

# WHAT'S THE RIGHT MANAGEMENT STRUCTURE TO ACHIEVE OUR OBJECTIVES?

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## Introduction

The management structure options available for running a farm business continue to evolve to meet the needs of a changing industry. Likewise, for those who aspire to farm ownership, the pathways also continue to evolve. This paper examines the trends in the industry, but more importantly how to decide which management structure is going to be best for you to meet your objectives. The discussion will examine the pros and cons of the various management structure options and key areas to consider for success.

## What are the trends?

Sharemilking has long been considered a cornerstone of the New Zealand dairy industry, providing a viable progression pathway for young dairy farmers to build experience and wealth, and traditionally aiming to achieve their ultimate goal of farm ownership. This pathway has been put under pressure in recent years, with the number of Herd Owning Sharemilking (HOSM) positions steadily declining, due to a variety of factors. In the past five years there has been significant fluctuation in the milk price paid to New Zealand dairy farmers, and this volatility has created additional problems for farm owners and sharemilkers alike.

The dairy industry in New Zealand continues to evolve, with larger farm sizes, more corporate ownership, and higher debt levels. These are some of the factors that have led to a steady decline in the number of herd owning sharemilking agreements in New Zealand, as evidenced in the following table. However the overall number of sharemilking agreements as a percentage of farm businesses has remained constant at around 32%. In other words, although there are fewer herd owning sharemilking agreements available these have generally been replaced by variable order or contract milking arrangements.

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Notes:

With regard to changes in management structure, several key trends have emerged over the past few years. These include:

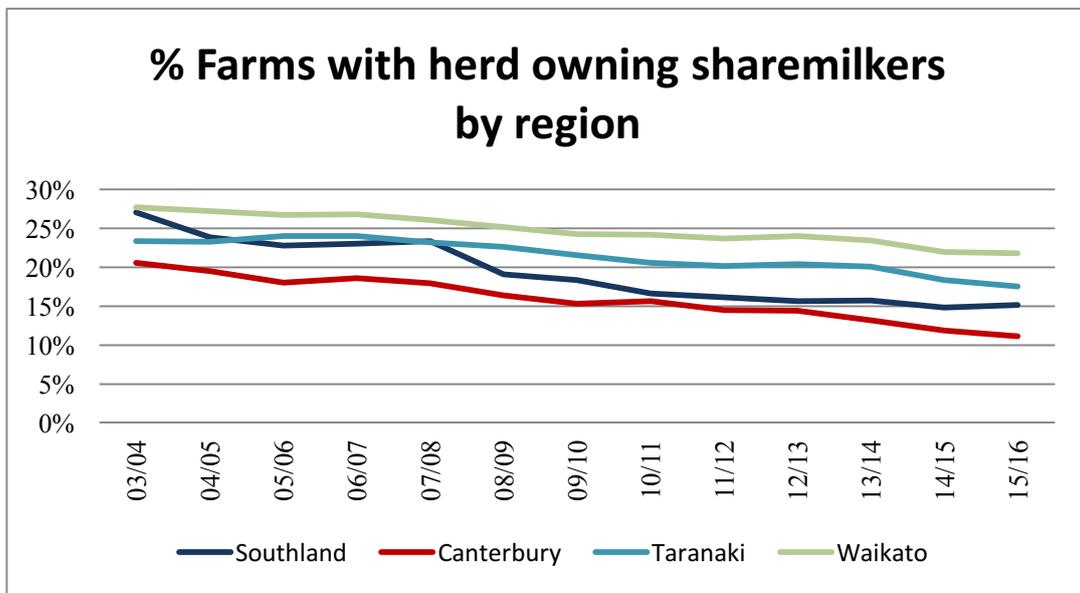
- The percentage of sharemilking agreements in the industry remains relatively static, but the percentage of HOSM continues to decline. Over the past five years the number of HOSM positions has declined by fifty per year
- The trend away from HOSM is more pronounced in the South Island
- The variation in milk price within seasons is causing problems with setting appropriate percentages for sharemilking agreements
- The variation in milk price between seasons, and the resulting fluctuations in herd values, is creating significant fluctuation in sharemilker returns, but also their equity levels. Timing of entry and exit is a critical feature for sharemilkers in terms of maximising equity gain (or minimising loss)
- A recent but significant trend away from variable order sharemilking into contract milking
- A steady rise in the role of the career professional manager, and associated structures on larger farms such as operational managers and general managers.

