

Watching the Dairy Bull Price Run

The bullish sentiments around dairy for 2008 and beyond are welcome news for all. They come after a long period of modest returns and reward the risk and intuition of those who have believed in the prospects of this solid sector.

The hype from the city and media commentators is revealing. The “sound byte commentary” implying overnight success is almost laughable. Their portrayal of Dairy as some sort of lotto winner simply illustrates the awareness gap between urban and rural. They appear blind to the capital, innovation and commitment that has been required from paddock to plate to bring these gains to reality. Perhaps the politicians and industry leaders have been too busy concentrating on their alternative “knowledge economy”!

The rural community hopefully know better and will keep their feet on the ground. In case anyone hasn't noticed – the \$4.46 recently announced is 7% higher than the average for the last 2 years while the forecast \$5.53 payment is only 10% better than the previous best and still 12 months off!!

While certain bank economists hype their profile by predicting moonbeams and our reserve bank governor reacts as if the Dairy Industry has committed some economic sin by its success – those involved in the sector need to be more considered to make the best of this roller coaster ride.

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

These aspects of dairy trading tend to operate around traditional thinking. But they don't function equally well in all economic environments without fine tuning. Changes of the current magnitude re-write the rule book and results are likely to vary considerably from those originally envisaged.

A prime example is variable order sharemilking s. These have struggled to deliver competitive profits to many milkers on past milk prices nearer \$4.00/kg MS. In response the Industry has attempted to “legislate” returns by fixing the milkers' share – especially for herds under 300 cows.

An increase in milk price of \$1.50/kg MS or greater is going to transfer an unacceptably high proportion of milk income onto staffing. 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 salaried staff and sharemilkers will be too great and farmers are likely to reduce their use of such agreements.

A similar outcome is likely for 50:50 sharemilking arrangements. The share of milk income foregone by farm owners may encourage them to purchase their own herds or transfer a higher level of costs to their sharemilkers. Again this threatens an important sector of the Industry and will limit opportunity for new entrants.

There are similar prospects for farm leases. Many of these are written with two or three year rental reviews. The rental tends to be assessed on historical information. Changes in milk prices can significantly advantage one party.

Striking a competitive balance depends on understanding the returns for investment in the various aspects of a farming operation.

A return for labour has been traditionally around 80 cents/kg MS (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 their 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.

I use these benchmarks as a base line for construction of staffing, sharemilking or leasing arrangements to help define the point above which "super profits" are likely. A little creativity enables these to be fairly allocated according to each party's investment.

These mechanisms can also be used to link returns to milk prices and maximise synergy. Arriving at the right formula is simply a matter of knowing the market and using robust "algebra" to accommodate the unexpected.

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

While increases in income 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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