

DUE DILIGENCE (EQUITY PARTNERSHIPS AND HERD SHAREMILKING)

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Introduction

The dairy industry in New Zealand has a range of structures that provide individuals with the opportunity to both work and invest in the sector to grow their wealth. Structures such as 50% Sharemilking have been a key feature of the industry for the last century while other structures such as joint ventures (equity partnerships) are a more recent development.

The level of investment by sharemilkers and shareholders in equity partnerships in dairy farming businesses is higher than ever, typically now often more than \$1.0M. Most dairy farming businesses no longer fit into the “small business” category. Not only is hard earned equity being risked but often investments in sharemilking and equity partnerships involves significant borrowing, which brings additional challenges.

Businesses generally are now subject to many more rules and regulations than was the case in the past and compliance with the rules is a significant risk to those in senior management or governance roles e.g. environmental compliance, workplace health and safety. The implications of failing to comply with regulations could see a sharemilker or shareholder director of a company fined or even jailed.

Given these factors it would be logical to assume that sharemilkers and equity investors would be undertaking detailed and comprehensive due diligence processes before entering into sharemilking agreements or equity partnerships.

Unfortunately my experience is that in many cases the level of scrutiny doesn't match the risks involved. During my time as a consultant I have been involved in a number of disputes between equity partners and sharemilkers and farm owners where the issues at the core of the dispute were evident at the outset of the relationship but were not uncovered, or if they were the issues were not dealt with at the time.

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The cost of getting it wrong today is significantly greater than it was in the past.

There is a level of complacency in relation to sharemilking agreements (including contract milking agreements), where the respective parties believe the risks are less because the relationship is covered by a standard sharemilking agreement. Nothing could be further from the truth. Every sharemilking position is unique and should be treated as such.

Often the sharemilking or investment opportunity is within a family farming business. Here too there is often too much complacency around the due diligence processes and a lack of formal agreements. This is ironic as the worst disputes I have been involved in over the years have been where the respective Parties have been related.

So what does a sharemilker or potential equity investor have to do to assess the risk (and opportunity) in a particular venture – what does good due diligence look like?

Due diligence processes

The term ‘due diligence’ sounds daunting but in simple terms I would define it as: -

“A systematic investigation into the people, processes and assets that comprise a business, which provides the necessary information for a potential investor to evaluate the costs, benefits and risks to enable an informed decision on whether to invest in the business.”

In addressing due diligence for a dairy farming investment (including all forms of sharemilking) I am going to concentrate on the risks that will be specific to a particular farm property.

It is worth noting that right now the biggest risk to investors in the dairy industry is probably milk price volatility. Interest rate risk isn’t far behind. Neither of these risks can be controlled but there are tools to enable the risk to be managed. A particular investment needs to be considered in the context of these major risk factors.

I broadly define four main areas of focus for a systematic investigation:

1. People
2. Processes
3. Infrastructure
4. Biological assets.

People

I have put this at the top of the list because it is the most important aspect of any business relationship. In the dairy industry there has tended to be a focus on the hard assets of the business – land, cows, water etc. These are important but if the people that comprise the investment don’t get along then the investment is unlikely to succeed.

So the due diligence process needs to focus on the people – the owner or employer of the sharemilker and the shareholder and directors of the investment entity.

A sharemilker will often go through a thorough recruitment process before being offered a job, which will often involve having to supply referees details or references. The sharemilker can go through the same process – maybe requesting the employer to provide referees (if they haven't already offered); ask to speak to existing and past sharemilkers and/or employees. This is a relatively simple process for an individual owner/operator employing a sharemilker but can be more difficult where the employer is a corporate. In this situation it is important to know who will supervise the operation of the farm.

The sharemilker/equity partner should create an opportunity to “interview” the prospective employer. This might take the form of a discussion where the sharemilker gets to directly question the employer about aspects of how they work with people and manage relationships.

This is doubly important for a prospective equity partner, who might not only be a shareholder but also a company director and may also work for the business. Good governance is fundamental to the success of a company and good governance is in part being able to work constructively with people who have differing views. If there is not honesty, respect, tolerance and a level of trust around the board table good governance will be compromised.

Processes

This is how the business is run. This is highly dependent on the people involved in the business and relates to how well the business is structured and operated.

Processes can be assessed by analysing the documentation involved in operating the business.

In the sharemilking situation this might include:

- The sharemilking agreement and the process by which the sharemilking agreement was completed:
 - The split of costs and cost sharing arrangements
 - Livestock number allowances

Notes:

- Any limits on milksolids production
- Share of revenue.
- Structured communications:
 - Reporting
 - Regular meetings
 - Annual review of performance.
- Compliance documentation:
 - TB status
 - Effluent compliance reports
 - Effluent management plan
 - Irrigation water use compliance reports
 - Farm environment plan
 - FEP audit reports
 - Nutrient budgets
 - Dairy company audit report.
 - Workplace health & safety audit reports.
- Performance reports:
 - Historical milksolids production
 - Historical milk quality data
 - Herd MINDA profile
 - Soil test reports
 - Fertiliser history
 - Pasture production
 - Re-grassing plans
 - Historical feed inputs.

It is important to understand how the farm is being operated now and if any changes are anticipated. What is the farm system being operated? Will feed and nutrient inputs continue at current levels? Are any major farm improvements planned? Will the sharemilker be provided with a copy of the operational budget for the farm?

The potential equity investor should try and access the same information as the sharemilker but the information requirements for equity investment are considerably greater. An equity partnership that has operated for some time should be able to provide the potential investor with a raft of detailed information, including:

- Company constitution
- Shareholders Agreement
- Strategic Business Plan

- Company minute book
- Annual financial accounts and budgets
- Company policy manuals
- Access to the Company's professional advisers.

