

WORKING WITH YOUR BANK TO CREATE SUCCESS

FOR MANAGERS, CONTRACT MILKERS & SHAREMILKERS

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Today I will be to the point and honest about how I see things; that is I will not be glossing things up. So it may get a little bumpy, but this is well intentioned. In business you often learn from mistakes, both yours and others.

I will cover:

- The self-rating tool and the Bell shaped curve
- Your statement of Position
- The importance of cashflow
- The Bank's 3 criteria and requirements
- The decision-making process
- Common issues we see.

How many times have you heard a young person say something like:

- The bloody bank they won't lend me anything
- The bank has got it wrong
- The bank doesn't know what they are doing?

Young people often see banks as large faceless organisations and think it's cool to slag them off if they do not get their own way. They often do not get their own way because they are unprepared, inexperienced and do not know what they are doing when meeting with a banker.

Some young farmers want funds when they have not got "skin in the game" and cannot articulate or explain their business verbally or on paper in a logical format. They want the bank to take all the risk. They want the bank to just front up with the money and trust them – even though they have no track record.

Notes:

Banks are in the business of taking deposits and lending funds. That’s how we make most of our profits. The fact is we want new customers, but they need to be profitable customers as banking does not work well when customers are not profitable and we end up with what we call poor performing loans or bad debts. We are not a charity, we are a business.

The more experienced person will simply see through the above sort of comments as immature, knowing that the bank is most likely making a fair assessment of the situation.

Borrowing money is not a right or an entitlement – you have to earn the right to borrow. You have to create a track record and make a compelling and logical reason as to why the bank should lend funds to you.

Borrowing bank funds and using smart leverage for a business can be a way to help career progression, but the emphasis is on smart leverage – while building a great relationship with your bank and other professionals that touch your business.

Poor leverage will often lead to fundamental business issues and governance questions by the bank. We see this often with young business owners.

Poor leverage could include borrowing for:

- taxation
- repaying the credit card
- household items
- cars and car do-ups
- boats
- holidays
- excessive drawings
- repaying the OD.

When times are tough, that is when you step up contact with the bank, not hide from the bank. It’s when you obtain more advice and aim to be smarter and tighter with decision-making.

We see this with the top end farmers, but the total opposite with the bottom end. The ostrich “head in the sand” trick doesn’t work – communicating does work.

The self-rating tool

Please rate yourself as a Contract Milker or Sharemilker or if you are a farm manager or farm worker, rate yourself in your current role.

Extremely Poor	Poor	Below average	Average	Above average	High achiever	Cracker Jack
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- How did you rate yourself?
- What criteria did you use?
- Who did you compare yourself to?
- From my experience, on average we rate ourselves above average! That would be a type of oxymoron, as it is contradictory. But that is what we see as bankers.
- Perhaps an even better exercise would be to get someone who knows you to critically rate you, or even the person sitting beside you after a 10 minute conversation.
- Many below average farmers will rate themselves as average or above average in ability.
- Those who correctly know where they are at and know their short comings have the opportunity to obtain personal development to improve areas of weakness.
- It doesn't need to be an impediment to a business to be weak or poor in a certain skill area. The largest impediment would be not knowing or recognising a weak skill area.
- Our best clients know what they are weak or poor at. They know that for them to be successful they need to know their own limitations and know how to mitigate these limitations or weaknesses. This is possibly one of the best business skills for anyone to have.
- Those who consistently rate themselves higher than they actually are do not see their own short comings and make mistake after mistake and often fail to learn. This is not good for their business.
- Here's the link. As a bank we rate every client on a range of measures, you need to understand this. We rate you on your:
 - ability on farm
 - ability financially
 - ability with staff
 - honesty and integrity
 - ability to deliver to plan.