The following tables and charts illustrate the above points.

**Table 1.** Trend in number of dairy farms and sharemilking positions over the past 20 years

	1995	2005	2010	2015	2020 * (est)
All farms	14,597	11,883	11,691	11,970	11,000
All sharemilkers	5,016	4,260	4,041	3,879	3,500
HOSM (average drop in positions/yr)	3,614	2,719 (-90/yr)	2,303 (-80/yr)	2,050 (-50/yr)	1,800 (-50/yr)

\* The estimate for 2020 is based solely on the author's expectation on the number of dairy farms in New Zealand, combined with an extrapolation of the current trend in the decline of HOSM agreements.



Reasons for the decline in HOSM agreements include:

- Increase in average debt levels on dairy farms. The farm owner needs to have a moderate to low level of debt if they are to work with a HOSM using the traditional 50/50 split
- A perceived inequity in the financial returns between farm owner and HOSM
- A desire by some larger farming entities and/or corporates to retain ownership and control of their livestock assets.

It is important to note that this is **not** signalling the end of HOSM. There are many reasons why a farm owner would want to employ a HOSM, and it is still one of the best career pathways for young farmer to pursue. It is however highlighting the need to constantly adapt our thinking.

### What other trends are we seeing?

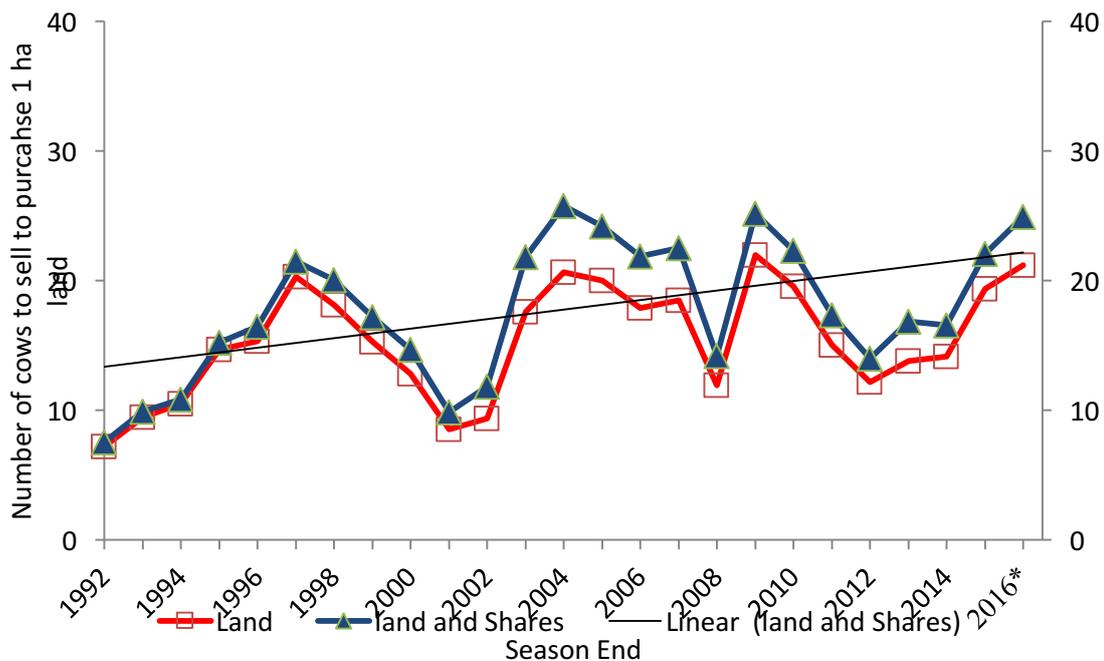
- HOSM staying in positions for longer. This is a combination of difficulty in progressing to the next step of farm ownership, but also an increasing number of HOSM are realising there are good business reasons to retain their existing position

