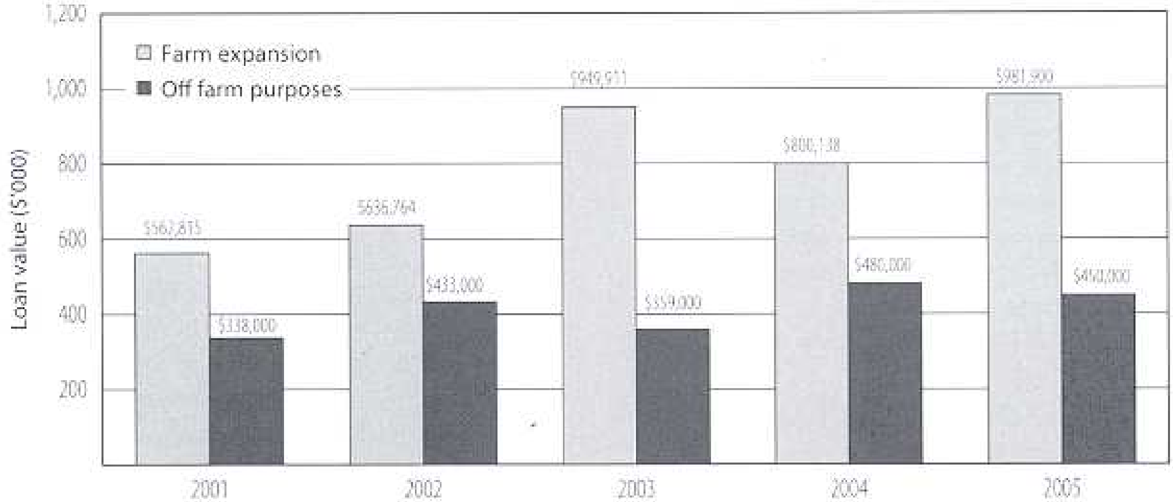

Figure 2 Average value of ANZ loan approvals for farm expansion and off-farm purposes 2001-2005.
Source: ANZ Internal Data (Risk Online).

Other benefits of scale include the potential for more efficient use of often high cost technology such as irrigation systems, farm plant (eg tractors and harvesting equipment), increased 'upside' potential for elevated earnings to occur when the combination of yield and price turn favourable. Further benefits of a larger scale can comprise production and geographical diversification and a larger capital base to derive capital appreciation over the longer term.

The difficulty for farmers in regard to farm expansion activity is that the opportunity to expand often comes unplanned as it is invariably driven by the sudden opportunity of a neighbouring farm being placed on the market. Frequently it will occur at an inopportune time for the potential acquiring farmer, presents itself during a high land value period (farmers tend to sit out poor periods and sell in the next upside or improved valuation period) and of course can never be tailored in regard to size to match the perfect expansion fit for the acquiring farm business.

As such, farm expansion can prove a difficult course to manage and may present new risks. Farm expansion now also often demands larger debt exposure due to the higher land values and these farmers must become more informed about debt and capital management.

The amounts involved in financing expansion have increased significantly. ANZ lending data reveals that the average size loan approval for farm expansion purposes has nearly doubled in the last three years increasing from $560,000 in 2002 to $980,000 in 2005. This significant increase in debt requirement means that farmers most likely need to hone their financial literacy and farm capital management skills in order to manage this new level of capital effectively.

However now that very high land values exist, the decision to expand is now less clear, both on economic return analysis and more importantly financial capacity to fund the purchase. Farm income levels have not lifted anywhere near the increase in land values and in many parts of Australia, returns in excess of 2% from farming are proving difficult to achieve. As such, the farm cashflow position has tightened for farmers debt funding or contemplating debt funded farm expansion and demands significant consideration (Figure 2).

Another aspect in regard to farm expansion is the issue associated with competition. Part of the equation leading to high land values involves competition among farmers for the land. ANZ has experienced numerous auctions of farm land where more than one of its farm customers have gained approval to purchase the same parcel of land – clearly only one can emerge as the successful purchaser. New forms of competition are arising for farm land including demand for land from 'hill changers', urban encroachment, managed investment schemes, investment syndicates and superannuation funds. For many in agriculture there is a sense of being 'land locked' due to local values and competition rendering further farm expansion unlikely.

For many farmers, the need to expand has also come in to question due to family succession issues. Statistics are revealing that the passing of the farm to the next generation has reduced dramatically since the 1970s as less young people elect to resume the traditional farm family path of intergenerational farm transfer.

Therefore despite farm expansion being a key attribute to on-going farm business success for many it is now not an option likely to be pursued prompting the question as to what other aspects do farmers need to consider in order to continue to remain in front of the farm cost price squeeze.

Use the farm to invest in other sectors

Farmers can potentially derive increased revenues and wealth creation from their farm businesses if they viewed their farm businesses in two parts, one being the management of the farm itself in terms of production and operational efficiency with the other being the management of the farm capital via utilising the equity built up in the farm and its subsequent income to leverage into investments away from the farm designed to provide diversified income and further capital gains.

Farmers have a significant financial capacity to make investments into other sectors outside the farm yet very few do so despite evidence suggesting that investments in off-farm can provide favourable returns (particularly when compared to the farm) over long term.