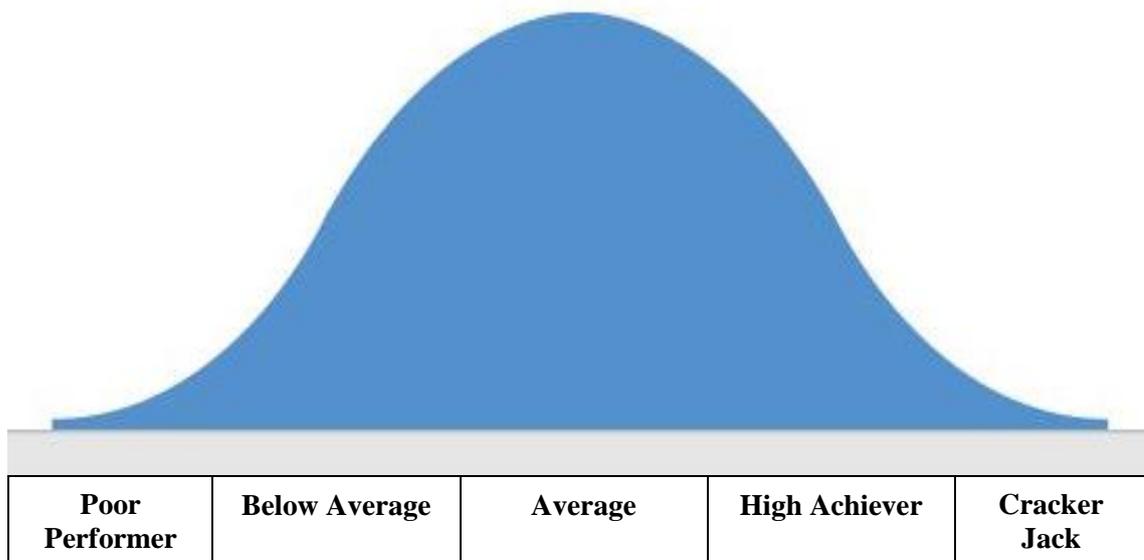
Notes:

Note, trust and track records are earned, they are not a right or a given. This is very important – you need to understand this.

We sum the above ratings up as “personal factor”. You want to have a bank rating your personal factor high. Banks will have non-clients who they do not want banking with them. That is personal factor decision-making to the fore. It pays not to get into this position as it restricts your options in debt funding. If these people come in, they will be given the time of day and be listened to, but the response will most likely be a decline, unless they can demonstrate great reasons for a Bank to lend.

- Get a mentor or mentors.
- Learn farming skills.
- Learn business skills.
- Learn what a bank wants and deal with them one on one.
- Be professional, organised and build relationships.

The Bell shaped curve



- The Bell shaped curve links into the self-rating tool and personal factor.
- You may have seen the Bell shaped curve at school, about year 9 or 10. It is a good concept for understanding people, results and outcomes in real life.
- When I get a new manager, in loan reports it sometimes seems we only bank above average farmers. The keen young banker just rates everybody high.
- Well we all know that is bull “shite”. It just means the manager is not seeing the true situation for some of their clients and deals. They are not seeing the true picture.

- We can bank all sorts of farmers including below average farmers, and we do bank many below average farmers. There will be a number of below average farmers here in the room today. And that is fantastic, as the way to move from a below average operator to an average or above average operator is via understanding your true situation and by learning. The same applies to every industry including bankers like myself, accountants, solicitors, consultants and even doctors.
- The issues arise if we bank a below average farmer into a situation that requires above average skills. This can end in a messy situation, especially if the timing is wrong as well.
- Just because someone is high profile or vocal, doesn't mean they are above average. They may just be high profile or vocal and below average.
- The financial skills in farming are often less than what is required. This is an area that has been improving but there is still significant further improvement needed, especially as the businesses get bigger and more complex. The industry has an issue here and as young people you need to start learning financial skills and continue to develop these as your business develops.
- As contract milkers and sharemilkers are usually young and inexperienced, your financial ability is often poor because of this inexperience. If you know and acknowledge this, you have made a good step to fixing it.
- These skills can be coached and learnt. Two good sayings - **The best time to learn is now.** **Failing to plan is planning to fail.** We see this often. But if you have the attitude that you will run your business and have a great open relationship with your advisors, you will be moving in the right direction.
- You can employ a professional to help.
- You can train via Primary ITO, Lincoln, Polytechnic.
- You can get a mentor.
- IRD has training, talk to your accountant, consultant, bank etc.
- DairyNZ have great courses and a fantastic website.
- Like milking cows, good financial management needs daily attention, not just once a month when the bills are paid.