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Notes:

- There is a noticeable trend away from sharemilkers aspiring to farm ownership. In 1996 70% of sharemilkers responding to a survey were intending to go onto purchasing a dairy farm, compared to 47% in 2016. While in some cases this is almost certainly due to sharemilkers seeing farm ownership as a goal beyond their reach, there are increasing instances where they are content to remain in their position until retirement or in a career change. Additionally, there are instances where sharemilkers take on multiple positions, which further complicate progression pathways.

The relativity of cow price to land price is an important ratio impacting the ability to progress from HOSM to farm ownership. The trend in the number of cows required to purchase one hectare of land has risen from under 10 to over 20, as shown in the following chart. This creates another problem in the traditional progression pathway. This also highlights the importance of timing. Cow prices are strongly correlated to milk price, and astute sharemilker with good timing can take advantage of these trends.



## Which structure should I choose?

### *What does success look like for a progressing farmer?*

Although farm ownership is still a goal for many progressing farmers, having a business that provides good cashflow, a good lifestyle and opportunities to make other off farm investments, is now seen by many as a viable end goal in the dairy industry. To this effect, successful HOSM, VOSM and contract milkers are sometimes content to stay in these positions for longer periods, and may have no aspiration to progress to full farm ownership.

In some cases, larger scale HOSMs are in a position where staff might do the majority of the hands-on work, they live in a desirable location and have relatively low debt. If they move to buy a farm, they would typically need to decrease the scale of the property, may need to increase their daily hands-on role, may have to move to a more remote location where land is cheaper, and may significantly increase debt and business risk. The drive to own land is still strong for many New Zealand farmers, but the business and lifestyle case for doing so is not as clear as in the past.

Whilst cognisant of the above points, it is also important to recognise that the ability for a farmer to achieve the goal of farm ownership is still recognised as important for the dairy industry as a whole. The ability to achieve farm ownership provides a strong business incentive for farmers to continually innovate and seek new solutions for industry issues, thus driving productivity and profitability within given constraints.

### ***What does success look like for the farm owner?***

A successful progression pathway should look to achieve the following:

- Achievement of the farm owners' goals and aspirations for their business and their personal goals
- Continued pathway of well qualified and highly motivated farmers to manage/sharemilk their properties
- Continued pathway of farmers/investors who are willing to purchase their property, in order to create and exit strategy.

### **What does success look like for the industry?**

A successful career progression pathway for the dairy industry contains two key elements:

