

9 POSSIBLE BUSINESS MODELS AND ASSOCIATED STRATEGIES

Are there alternate ways of operating farming businesses to better manage these pressures for improved sustainability into the future?

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9 POSSIBLE BUSINESS MODELS AND ASSOCIATED STRATEGIES

Traditional family farm businesses in Australia are facing increased pressure to remain viable due to the challenges of increasing climate risk, volatile market prices and rising costs.

KEY POINTS

- The traditional family farm business model is not the only viable ownership and management structure available to farmers.
- Business models that have worked in the past may not be your best option for the future.
- Changing sources of capital and ownership structure, such as leasing extra land to improve efficiency, may significantly improve your overall business performance.
- Alternate models to the traditional family farm include collaborative and corporate farming.

As a result of these pressures, the number of farmers and farm business has declined steadily over time, with owners of small unprofitable farm businesses selling up to profitable farming operations. According to 'Australian Social Trends', published by the Australian Bureau of Statistics in 2012, in the 30 years to 2011, the number of farmers in Australia declined by 40%, or approximately 13% annually. This structural change follows growth in the economy at the same time as a decline in the contribution that agriculture makes to the Gross Domestic Product (GDP), a phenomenon seen in all developed economies. One challenge for Australian farmers confronting volatility of weather and markets, competition for land, labour and capital, and the continuing cost-price squeeze, is to consider whether there are innovative ownership and management approaches that may better equip them and their farm business to maintain profitability.

Traditionally, family farms in Australia have been characterised by the family business owning all the assets, taking on all the liabilities, selecting and managing the enterprises, and taking the full reward in profits or losses and capital growth. This 'business model' has served Australian agriculture well since its inception over 200 years ago, proving to be highly durable and able to cope with volatile conditions, with the result that the vast majority of farm businesses in Australia remain family owned and operated. However, significant increases in land values over the last 20 years, as well as declining terms of trade over the same period, have made it difficult to contain costs of production and maintain profit.

Rethinking management methods and business models can help maintain and improve efficiencies and profit. It is useful to challenge your business management thinking, as the economy and production environment continually change, but the fundamental need for positive cash flow, sound profitability and wealth creation remain the same. You have been introduced to farm management thinking and

budgeting throughout this manual. Use these tools to test other business models and determine if another business model better suits your farming future. One strategy to improve efficiencies of scale without the need for huge capital input has been the trend toward leasing and share farming land. This is addressed in greater detail at the end of this section.

This section looks at different business models currently used in farming as options to expand and maintain a sustainable farming business. The focus of this section is on business models rather than the various legal structures of trusts, companies and partnerships, structures often used by accountants to assist farm businesses in managing tax and succession issues.

9.1 MAJOR FARMING BUSINESS MODELS

As outlined in Modules 1 and 2, the essence of a business is achieving business goals through liquidity, efficiency and wealth. As long as adequate cash flow can be generated, profits made and wealth improved over time, the business is seen to be sustainable. It is not necessary though for the farm business to own all the assets under management, to take on all the liability, or to provide all the management and labour. While there are many different combinations that can make up a farming business, three of the most commonly used farming business structures are the family farming business, collaborative farming and corporate farming.

9.1.1 The family farming business

This is the typical family farm where the family own most of the assets they manage, including land, livestock and machinery. Against these assets, they borrow funds to manage the business: loans against land, livestock and machinery. The family also supply the management and most of the permanent labour to the business. Various generations contribute labour and management to the farming business and generally take family drawings and equity, rather than a wage, for their efforts.

Management of these family operations generally functions with informal meetings that focus primarily on operational and tactical management. The family take all the risks and the rewards are the profits from the business and wealth generated from both the profits over time, and capital growth from land price increases.

Advantages

- **Resilience** – The family structure provides significant business resilience as the major goal for most family farms is to maintain reasonable cash flow, rather than have a high return on total capital managed. In times of drought and poor commodity prices, family drawings and new capital purchases will be minimised and surplus livestock sold to minimise losses and survive the tough times.
- **Flexibility** – Family farms can be very responsive to seasonal circumstance, changing commodity prices and improvements in technology, making decisions quickly when needed.
- **Focused on the long-term** – Most farming families have an aspiration to pass the farming business on to the next generation, as the farming business may have already been in the family for a number of generations. This means there are significant long-term goals, giving family farms the incentive to survive through prolonged periods of poor financial performance with the hope that once conditions improve, business will pick-up and will be preserved for the next generation.
- **Lifestyle** – One of the attractions of the family farm is that it combines family living with a working lifestyle in one location. Farming businesses offer a rural location with usually strong community connections, and a sense of belonging, which helps to create a positive environment for raising families.

Disadvantages

- **Succession planning** – While the long-term major goal of most farm families may be to pass the farm on to the next generation, there are often no well-defined plans as to how and when this transition might happen, in ways that meet the goals and needs of all concerned. Cash surpluses, when they occur, are most often put back into the farming business to regenerate capital, increase productivity and maintain sustainability. This means the financial resources needed to assist the older generation to move off the farm without continued financial reliance on the farm can be limited. This is a complex area for any farming family to manage and needs open communication and careful planning.
- **Limited financial reserves** – The saying that family farm businesses are often cash flow challenged but asset rich is true in many cases. When seasons become financially

tight, it is generally the support of the banking industry that allows farmers to maintain their business into the following year. Having limited financial reserves means the business has limited opportunity when it comes to managing periods of poor financial performance.