Notes:

- Dairy farming is not just about cows and grass, it is a business that needs business skills as well.
- Show some respect to yourself and to your business, don't be lazy, and invest in developing your skill base (being here today is a good start). The younger you start, the more time in business you will have to benefit.
- Contract milkers and sharemilkers can often have a solitary working existence, so this can be a real challenge that needs to be worked on and called out at times. Some will need to push themselves outside their comfort zone to develop their farming, business and financial skills. Just do it.

Statement of financial position

- Firstly what is the definition of investing? Investing is foregoing consumption now in order to have the ability to consume more at a later date, i.e. build wealth. Note some entities destroy wealth.
- Who knows what a statement of financial position is?
- It just shows what your financial position is, at a point in time. Like today.

Date		20 June 2016				
Liabilities			Assets	Hd	Value/hd	
Bank OD		\$15,000	Cows	40	\$1,400	\$56,000
Credit card		\$2,000	Yearlings	20	\$700	\$12,000
Taxation		\$12,000				
Total Liabilities		\$29,000	Calf gear			\$20,000
Equity	74%	\$84,000	Car, bikes & plant			\$25,000
Total		\$113,000	Total assets			\$113,000

- What is an Asset? – something that has a value
- What is a Liability? – a debt (Hire Purchase, Bank debt, credit card, the owner, anyone you owe money to)
- What is Equity? – Assets minus liabilities (this should be a positive number).
- Equity percent is very important – work this out for yourself. This basically shows the percentage of the business you own. The more you own the better. The less you own, the more other people have an influence on your business.
- How do you work out your equity? As above ($A - L = E$)

- So a statement of position is simple – you should work it out for yourself every 6 months or so, or at least once a year and compare this year with last year and each year going forward. This will indicate if you are progressing (on a net wealth basis). Measure your progress. Put it on a graph! Measurement usually leads to better understanding and hence better performance. You can also graph your equity percentage.
- Understand why your equity level (in \$) and your equity percentage change from year to year. It is important. Is it from cashflow or capital valuation change? The top performers usually have cashflow gain and capital gain.
- Having cashflow losses and equity gain is a warning sign if often repeated. It will most likely mean you are vulnerable to a downturn – we are seeing some of this currently in the market place. If the downturn comes you may well be starting from a poor position and then have cashflow losses alongside equity losses. These will be the ones that may have to exit.
- A low equity percentage usually corresponds with higher risk and a high equity percentage usually means lower risk. Equity measures the amount of skin in the game you have.
- What equity percentage do you think the bank is looking for?
- Allow for taxation liabilities as tax is a real cost of being in business. This is often an issue going into a second or third year of business assuming you are making profits. If you do not know about taxation, ask questions.
- Value livestock at their true value. I know you will rate your cows highly, but all herds have empty stock, 3 titters, older cows and high cell count cows.
- If you have inherited any funds, what net wealth have you created, on top of this inheritance? Again are you creating or destroying wealth? Creating wealth is more fun and more sustainable than destroying wealth.
- At the same time, review your short/medium/long term strategies and goals. What are they? Make them easy and simple! Write them down, review them critically along with the statement of position, and share them with your trusted advisor, bank and partner. Try and make them measurable.

Notes:

- Understand the difference between a goal and a dream. A goal has a pathway to achieving it; a dream is just that, a dream, with no pathway.