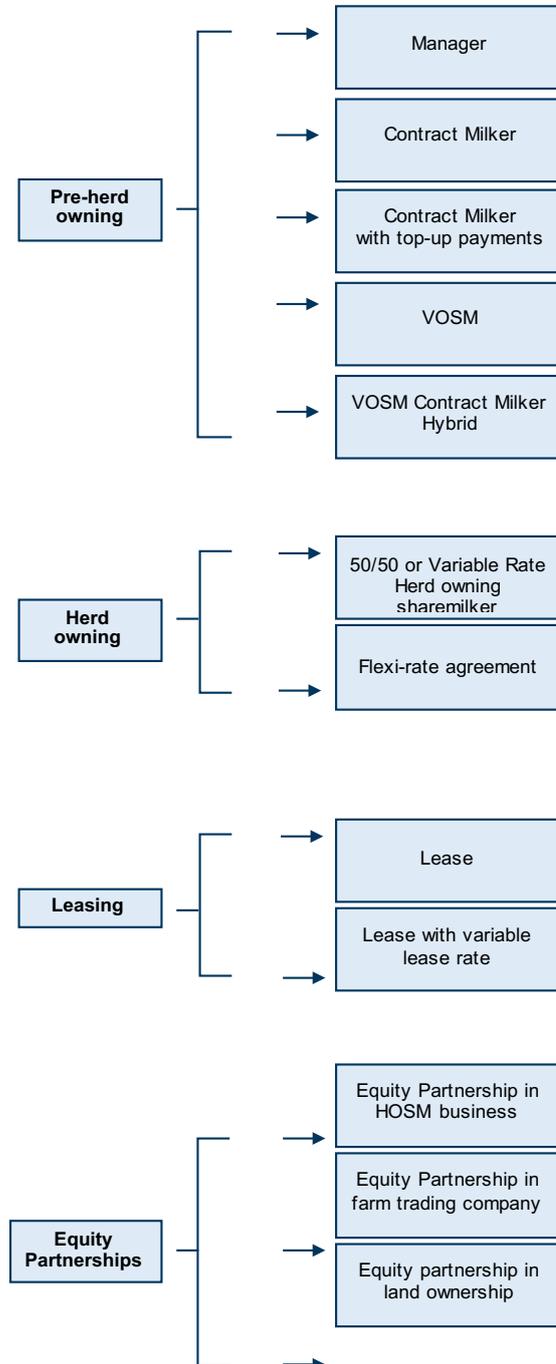
1. Retention of talented farmers in the dairy industry
2. A continued ability for farmers to progress through to farm ownership.

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Notes:

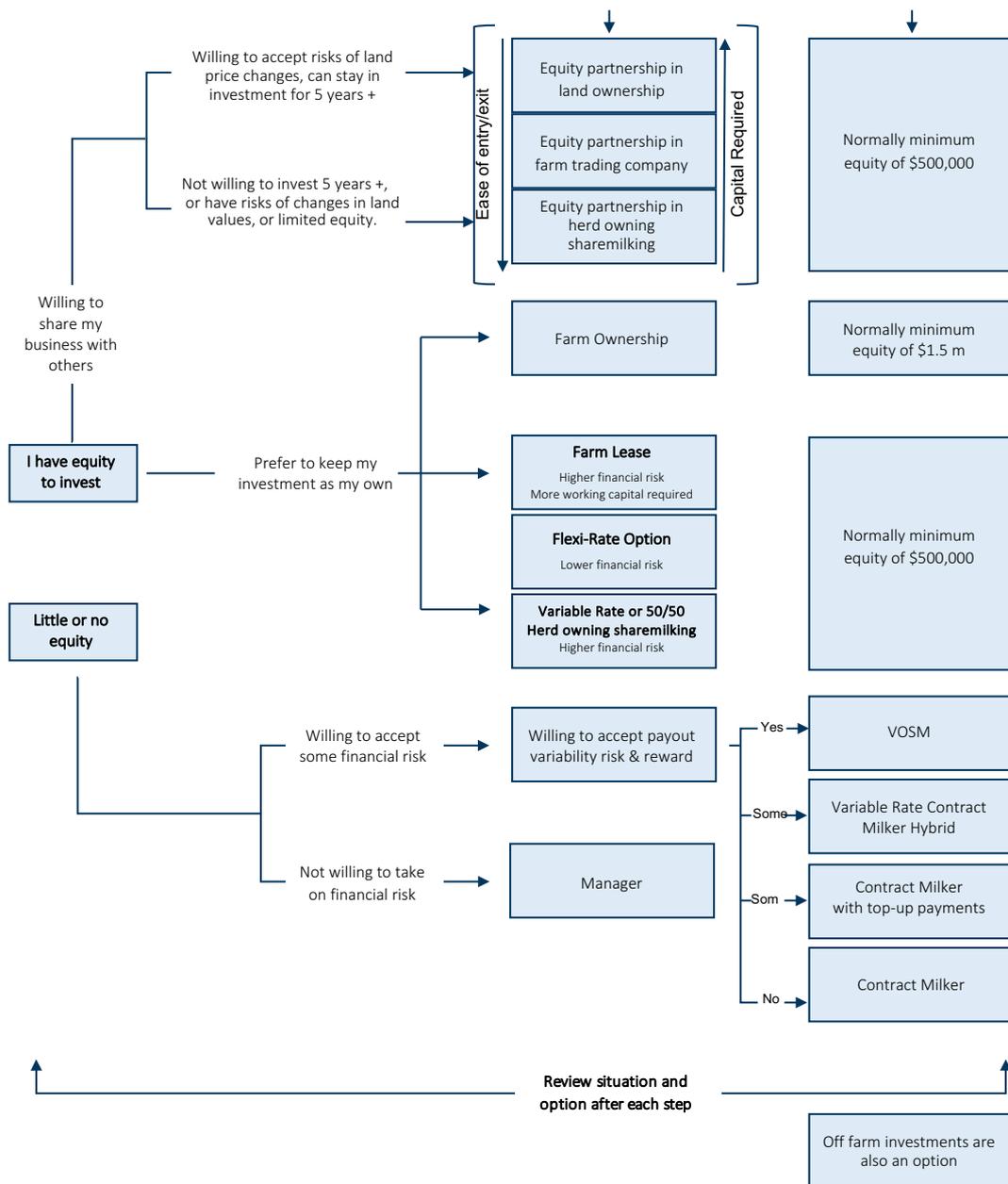
## How do I decide on the right structure?

