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BUSINESS MANAGEMENT FACT SHEET

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SOUTHERN REGION

THE BENEFITS OF SEPARATING LAND ASSETS FROM THE OPERATING BUSINESS

Traditionally, land assets and farming operations have been run together as one farming business. The benefits from separating the real estate (farm land) from the operating business relate to alternative options for farm scale expansion, succession and retirement.

KEY POINTS

- Broadacre farming is predominately a combination of two businesses, an operating business and a real estate (land) business.
- The performance of each needs to be analysed as a stand-alone business, as well as in combination.
- Treating the operating and real estate businesses separately provides effective and flexible options for succession and retirement, investment and expansion pathways.

Asset separation

Grain growing businesses are a combination of two key components:

- the operating business; and
- the real estate (farm land) business.

Typically, these components are treated as one, however, it is useful to understand the relative performance of each area and how they contribute to the overall financial position of the farming business (see Figure 1).

There are some distinct differences between the two business components, as outlined in Table 1. The operating business generates income from the production of grain and livestock. In comparison, the real estate business earns an income from renting land to an operating business as well as accumulating capital value over the long term.

Each component has a different risk profile, as illustrated in Figure 2. Typically, farm land (real estate business) has a lower profit potential and lower risk than an average grain growing (operating) business, although it generally has a higher earning capacity than cash.

A high input farm operating business has the potential to generate significantly higher profits, however, the financial risk is much greater due to season and price volatility.

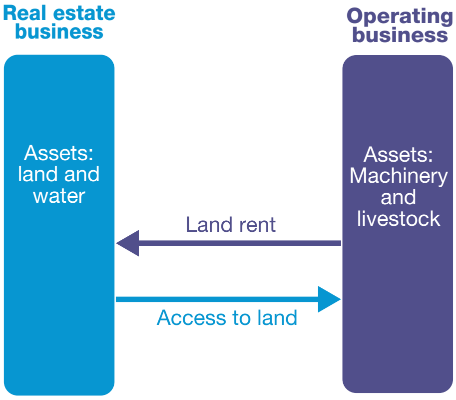
TABLE 1 Differences between the operating and real estate businesses.

Business component	Income or profit	Asset
Operating business (including machinery and livestock assets)	Farming system income	Depreciating or liquid
Real estate business (includes land and water assets)	Rent or share-farm income	Long-term capital growth

TABLE 2 Calculating your return on land assets.

Return	Calculation	Typical percentage return
Return on capital		4–5%
Capital growth	land rent - expenses / land assets	4–5%
Total return on assets		8–10%

FIGURE 1 The two components of a grain-growing business.



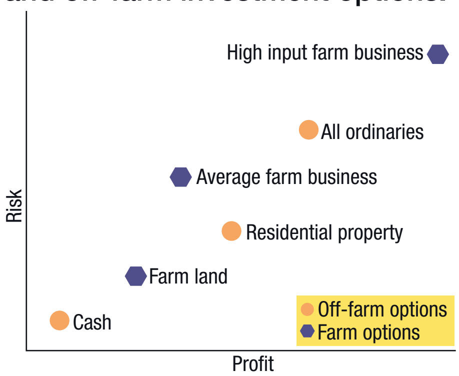
Measuring asset performance

The real estate business

Farm land earns a return on capital (ROC) as well as capital growth (see Table 2). These combined, typically result in a return on asset of eight to ten per cent.

The decision to purchase land is often underpinned by the expectation that land values will increase over the long term (capital growth). In addition, land owners should apply rent to the land to get an ROC. Rent paid by an operating business to the real estate business can account for any opportunity capital cost.

FIGURE 2 The risk profile of farm and off-farm investment options.



ADAPTED FROM: WEALTH CREATION, P. O'CALLAGHAN, BEST WOOL CONFERENCE, 2005.

It also has the potential to reward owners appropriately based on their individual level of investment.

The operating business

The operating business's return on capital is equal to farm profit before interest less land rent, and divided by the business assets, such as machinery, livestock and inventory (see Table 3).

An operating business should target an average return on capital of 10 to 20 per cent. While this return is higher than the return on capital in land, it reflects the significantly higher risk due to seasonal volatility in price and production.

The benefits of asset separation

Succession and retirement

A number of paths open up for developing effective farm succession or retirement strategies when land and operating assets are dealt with separately. Consider the following example.

- The land stays with one generation and the operating business transfers to the next generation.
- Transferring the operating business provides an entry point for the next generation to get started by renting or share farming land owned by others. Their funds can then be focused on the operating business.
- In this case, the retiring generation can retain the land and gain a reliable and secure income from the land rent.

TABLE 3 Calculating your return on operating assets.

Return	Calculation	Typical percentage return
Return on capital	$\frac{\text{farm profit* - land rent}}{\text{business assets}}$ *before interest	10–20%

The operating business benefits from accessing the land for farm scale expansion. The result is the retiring generation owns assets in an industry they understand and feel comfortable with.

Expansion of farm scale

Renting farm land can provide an operating business with an opportunity to expand farm scale without the need for further investment in real estate. This allows operating businesses to focus on working in 'scalable cells' and getting the most profitable return from assets.

Rather than tying up capital in land acquisition, an operating business may choose to invest surplus funds to grow machinery and/or livestock assets and therefore improve efficiency or create economies of scale.

Asset protection

Separating land assets from the operating business is commonly undertaken as a form of asset protection. It helps protect the land from risks taken in the operating business.

Tip: If separating for asset protection, seek advice from your accountant.

Leveraging

Often, the real estate business provides land as security for bank borrowings used to fund operating cash flow or trading losses. While land values have tended to increase steadily at an average of four to five per cent over the long term, operating profits from cropping farms have become more volatile underlying the need for the operating business to leverage the land as security.

If land is leveraged to support the operating business, then the financing cost of that debt should be serviced by the operating business.

Third party investors

There is a trend towards land being owned by investors that are not necessarily farmers. For example, self-managed superannuation funds (SMSF) are investing in farm land that is managed as a separate entity requiring land rent to be paid to the SMSF.

Growers can still continue to buy farm land when suitable opportunities arise. However, that land does not necessarily have to be operated by the growers who own it.

Being prepared to own, but not operate, land also opens the door for farmers to benefit from diversifying in different geographical locations, and from investment by third party operators.

FREQUENTLY ASKED QUESTIONS

If we purchase a new block of land, which business component pays the interest on borrowings?

Financing costs associated with debt for land acquisition should be serviced by the real estate business from the land rent income received from the operating business.

Can we achieve asset separation if both components have the same owner?

The principles of asset separation can be applied regardless of ownership. However, to achieve the benefits of asset separation, then separate ownership is required.

Can asset separation help our succession planning?

A good way to get started with succession planning is to commence a new operating business for the next generation to either lease or share farm additional land or land currently farmed by an older generation. This commences wealth creation for the next generation, while retaining the land assets with the older generation.

USEFUL RESOURCES

The efficient use of capital in farm businesses
www.nuffieldinternational.org/rep_pdf/1262830879Brendon_Tierney_Report_Final.pdf

The efficient use of farm business capital
www.grdc.com.au/GRDC-UpdatePaper-Tierney2011-FarmCapital

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