The importance of cash flow

- Why are you a contract milker or sharemilker?
- What is your purpose for being in business?
- What are you trying to achieve?
- Another saying – **There is no capital gain in contract milking or sharemilking.** Who disagrees? Do you think I am right on this?
- So again, ask yourself - Why are you Contract Milking or sharemilking?
- Hopefully - A career choice (you enjoy it and the challenge) and to make a profit and a living, hopefully to progress from retain earnings!
- Plan profits; don't wait for them to appear, otherwise losses might turn up.
- Who knows their production today? Production year to date? Production for the coming month?
- Who knows their bank balance today? Cash result year to date? Bank balance for the coming month end?
- What is the definition of a business? One definition of a business is – an entity that makes a profit. So if you are not making a profit in most years, have you got a business? I would say no. You may just have an entity.
- Running a loss making entity is not a sustainable activity you want to be involved in. Banks do not like these either.
- If you do not know your cash flow, who does? Should anyone else be more worried about your cash flow than you? Basically no one else really cares that much about your cash flow, perhaps the Bank will, but you the owner should be real focused on your cash flow.
- If you wish to be successful, this is imperative – you should know your cash flow.
- A favourite saying -**To be in business you have to be able to cash flow the down cycles – otherwise you are at the mercy of your bank.**
- If you do not want to budget and monitor – perhaps stay on a salary, maybe being in business is beyond your skill level. – Perhaps learn the skills required.
- Another saying – **If you were profitable last year, why are you asking for more funding?** We have to often ask this question, why? Because the customer most likely doesn't understand profitability and cash flow.
- Another question we also often ask is - **Why are you applying for a loan to pay tax to the IRD?** Where did the profits go?

- We can get the comment that yep I made a profit last year. \$40k! The client thinks that the profit is the figure retained after drawings, which is obviously wrong. The cash flow looks a bit further, and what you did with that profit. If you drew \$70k and bought plant for \$25k and paid tax of \$6k, your cash flow has gone backwards, and you may not be able to afford this. This doesn't look like a business that's working. Perhaps working for wages of \$50-\$60k would be better. Profit is not cash flow or how much your Bank balance has increased or decreased by. Profit is used to calculate an important cost – taxation.
- Paying tax is good as it indicates a profit. Being cash flow positive is also good as it may indicate cash coming in is greater than cash going out.
- From the profit, you need to take your drawings and pay tax as a minimum.
- Why measure production against budget if you do not measure cash flow against budget? Surely the second is more important and more aligned to why you are in business. Production on its own doesn't pay the bills, but profit and cash flow will. So the question “why are you in business?” - is important.
- What is the profitability of milk production? How do you work this out?
(Milk production * Milk price) – cost of production (both fixed and variable costs)
So there are 3 variables:
 1. Milk production - under your control
 2. Milk price - out of your control.
 3. Cost of production - under your control
- In any budget you can be
 - optimistic
 - pessimistic, or
 - realistic.
- For the average business person the first and second will lead to incorrect management decisions and most likely magnify any situation. The third is where most businesses should be. That is a realistic budget.
- The production should be set at a level you will achieve, not a magic figure that would be great to achieve.

Notes:

- The issue around budgeting is that someone's realistic budget is someone else's optimistic budget. Ask your bank what they are using in their budgets. Get advice.
- Understanding Fonterra or your milk company's payment structures for milk is important; get someone with knowledge to explain these to you. We see many budgets with this wrong. Use Fonterra's payment predictor, it works.

The bank's 3 criteria and requirements

- In approving a loan we have three broad areas that we want to satisfy and understand. These criteria have not changed in 25 years.
 1. Personal factor - we spoke about that with the Bell shaped curve.
 2. Cash flow - we have just covered
 3. Security (is the third) - I will cover this quickly now.
- Security is taken to cover a loan in case the business cannot cash flow or afford to service its debt. It is a safety net for the Bank to recover its lending, as the funds effectively come from our depositors. Our depositors expect us to look after their funds very well. We expect security to cover our lending as unsecured lending to businesses, especially with no track record tend to result in debt write offs over time. So be prepared to provide security.
- Another option sometimes used is a guarantee from a family member or an owner to get a funding facility. These can be handy but any guarantee effectively means if you do not repay the debt, the other party will. We tread carefully with these, but do put a number in place each year.
- If you are given a guarantee to start in business, you should be looking to get in a position where this guarantee can be released.
- CM and VOSM are cash flow businesses. You should not look to be having long term debt positions. You should be building up cash. Avoid debt and hire purchase agreements. There can be exceptions but make sure you understand what you are doing. Use smart leverage.
- If you have not saved any funds as a manager, why not? Why would we want to lend you money when you can't save any! Why should we take on a risk when you are not putting any funds at risk! Banks like clients to have skin in the game; cash and equity at risk if the bank is to have cash at risk.
- Obtain a track record of producing cash and then look at borrowing for appreciating assets or at worst borrow for short term cash flow situations.
- People take calculated risks - just ensure your calculations are correct, when starting out ensure you surround yourself with good people that can help.
- What you do, what you say, and what information you produce, creates your track record. Have realistic budgets and deliver on these. That is production, costs and cash surpluses.