- The pathway to success is no longer a linear pathway, and the options are much more complex than ever before. For example, the traditional pathway to achieving financial stability and farm ownership was:



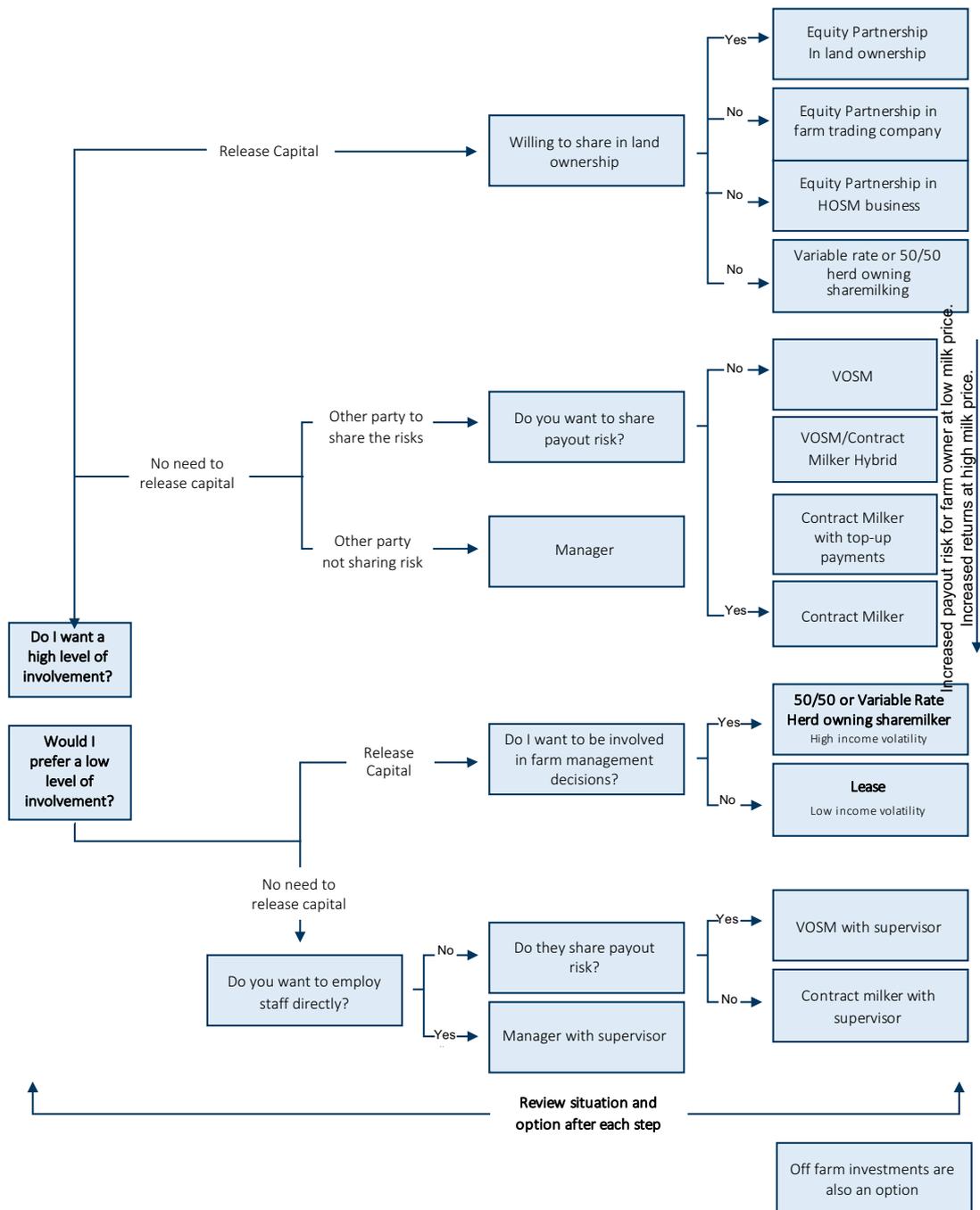
**Figure 1.** Progression Pathway Options

