

GETTING STARTED – FIRST \$50,000

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Introduction

Our background

- Scott is a Rural Manager for the National Bank dealing with Farmers in the Canterbury Region. This includes giving advice regarding investment, budgeting techniques and overall lending for business progression.
- Phil has been farming for five years and learnt significant ‘do’s’ and ‘don’ts’ with regard to farm practise and using farming as a vehicle to equity growth.
- Both Scott and Phil have experience in investment; Scott in residential property and learning from his clients’ own investment strategies, and Phil in cash term deposits including strong budgeting.

Our growth so far

Phil Colombus equity progression

Phil is excellent at budgeting and using a modest farm worker/manager salary to save significant cash deposits. Phil started with \$10,000 in 2002 and has now increased this to \$110,000 five years later.

Table 1: Phil’s saving history over the last 5 years

Year End	\$ Saved
2002	\$10,000
2003	\$20,000
2004	\$45,000
2005	\$70,000
2006	\$100,000

Scott Chapman equity progression

Scott uses his skills learnt from university study and as a Rural Manager at the National Bank to invest in residential property. Scott started with \$10,000 in 2003 and has now increased this to \$125,000.

Table 2: Scott's equity growth over the last 4 years

Year End	\$ Saved
2003	\$10,000
2004	\$60,000
2005	\$100,000
2006	\$125,000
2003	\$10,000

Getting started towards your saving goals

Budgeting

Budgeting is an extremely important role either to invest in property, stock or save. This needs to become habit!

Phil uses budgeting to excellent effect! Phil has been a farm worker/manager for the last five years and therefore is in exactly the same position as most farm workers in New Zealand.

Budgeting requires planning and dedication. As the table below, shows Phil has \$887 per fortnight left for saving. This is \$23,000 per year that can be saved. Including bonuses, if Phil saves all of this there is potential to save \$28,000.

An example is shown below:

Notes:

Table 3: Typical budget for Phil

Income: Fortnightly net after tax	\$1,182
Expenses:	
Phone	\$30
Power	\$40
Food	\$150
Fuel	\$25
Entertainment	\$50
Cash Left to save	\$887

Farm workers are in a unique position to save!

Firstly, rental is free. If you were flatting and working in the city, there would be another \$100-\$150 per week of costs for rent, or \$5,200 per year! Secondly, bonuses such as free meat could save you another \$1,000 per year. This extra \$6,200 alone should be a base for saving.

It is recognised that some people are natural savers. Phil Columbus is obviously a natural saver. Saving 60% of your gross income is difficult, but Phil proves it can be done. If families have children then it is harder, but the benchmark for saving should be 40% of your gross income. The flow on effect from here is strong budgeting techniques. This saving could be replaced in the future with debt servicing so it is advised to make this habit now.

Table 4: Saving 40% of gross income with a partner or children, income of \$38,000 pa.

Income: Fortnightly net after tax	\$1,180
Expenses:	
Phone	\$30
Power	\$60
Food	\$300
Fuel	\$75
Entertainment	\$150
Cash Left to save	\$565 per fortnight = \$14,690 per annum

The effect of compounding interest

Compounding is an extremely powerful tool and can be used to great effect! Below is a table that shows the effect of compounding:

Interest rate based on 7.00% gross. Less tax, interest earned is 5.60%

Table 5: Compounding example based on Phil's saving history

Year	\$ Invested	Balance	Interest Earned	Balance at End
1	\$10,000	\$10,000	\$560	\$10,560
2	\$10,000	\$20,560	\$1,151	\$21,711
3	\$25,000	\$46,711	\$2,616	\$49,327
4	\$25,000	\$74,327	\$4,162	\$78,489
5	\$25,000	\$103,489	\$5,795	\$109,284
Total	\$95,000		\$14,284	

This table shows the total \$14,284 interest earned, which is \$2,857 a year on average or an extra \$55/week!

Therefore, the more you save in the earlier years the greater the effect compounding can produce.

Utilising property to get ahead

Property can be a great way to increase equity!

However, you must first:

1. Do your homework!
2. Have a longer term plan, 3-5 years
3. Understand the purchase and sale process
4. Have passion or liking to property

Notes:

Property can be used as an alternative to saving. It obviously has much higher risk, but is still considered medium risk - higher risk being share trading. Property is a longer term option than saving and is not as liquid. Therefore, it takes longer to have the cash in your hand if required. Moreover, if you require the funds in 12-24 months then the risks outweigh the benefits.

Property can be used where people are either lower order sharemilking or 50/50 and want to diversify their risk from cows. It is advised that a 5% deposit minimum is the best option, so it is suited for investors with \$10,000 plus already. However, this is about investing \$10,000 to \$50,000.