Where an equity partnership is being established, many of these documents will have to be prepared and negotiated between the shareholders.

A key document for an equity partnership is the shareholder agreement. This agreement should detail how the shareholders intend to manage the business and should cover such issues as:

- Partners' goals and aspirations
- Allowable levels of shareholding by Shareholders
- Partners' guarantees
- The role of Shareholders in the running of the Company, the day to day business and their remuneration
- Professional input - banking, legal, accounting, business consultant – ideally these should be independent of Shareholders
- Details of the business (farming) policy
- Shareholder loans – how these are managed
- Dividend policy
- Debt levels and targets
- Future equity contributions from Shareholders
- Arbitration and "divorce" clauses - what happens if the Shareholders cannot agree?
- Reporting and decision making processes
- "Sunset" clause.

In the event that key items on these information lists are not provided this should immediately raise concerns about the quality of the processes of the business and/or the motives of the people operating the business.

Notes:

Infrastructure

This involves an assessment of the farm infrastructure and its suitability for the farm system being operated and generally this evaluation is done to a good standard.

Obvious key infrastructure items of infrastructure are:

- Staff accommodation
- Milking shed and effluent system
- Cow lanes
- Irrigation systems and water supply
- Stock/shed water supply
- Calf/implement sheds
- Fencing
- Stand-off pads
- Farm machinery – if provided for a sharemilker

Given the current focus on environmental management and compliance, aspects of the fencing and bridging or waterways are important considerations. The quality of the effluent and irrigation systems to be able to operate within consent conditions now has more of a focus, as have the sheds and standoff areas to manage the welfare of livestock.

There is no such thing as the perfect farm and I find there are always “trade-offs’ to consider. For example the milking shed and yard might be a bit stretched by the cow numbers but the accommodation is of good quality and the farm is close to town, so that recruiting and retaining the labour needed to operate the farm should not be a high risk.

Biological assets

The animals and the pastures that form the basis of a good dairy farm. The evaluation of these aspects of a business is usually well done.

The evaluation process

Once the information has been gathered the next step is to evaluate the information to inform a decision by the sharemilker or investor as to whether to proceed or not. Not everyone will be confident to do this themselves and I would recommend that professional advice is sought to make the evaluation.

Seeking professional advice from an accountant, lawyer or consultant is often viewed as expensive and unnecessary. In my view it is often the best investment a sharemilker or investor can make. The professional advisor will identify risks that might not initially be obvious and they can act as a sounding board for trying to alleviate the risk.

In the context of an investment worth hundreds of thousands of dollars or more, expenditure of \$10-20,000 on professional advice is not expensive and may lead to significant savings further in to a contract.

Evaluation tools

When assessing a potential investment it is useful to take a quantitative approach rather than make a qualitative judgement. There are some simple “tools” that can assist a quantitative assessment. Two of these are:

5. Risk Ranking
6. Financial Budget Model.

Risk Ranking

This is a relatively simple process of developing some key criteria for the sharemilking position or equity investment under the headings detailed above. Each criterion is given a weighting and a simple 1-5 ranking criteria (1 being very low risk, 5 being very high risk) is applied to each criteria. The ranking is then multiplied by the weighting and the weighted rankings are totalled to give an overall ranking for the proposition. The lower the total the lower the risk.

Notes:

Risk Ranking			
Key Criteria	Weighting	Ranking	Weighted Ranking
		1-5	
People - 30% weighting	30%	3	0.90
Processes - 25% weighting			
Information Availability	5%	2	0.10
Information quality	5%	3	0.15
Farm system	5%	3	0.15
Sharemilking Agreement	10%	1	0.10
Infrastructure - 25% weighting			
- Irrigation	10%	1	0.10
- Milking shed/Effluent	5%	2	0.10
- Staff accommodation	5%	2	0.10
- Other	5%	2	0.10
Biological - 20% weighting			
Livestock	10%	2	0.20
Pastures	10%	4	0.40
Total	100%		2.40

If in the position to evaluate more, the risk assessment can provide a formal guide as to which option stacks up best against the set criteria.

Financial budget modelling

At some point in the process a budget for the investment will be required. I find it useful to start budget modelling early in the process and as information becomes available update the model with the new information. I find basic spreadsheet models are ideal for this analysis.

The model should reflect the risks associated with the investment. Taking the milking shed example from above – the fact that it will be a bit stretched might mean that the sharemilking business will need an extra labour unit – this would be reflected in the cost structure and possibly impact the bottom line.

The budget model can be prepared to provide some key metrics for the business. The focus may be on cost of production or cost of production per kilogram of milksolids. It may be on net cash trading profit or cash surplus.

Ranking these metrics against a target or again comparing options can provide a clear evaluation of the options.

The budget model is also a useful tool to do a sensitivity analysis.

- A “status quo” option where the business achieves potential production at a long term milk price and interest rate, and a certain cost of production.

- Alternatively, a “worst case” scenario might be run where low production and milk price and high costs are used.

Running these scenarios will define in financial terms the range of risk for a particular investment.

Summary

The relatively high level of investment required in dairy farm businesses today and the rule and regulations that govern how dairy farms are operated create significant risk for those involved.

Sharemilkers and equity investors contemplating investment in the dairy sector can mitigate these risks by undertaking a robust due diligence process before committing to an investment.

Good due diligence processes involve the collection of large amount of information about the people, processes and assets of the business and then analysing this data to provide the information to make an informed decision on whether to proceed.

Farm infrastructure and biological assets are usually assessed to a good standard by dairy farm investors. Stronger due diligence is required of the people and the processes by which the investment will be operated.

Quantitative assessment tools such as risk ranking and financial budget modelling are useful tools to take the emotion out of the investment.

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