

## Sharing the gains - sustainably

The bullish sentiments around dairy products for 2008 and beyond are welcome news for all. They come after a long period of modest returns. For many of my New Zealand clients it will be the first time they have been close to adequate returns for their investment. It's welcome reward for the risks taken and intuition exercised by those who have and committed themselves to this traditionally solid sector.

Given the climatic trials for Australian dairying this outlook must be equally appreciated on both sides of the Tasman!

The hype from city based commentators in New Zealand has been revealing. Their "sound bite commentary" implying the industry is experiencing some kind of overnight success is almost laughable. Dairying has been portrayed as some sort of lotto winner - simply illustrating the awareness gap between urban and rural. Most are totally unaware of the capital, innovation and commitment that has been required from paddock to plate to bring these gains to reality.

The farming community hopefully know better and will keep their feet on the ground. Fonterra's recently announced final price for New Zealand Supply in 2007 is only 7% higher than the average for the last 2 years. The forecast for next season is less than 10% ahead of the previous best season and still 12 months off!!

There are a number of potential traps in gains such as these. As a start point, I recommend careful thinking in three key dairy relationships – sharemilking, wages and leasing.

These aspects of dairy trading often operate on traditional formulas. But those formulas don't function equally well in all economic environments without fine tuning. Changes of the current magnitude re-write the rule book and mean results can vary considerably from those originally intended.

A significant increase in milk price has potential to transfer an unacceptably high proportion of milk income onto either party's share. While it could be argued this is simply a reward for the risk taken by those who entered the agreement, it is clear the relativity between costs of operating under a share milking arrangement compared to employing staff may become less competitive. The share of milk income foregone by farm owners' risks encouraging them to purchase their own herds or transfer a higher level of costs to their sharemilkers.

This threatens an important career and business development mechanism to limit opportunity for new entrants. We need to find new ways to continue to use structures that have our industries well to date.

There are similar implications for farm leases. Many of these are written with two or three year rental reviews. The rental is usually assessed on historical comparison with rentals paid for similar properties. Unexpected changes in milk prices can significantly advantage one party and threaten the continued involvement of the other.

Striking a competitive and sustainable balance depends on understanding the returns for investment from the various components of a farming operation. I try to view these as a "portfolio" comprising land, stock, plant and management expertise.

For New Zealand operations, costs for labour have been traditionally around 80 cents/kg M milk solids (including the value of the owner or manager's physical input). Investors in stock as sharemilkers or lessees generally expect a 15% to 20% return on those assets. Those who lease milking land and own Dairy Company shares are probably looking for better than an 8% return on the investment in Fonterra.

These benchmarks can be used as a base line for construction of staffing, sharemilking or leasing arrangements. They will help define the point above which "super profits" are likely to result. A little creativity and robust negotiation will enable any surplus to be fairly allocated according to each party's investment.

The result will be mechanisms that better link returns to milk prices and maximise synergy. Arriving at the right formula is a matter of knowing the market and applying well thought out "algebra" to accommodate the unexpected. Most importantly the process should indicate what is sustainable.

Now is a good time for Industry players to give this careful consideration. Without such a review, there is a real risk of unsustainable arrangements or loss of trust between parties as they struggle to impose their will on the other.

While product price increases are always welcome, they do bring with them challenges to manage the unforeseen. Contracts written with flexibility to respond to such events will minimise the potential for distraction and enable everyone to move forward and enjoy hard won gains.

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