Below is an example of a house purchase scenario:

Table 6: Residential budget example

House Returns	\$
Purchase Price	\$250,000
Deposit, 8%	\$20,000
To Borrow	\$230,000
Rental Income @ \$380/wk	\$19,760
Interest Cost at 8.5%	\$19,550
Rates and Insurance	\$2,000
R & M, Vacancy etc	\$2500
Cash result	-\$4,290

This example has a gross return of 7.9%. This is good in the current market with many scenarios in the 5-6% band only. There are very good buys out there but the returns have decreased. The example above shows that the costs are 23% (excluding interest) of gross rental income. A good rule of thumb is about 25%. Hopefully, they will be lower than this with only fixed costs such as Rates and Insurance. But if the house requires maintenance or is vacant for four weeks then the costs can add up.

The key here is the ownership set up of the property. A Loss Attributing Qualifying Company (LAQC) can be utilised. Therefore, the loss can form a rebate from either personal income or from paying too much tax in a sharemilking position.

This is where the advantage of using property over the longer term is beneficial.

With lower gross returns, how does this help grow equity?

Assume that land values grow on average 5% per annum.

Table 7: Capital appreciation in residential property

Year	\$ Invested	House Value	Appreciation in Value	House Value at End
1	\$20,000	\$250,000	\$12,500	\$262,500
2	\$0	\$262,500	\$13,125	\$275,625
3	\$0	\$275,625	\$13,781	\$289,406
4	\$0	\$289,406	\$14,470	\$303,876
5	\$0	\$303,876	\$15,194	\$319,070
Total	\$0	\$319,070	\$67,070	\$319,070

Over this five year period the appreciation in equity is \$67,070. This is with no further investment in the property and no debt repayment. Therefore, the \$20,000 initial investment is the only funds required. Residential investment can then be the start of a larger investment portfolio. For example, after two years the investor can purchase another house and use the increase in equity from the first house as leverage. Moreover, they can still run a savings plan by using a standard savings account such as Phil's above, plus cover the extra expenses that the residential property requires (\$4,290). Then, at the end of the financial year a tax adjustment can be received.

Using stock to grow equity

We are all farmers and some are at the stage where they want to progress into sharemilking – this requires cows!

Cows are considered to be higher risk than property. This is mainly due to the larger fluctuations in cows values over certain years. It was only three years ago that an average mixed age

Notes:

cow was valued at \$950/head, compared to \$1,250-1,350/head now. The purchase of cows, however, can still be an important consideration in preparing for sharemilking and increasing equity.

For example, if you are a manager or farm worker and have a strong relationship with your owner, you can purchase cows and be the lessor (the owner leases them off you). Below is an example of someone with \$10,000 cash saved and purchasing 25 cows at \$1,250 per head.

Table 8: Purchasing cows and growing your own herd

Year	Cows Purchased	DEbt	Lease Income (10% value)	Interest Cost	Debt Repayment
1	25	\$21,250	\$3,125	\$1,806	\$11,319
2	25	\$31,181	\$6,250	\$2,650	\$13,600
3	25	\$38,831	\$9,375	\$3,300	\$16,074
Total	75	\$22,757	\$18,750	\$7,756	\$40,993

This table shows that after three years, 75 cows are owned with a value of \$93,750 less debt of \$22,757. Overall, an equity increase of \$70,993. This is a different approach! Instead of saving, the investor will use the extra income from leasing cows to pay off debt, also repaying \$10,000 per year extra from their individual salary. The main reason for this faster debt repayment is that to continue to purchase 25 cows per year the bank can lend to 65% of the value of the stock. The faster you can repay the original debt from your income sources, the greater number of cows you can purchase in the second year, third year and so on.

The faster you save and then start to purchase cows the quicker your herd grows. If you get into the habit of saving, this money can then be used to repay debt on purchasing cows.

Conclusions

Budget, plan and research!

Budgeting is the beginning of saving and investment. If you have nothing now then the first step is to plan a budget. After this step, a habit must be formed. By opening a savings account so that access is difficult to everyday funds is a great start. Then the other forms of investment must be looked at closely and researched. They must be understood so that each individual future needs can be meet.

The use of the three investment approaches outlined above can be used together or separately, but the first step is to save! Once \$10,000 or more has been accumulated then the next step can be achieved. This would take on average 12 months. Saving becomes a habit and gets easier over time.

That's why you can save more in the later years. Taking advantage of compounding interest is also very important and can help achieve your saving goals. Cash is great for both the short and long term. People who don't want to invest in property or cows can use cash. Cash is also easy to utilise in the short term: you don't have to wait for a house to sell to realise the benefits.

Once a deposit is saved for a residential investment, this medium term strategy can be a great way to increase equity. The benefits also stretch to tax rebates through the ownership of the property or properties. Over time this can be the best source of equity growth, but time is the issue. If your goals or plans for the future require the use of money in less than three years then residential investment is not the best option. However, if you are already in a lower order position or similar this can compliment the business strategy well.

Finally, moving up in the dairy industry takes time and to get to farm ownership, most must follow the pattern of lower order to 50/50. To speed up this process, buying cows comes in. It is a great way to build cow numbers and equity while working as a manager or farm worker. Combined with an amount of saved money this option allows people the opportunity to get into 50/50 positions and more importantly borrow money from the bank easily. Security from the bank's perspective is the hardest obstacle for a sharemilker. Hence, building up stock numbers early and increasing equity along the way with principal repayment is an excellent step forward.

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