Despite these opportunities, very few farmers undertake off-farm investments with ANZ lending figure revealing that loan approvals for off –farm investment purposes comprise less than 5 % of approvals for farm expansion purposes (Figure 3).

The aspect of lack of off-farm investment appears to strongly reflect cultural or traditional capital management practices rather than any specific financial or economic reason and requires questioning and consideration in a modern farm business. Although the old adage of not investing in anything you do not understand is still relevant, farmers, if committed to farm capital optimisation can improve their understanding of markets and investment and have ready access to advice in this area. Evidence has emerged to demonstrate that whilst farm land is a good store of wealth and has recently experienced

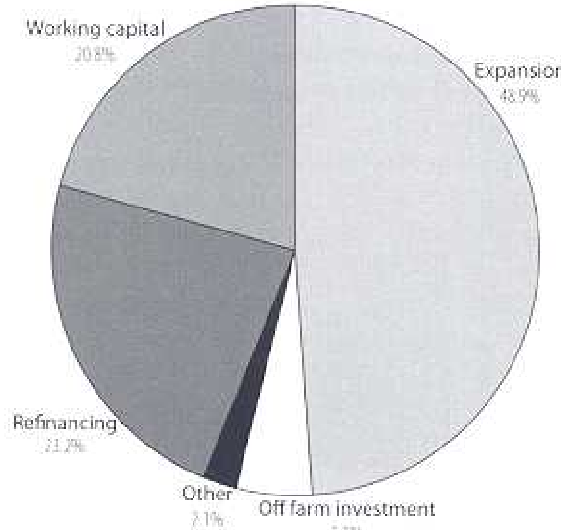

Figure 3 Purpose of lending by ANZ to Australian farmers (average 2002-2005).
Source: ANZ Internal Data (Risk Online).

significant increases in values, it lags other investment mediums in regard to returns and thus farmers should consider investment diversification into these sectors to optimise total returns to their businesses (Figure 4).

Conclusion

In concluding, farming in Australia in the new millennium remains an attractive business sector particularly for those willing to manage their farms on key business principles including focus on capital management aspects of the farm. The later is becoming increasingly important given the capital cost of farming and the value of assets required to farm. Three key aspects where farm management should continue to concentrate comprise increasing

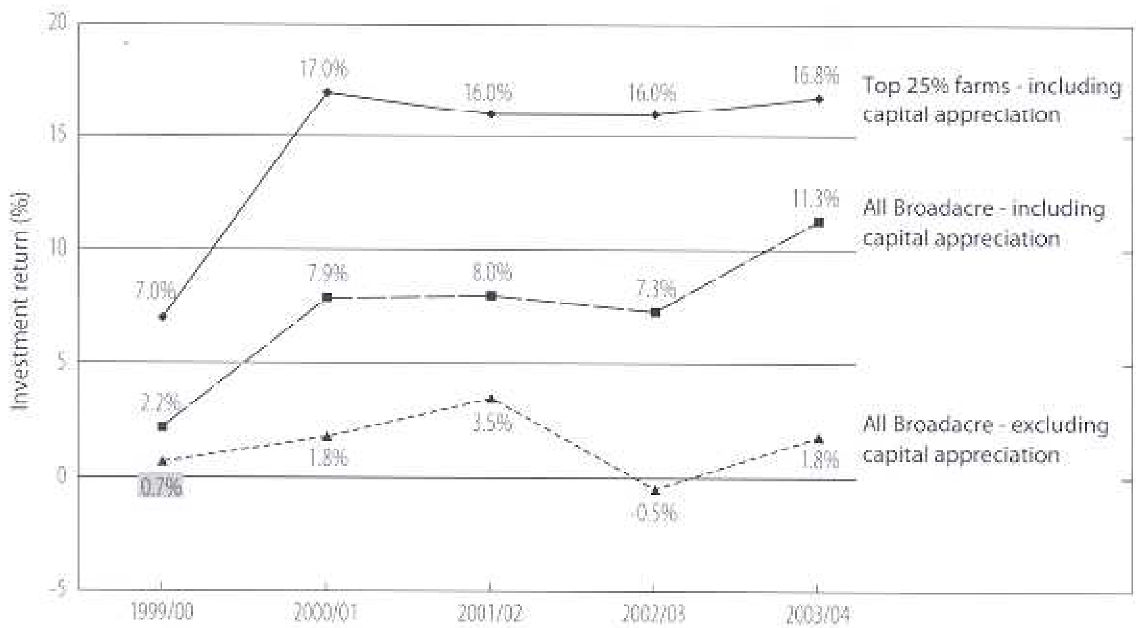

Figure 4 Investment returns. Source: ABARE data extract.

farm efficiency on-farm, farm expansion planning and execution and importantly consideration of off-farm investment opportunities. The later has not formed a key part of traditional farm management practices yet strong evidence exists in both financial and economic terms that this practice could bring significant new opportunities to traditional farm businesses in the form of farm risk management and income and asset diversification.

Simply put the modern day Farmer must learn to 'farm the farm' and also to 'farm the farm capital'.