When assessing the pathway options for a progressing farmer or a farm owner deciding on the correct management structure, the following flow charts and decision matrix have been developed:



**Figure 2.** What type of operating structure should I pursue for progression?

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**Figure 3.** As a farm owner, what type of operating structure should I have?

The DairyNZ website also contains a matrix that allows a farmer to create their own list of criteria. This can be found at:

<https://www.dairynz.co.nz/business/sharemilking/making-decisions/>

It is also essential that all farmers undertake sufficient due diligence on the position available and the other parties involved. Further information on due diligence can be found at:

<https://www.dairynz.co.nz/business/sharemilking/do-your-homework/>

## What will happen over the next decade?

As always, the market will ultimately decide on the best management structures to achieve the objectives of the individuals. Some points to consider:

Herd Owing Sharemilking agreements - Unless there is a significant change in approach there is no evidence to suggest that the decline in HOSM agreements will stop. However, it must be kept in mind that the HOSM agreement does contain a high degree of flexibility. The most obvious one being the percentage split between farm owner and sharemilker. However, if there is a significant reduction in the percentage of income paid to the sharemilker, one must consider safeguards for low pay-out years where the sharemilker is at significant risk of losing their business. This can be addressed by a minimum price that the sharemilker would receive.

Ultimately the HOSM agreement and the contract milking agreement are simply contractual arrangements between two parties. These clauses can be negotiated as required.

In contrast, the Variable Order Sharemilking agreement is governed by a legal statute. A key point to always remember is that the clause in the agreement cannot be altered to the detriment of the sharemilker.

The role of the professional farm manager is now clearly an established career option in its own right. This could range from Farm Manager to Operations Manager to General Manager. The key question for the individuals in these roles to address is how to effectively manage and grow their personal wealth, particularly if investing in the farm is not an option. This is no different to the majority of working New Zealanders who do not have the opportunity to invest in the business they work for. This highlights a need for an increase in financial literacy and understanding of alternative investment options. As an example, investing in a residential property, the New Zealand share market or even Fonterra shares may have provided a higher degree of return on investment in recent years than dairy farming as a business. This does require a change in our traditional way of thinking, where your wages for management and your investment returns were pooled into one entity. Separation of your return on your time from your return on your investments provides a much greater degree of commercial discipline for all.

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## **Conclusion**

This paper highlights the changing nature of the traditional progression pathway for the dairy industry. While this is challenging for some, for those who can adapt it does create many opportunities. Be prepared, seek advice, have a plan and be commercially focused with your investment decisions.