This creates your track record. Continuously not achieving your targets creates a poor track record.

The decision making process

- Decisions to make – do I or we go VOSM or do we go contract milking or do we stay on manager wages. These decisions are big and many people get it wrong through naivety and inexperience. They often like signing up to a new title. Please note a new title is not progress on its own.
- Each job is different, and each job comes with different risks factors, different owners, soils, climate, costs, cows, location, cowshed, housing, plant, number of staff, etc. Choose very carefully, do some due diligence on the owner, the cows, the property and contract. Talk to the current VOSM/CM and your advisors. If you need funds who will provide them? Is the profit enough to reflect the risk you are taking on and the equity you are putting at risk? What are your risks?
- It may pay to avoid some owners as they may be too tough. Some contracts will also be too tough, be prepared to walk away from a poor owner or contract.
- If you decide to go into VOSM or CM get some advice, get an accountant who knows the industry. Put a budget together and cash flow this. Talk to your bank. Learn about PAYE, GST and tax. This all needs to be done prior to signing any contract.
- Do you trade as a sole trader, partnership, company, trust or limited partnership? This is an important decision and best done early.
- A key ratio is the level of drawings. How keen are you about being successful? We see some CM and VOSM drawing more than owners, having more toys than owners. These operators don't usually last or progress.
- Some people like the title and then think they have made it, hence start spending more.
- If you are a contract milker and moving out of the shed, have you got your cost structure and priorities right?

Notes:

- Iron disease is out there. Just watch for it because it can creep up on you. Tractors, cars, utes, boats, bikes, they all rust, get old and lose value; do not overload on gear or depreciating assets. Wisely investing in appreciating assets is more appealing.
- If you verbally agree to a contract, conclude the negotiations and then get the contract signed as soon as possible, preferably within two weeks. Do not let it drift as the owner may change their mind or change clauses on you.

Common issues we see

1. Signing up contracts in a hurry with no advice. – **get advice.**
2. Not doing property and owner due diligence. – **do due diligence.**
3. Trying to repay principal and build stock numbers at the same time. – **understand your cash flow.**
4. Not putting the effort into building relationships. – **build a great team around you (owners, bank, accountant, consultants, lawyer).**
5. Not measuring grass - I know better! – **Grass is your major or only feed source, measure it every week.**
6. Expanding too quick and ignoring taxation. – **Monitor equity alongside cash flow and understand your risks.**
7. Iron disease – too many new vehicles, cars, boats, bikes, tractors. – **minimise the amount of gear you have.**
8. Thinking it's all about production, and not up-skilling in the strategy and financial area. – **develop yourself into a dairy farmer and a business person.**
9. Bull “shite” budgets. – learn how to do meaningful realistic budgets.
10. Running a high cost system but not achieving the income to justify it. Analyse your results and ask yourself where you can improve, and get critical outside advice. Be careful with high cost systems.
11. Not admitting you have made a mistake, hence you do not see any reason to change and/or improve. Our very best customers are good at acknowledging their own failures. This is an extremely good trait for anyone in business - a mistake is simply a learning opportunity. Our best clients have had a lot of learning opportunities, our worst clients often do not have as many because they do not acknowledge their mistakes. Be open to learning.

All of the above issues are the same or similar to any small medium size business. The old saying “not planning is planning for failure” is common in many.

In Summary

1. The dairy industry has a great pathway for young people to progress.

2. There are many avenues to learn and up-skill yourself to enable you to have the skills to progress.
3. The person responsible for up-skilling yourself is you – you need to show confidence in yourself and respect your future by investing in learning opportunities. Many will be free, some may cost a little.
4. There are plenty of willing people that can help and mentor you.
5. Build great relationships and have open communication not only with your bank but with all people involved with your business.
6. Some sacrifices will be required along the way.
7. Avoid iron disease.
8. Use a mentor.
9. The opportunities are out there.
10. All the best.

Notes: