Financing Agriculture in the 21st Century

Crop Updates 2013

Introduction

Thank you for attending this presentation. Is it a bit controversial, maybe? Do I expect all of you to agree with me, no, unfortunately. I most sincerely hope that it at least makes you think about what could be done to improve the Financing of Agriculture in the 21 st Century. This is not a presentation about debt recovery.

Why have I chosen to speak on Financing Agriculture in the 21st Century? It is because I have been involved in farm financing and advising for much of the last 22 years. From my beginnings as a lowly lending officer analysing dairy, beef and horticulture businesses in the early 1990's through a period in Katanning where my first exposure to broadacre farm financing coincided with the period that saw the rise of the Rural Action Movement. Later in my career was as an Agribusiness Manager financing mostly larger scale business in the southern Wheatbelt. I have been consulting and advising farm businesses in the same area for 9 years. I believe I have seen some of the best times in farming and some of the worst. The one thing that stands out to me is that I have seen, during my exposure to the Agriculture Finance industry, periods where Banks recognised the leading farms and serviced and analysed them differently than the mainstream business and times where they are treated the same. It is my experience that, due to the recent period of difficulties facing the industry, all farm businesses are subject to the same assessment processes and that the leading farm businesses are not getting the financing relationship they deserve.

We continue to hear that the opportunities that lay in front of agriculture are immense in particular with the rise of Asia and their changing diets. I personally believe that some of the predicted benefits to farm businesses are somewhat overstated however I do believe that the future is exiting and that the businesses that will take the most advantage of the opportunities that do exist are the growing businesses.

It is now time to look at these opportunities and to come up with innovative solutions to financing these growing businesses.

The ANZ bank recently commissioned a report by Port Jackson Partners titled 'ANZ Insight' which outlines *their* view of the opportunities and challenges confronting Agriculture in Australia and New Zealand.

The full report is a good read.

Throughout the report it highlights the need for the increase in capital required to advance Agriculture and take advantage of what they see are the future opportunities. One quote from the report, is:

"*Farmers face significant challenges in raising sufficient capital to fund growth and support farm turnover". "New structures for owning and operating farms need to be encouraged to attract investment from domestic and foreign sources and capital markets. These structures might include rapidly evolving equity partnerships, modern variants of share farming and the use of off-take agreements".*

Much of my presentation focuses on the challenges in farm financing from a domestic capital point of view and the potential implications for the future and possible government involvement.

What will be covered

- Short history of Agricultural financing in Australia
- The current position
- What Planfarm numbers are telling us
- Constraints of a growing business
- Future innovation in Agricultural Finance

History of Agricultural Financing in Australia

The key history of financing dates back to the 1890's when State Based governments established Rural Banks following the failures of Banks in the 1890 depression. The primary goal of these institutions was to service farmers and rural communities.

Followed by;

The establishment of the ‘Mortgage Bank Department’ the precursor for the Commonwealth Development Bank.

And then the establishment of the Primary Industries Bank of Australia.

Following years of debate at a Federal level the ‘Mortgage Bank Department’ was established within the Commonwealth Bank (the then Reserve Bank) to provide long term funding for primary production. This was bought about in 1943 under war provisions, to protect what is today called food security, after the legislation was shelved in 1938 following steep opposition from trading banks of the day.

In an paper written by Evan Jones, Associate Professor in Political Economy at the University of Sydney, published in 2002, he supports the view that change in agricultural finance has been best served by government intervention and not left in the sphere of the ‘free market’. Whilst I cannot divorce myself from my personal ‘free market’ views, Mr Jones makes some interesting and supported observations.

One contentious view presented in the paper is that the CDB ‘confronted directly the failings of the private banks. In the place of an emphasis on security, the Development Bank placed an emphasis on prospects’. Viewed as a true ‘lending on cashflow’!

In 1978 the Primary Industries Bank of Australia was established and owned by a consortium of the entire banking community which refinanced rural loans apparently making such loans more attractive propositions to lenders.

For much of this period and certainly up until the establishment of the CDB most Agricultural lending was via an Overdraft facility favoured by banks as they were short term facilities that were able to be extended and recalled at their discretion. Unfortunately these types of facilities were not vehicles by which a farm business could make long term investment decisions.

Current Position

All major lenders have some exposure to Agricultural funding offering funding vehicles that have, in the main, been extended from within their commercial businesses. Very few have been developed specifically with agriculture in mind.

We have seen Managed Investment initiatives come and for the most part go from agriculture financing. I have resisted calling these Managed Investments Schemes. Although my experience with analysing many of these as a commercial banking analyst with NAB tells me that many of them are just that, Schemes. Any funding vehicle which attracts investors based primarily on taxation incentives and not solid future returns is exposed to financial market failure and government intervention like what we have seen over the past 4 years.

Recent focus has been on the injection of outside capital. Much of this from foreign investment. Some of this has been direct (i.e. buying farmland to operate) and some has been to engage a passive investment (i.e. purchased to lease out).

However the Knights on White Horses are not mounting a crusade to save us all, including the Banks, from highly indebted, non performing, farm businesses. Apart from a reasonable high profile, well publicised transaction, the majority of properties that have been purchased in recent times will not contribute to the reduction of what would be called the non performing debt.

In fact the passive investment presents potential challenges to domestic financiers of how to fund the working capital for the Lessor to be able to operate the property.

Structural or policy issues.

Comments made in the ANZ Insights publication by Port Jackson partners is that the structure of the modern farming business does not easily support their future outlook of shared equity partnerships. There would need to be concessions made at federal government level due to the potential ramifications of capital gains tax when selling farms into these arrangements even if such arrangements were to be attractive to institutional investors.

With regard to the policy stance of mainstream financial institutions changes need to be made to accommodate the needs of what Ross Kingwell outlined as the “growing sector” of the farming businesses as it is these businesses that are the future of the industry and will be the ones that have continual struggles to access capital under current policies.

What the best businesses are doing

The past 6 year data for the top 25% performers within the Planfarm database would indicate that the best businesses are recognising the need to access capital via leasing of land as opposed to purchasing outright in ever increasing levels. This chart is on a return on capital basis being (NPBT – Depreciation – Lease cost).

As can be seen businesses across all rainfall zones that have recognised the benefit of accessing capital via lease have performed better over this 6 year period than those who have total ownership of the capital base of their business. This six year period is from 2007 – 2011.

Whether this result has been by natural progression or a conscious decision is unclear however I suspect that, with the top business, it is conscious as they have seen land values in most areas accelerate beyond the level of profitability that can be achieved. Particularly if purchased on highly geared finance.

This expansion has bought and will bring challenges in how these businesses' access working capital. It needs to be noted that business who expand too quickly whether it is by lease or purchase place themselves at higher risk, especially if the expansion is followed by poor season. All businesses need to understand the potential ramifications and position their business to withstand seasonal variation.

2 Client Comparison

Whilst it is difficult to compare the outcome of leasing land versus purchasing on a hard practical basis, this comparison presented is an interesting case study.

Before I provide more detail to the slide in front of you I must outline, for those who may not be familiar, what LVR or Loan to Valuation ratio means. Most of you in the room would be aware that Loan to Value Ration is the ratio of a borrowers debt level to the value of the direct security available to the financier. For example if a client has total debt facilities, including an overdraft, of $600,000 and the value of the direct security held by the financier is $1,000,000 then the LVR is stated as 60%. This is usually called Peak LVR as it is the maximum the client borrows at any one time in the season.

In this slide,

Both businesses are in the same district (some 10kms apart), both are mixed farming enterprises with similar cropping percentages and both run sheep. Land values applied are the same / ha throughout the period. One variation is that Farmer B includes export hay in his cropping enterprise. Both business have been regular visitors to the Planfarm top 25% performers on an Operating Profit basis and both have expanded their available hectares at similar rates over the comparison period.

Farmer A chose to expand his business base predominantly by leasing whilst Farmer B chose to purchase land on debt.

Both businesses commenced the period with low Core LVR's however as at 2012 Farmer A had maintained a low core LVR whilst Farmer B has had a substantial increase. As opposed to the definition of Peak LVR, Core LVR is total debt (excluding HP debt), usually at the start of the year, less any unsold commodity (grain, wool) and pre-purchased consumables (fertiliser, chemical). Both Farmer A and B have seen their Peak LVR increase over time. Whilst both Peak LVR's are now similar Farmer A did go through a period after 2009 and 2010 that saw Peak LVR at 69%.

The clear difference is the growth over the period. Farmer A has grown by some $733,000 whilst Farmer B has hardly had any growth at all.

Ross Kingwell outlined the key elements of a growing business.

The following data comes from one such business. It is not one of the businesses in the previous case study although some of the features are similar. They have;

Good economies of scale including a balance of owned and leased land

Good labour mostly young family members who are skilled and educated and under the guidance of their father.

Strong financial performance

They are challenged by;

Constraints on funding of working capital

Long term succession planning

What the data is showing

The business has expanded over the period 2007 to 2012 via both land purchase and lease and is expanding again in 2013.

Labour is mostly from within the family.

The business financial performance is strong even though they have had 2 consecutive years of loss in 2009 and 2010 with an average Net Profit (before drawings) of $565,000 (excluding projected profit). Return on capital averages 11%.

The balance sheet has been produced on the basis that land values are constant and equity has varied between 54% and 81%.

This business, despite financial performance, has constantly battled with funding even though they have funded a substantial amount of expansion from retained earnings. I would also like to add that the business also funded a large divorce settlement through the same period.

During this period (2008 – 2011) the business was constantly commented to by their financier that they had concerns about their risk and the business exposure to leased land and that they should consider relinquishing the leases in order to constrain working capital requirement.

The business chose to leave their then financier for one that appeared to recognise the benefits of leasing and understood their working capital needs. However, despite the new financier not considering the business to be a risk has placed a cap on working capital such that the business has to defer some fertiliser payments for the 2013 season in order to remain within the new financier's requirements. In other words the new financier just has a higher tolerance to peak LVR than the previous funding source. There appears to be little recognition for the key performance indicators of the business (i.e. Management, labour, financial performance).

I have included a measure of Core LVR to show what I believe to be the 'real' level of risk this business is to a financier.

To further demonstrate the strength of this business, and others like it, I have utilised an analysis program call @Risk.

Whilst I don't want to bore you with the details of what this program is in its entirety I will outline its main features and outcomes.

@risk is an analysis tool. Essentially a sensitivity tool. It has been used for quite a number years in project assessment particularly in the mining and manufacturing sector. Whilst not a new analysis tool it has, until recently, not been utilised in agriculture. The @Risk program was introduced to us, and other Western Australian consultancy firms through the GRDC funded "grain and graze' as a part of the risk and uncertainty project. Essentially it takes data from long term client history and runs Monte Carlo equations over the data and produces output such as the graph in front of you.

The bottom line shows the Potential financial outcome of the data entered and the values on the left are the frequency at which these outcomes occurred.

The chart demonstrates the ability to service all commitments including, interest, plant replacement, taxation and drawing along with paying off all loan principle in a period of 15 years in 73% of all years.

This bar on the left which is isolated on its own is the ramifications of what is known as a catastrophic year which is a year that occurs much less frequently than normal outcomes such as 2010 which has been classed in this business as a 1 in 25 year occurrence. It is not being discounted, in fact it is being highlighted rather than hidden in the averages as it is the risk to this financial outcome that must be considered by a growing business when decisions of expansion are made.

The following @risk chart is the same information however indicated the 88% of years that this business can meet at least interest only.

Financial Innovation for agricultural businesses in the 21st century

Financing the growing agricultural businesses in the 21st century comes with challenges. Challenges that require some innovative changes to current thinking. The emphasis of this presentation has been based on the increasing and ongoing need to access capital from which to increase profitability.

Innovations that should be considered by the financial institutions are;

Establishing true partnerships between banks and clients. These relationships should be based on long term plans with clear understanding by both financier and client of what is expected from both sides and the policies applied individually tailored to the clients business. These committed plans would/should survive manager changes and succession. Part of these plans could include;

Introducing financial products not reliant on Peak LVR as terminating levels. Consideration should be made for financial products based on core LVR. I do not ignore the issue that this style of funding could present higher risk to the financial institution and as such as is with other industries would attract, within reason, higher risk margins. I see no issue with this as an astute agricultural business would factor in the higher cost of funding in its expansion business plans.

Eliminating the slush fund style of funding where all debt is contained within one facility including what is clearly core debt and introducing/reintroducing Principle and Interest facilities with at least annual repayment. Nothing new, however the innovation is not such a facility but one that documents the ability to capitalise the principle (and possibly interest) in periods of poor returns. I would call this a 'catastrophic' provision. On the reverse side the facility, and the partnership plan with the client, should include the ability to pre-pay principle and interest when excess profits are made. In the case of the growing profitable business these two provisions combined would see the debt serviced in normal terms just recognise the variability of production.

Innovation that needs industry and/or government consideration

Shared equity. Whether this is between investor and operator or even consideration that financial institutions swap debt for equity either individually or within a co-owned entity such as PIBA of the 1980. As stated before there are significant barriers to the introduction of such arrangements. In addition financing of working capital would also need to come from within the equity partnership as, under current funding policies within banks, it would be difficult to source to source funding when there would be no access to security.

Off-take arrangements. These vehicles are already been utilised in some form with CBH Advance being one example. This product would be better served by signing longer term arrangements that allow for allocation of this funding earlier in the season and more certainty for producer and buyer.

Risk Mitigation insurance. It would appear that this box has been opened again in recent times. Given that, in reality this insurance is as much about protecting the financier against risk as it is the farmer, Banks need to be actively involved in the development and implementation of this innovation. I believe the industry would appreciate some 'financial skin in the game' from the Banks when it comes to this issue. Failing this assistance, and I suspect it will not be forthcoming, the introduction of this type of product will require the support of government, state and federal. I am not a supporter of direct subsidy as, being a bit of a cynic, I think the insurers will just bank the subsidy via more expensive premiums than necessary. However, as with the history of financing agriculture, government support at some level will be vital for this advancement to be made.

Summary

Agricultural financing has a long history however historically innovation has been slow and usually government generated.

MIS are littered with failures

Many growth/high profit business are constrained by current funding models

Innovation with potentially Government support is necessary for future investment.

Thank you for your participation and I invite any questions.

I would like to acknowledge and thank Glen Brayshaw, Planfarm consultant based out of Northam, for assisting me with the data I needed for this presentation and Dani England Planfarm's very own RIDC Agricultural Woman of the year for assisting me with the Power Point presentation.