- **Economies of Scale** – The challenge for any business is to fund business growth so that economies of scale – spreading fixed costs over more output - can be improved. Ideally, when growth occurs, land purchase, added machinery purchase and taking on more labour should occur at the same time in order to achieve improved business efficiency. However, with limited financial reserves, these investments are usually intermittent, resulting in inefficiencies occurring until all systems can be synchronised.
- **Isolated lifestyle** – As farm businesses are located in rural locations and only a few people work on the farm, social interaction with other people can be limited. This isolation can become problematic when the stress of poor seasons and financial performance needs to be managed. Effort is needed in these difficult times to maintain community connections to minimise the negative impact of managing tough circumstances in isolation.
- **Balanced lifestyle** – As family members provide most of the business labour, the responsibility of managing multiple farming enterprises means that finding ‘down time’ in the farming system is difficult. Time demands on family members can be great and at times excessive, limiting the ability to take breaks and holidays. If not managed, this issue can increase stress and severely affect the quality of family life.
- **Communication** – The management of differences in personality, goals, expectations and communication styles in a family business can be challenging. Where this is not managed well, the long-term success for the business can be compromised.

‘I think if you’re running a farm on your own, you need to be fairly resourceful and have people you can ring if you have specific questions that you can’t work out on your own. My father is a very patient teacher – I’m still learning from him because he has a vast experience in mechanical knowledge. I am really fortunate to have been given the opportunity to come back on the farm in the first place because I know a lot of other females weren’t given that opportunity that long ago...There’s something about this place I just love - I love the space, the freedom, the variety in the work, working outside, and I love the challenge of always trying to do things a bit better.’

Lynley Anderson,
‘Brookvale’, Kojunup, WA

9.1.2 Collaborative farming model

Collaboration between farmers can take many forms, from providing labour and helping with shearing on a neighbour's property to sharing the ownership and management of machinery. A collaborative farming business model has been developed by 'Collaborative Farming Australia' (CFA) with the first working example being 'Bulla Burra', a farming business in the Northern Mallee of SA. This collaboration involves the full combination of two viable farming businesses and is provided as a case study.

Advantages

- **Economies of Scale (efficiency)** – The 'Bulla Burra' business was established to improve efficiencies and this has been achieved. John Gladigau has stated that if he was still farming independently in the 2010 season, the cost of wheat production would have been \$204/t. The 'Bulla Burra' operation's cost of wheat production in that season was \$171/t, a significant improvement.
- **Accountability** – The management processes maintained by the advisory board, where plans and goals are monitored throughout the season, makes all owners and board members accountable.
- **Transparency** – As regular meetings are held for strategic, tactical and operation management, there is full transparency. This is needed to maintain trust within the business.
- **Professionalism** – Emphasis is placed on maintaining effective management and communication both with staff within the business as well as all suppliers, whether they be advisers, bankers, accountants or rural merchandisers.
- **Advisory Board** – An advisory board is used, and importantly, has an independent chairperson. This provides improved depth and spread of experience for sound decision making.
- **Succession** – As there are many roles in this larger business, the next generation can choose freely if they wish

to be involved in the business and at what level. The future of the business is not dependent on the next generation but the next generation are free to become involved.

- **Lifestyle** – As roles are allocated and there is more staff, the business operation is no longer dependent on one person. This means holidays and time away can be more easily managed. For example, in 2013 in 'Bulla Burra', John undertook 7 weeks of study leave and Robin completed a Nuffield scholarship requiring a 13 week absence from the business, all without operations being significantly compromised.
- **Corporate principles** – The aim of this business model is to adopt sound corporate governance and financial reporting while maintaining the family values, farming lifestyles and the flexibility of management offered by traditional family farming.

Disadvantages

- **Loss of independence** – One of the values closely guarded and protected in Australian family farming businesses is the element of independence. Farmers are proud to be seen as independent and the rural community look up to people who are resourceful and successful. This determined independence has to change for collaboration between farmers to succeed.
- **Risk Management** – In one respect, with improved accountability, reporting and use of an advisory board, risks to the business are able to be more fully identified, understood and managed. However, larger operations by definition have larger financial risks. If improved management systems are not put in place to manage these risks, larger operations could experience greater losses during challenging periods, particularly in the first few years of establishment.
- **People management** – With more hired and permanent labour needed, people management skills and processes need to be adopted. This can be a challenge for family farming business where they have only previously managed themselves.

Collaborative farming case study: 'Bulla Burra'

One of the primary aims in creating 'Bulla Burra' was to achieve a high level of business efficiency given the constraints of finance, the relatively high cost of land, machinery and labour. The initial thinking of management was to separate the business of land ownership from the business of farming and then assess what the most efficient farming business operation would look like, regardless of the farmer's financial capacity. It was determined that about 4,000ha (10,000ac) was optimum for a farm in the Northern Mallee of SA, given two full time labour units, one header, one spray unit and one wide-line. To gain labour and machine efficiencies during seeding and harvest, operations are managed in 24-hour shifts. A local transport is used to cart grain, and where needed, experts such as agronomists are used. An advisory board is used with an independent chairperson to introduce more corporate approaches to strategic management and decision making. In 2008, John and Bronny Gladigau, and Robin and Bec Schaefer, combined their two independent operations and created a new farming business called 'Bulla Burra'. The key steps were:

- A lease price for their individual parcels of land was determined, and the land was leased to the new business, 'Bulla Burra'.
- Old and surplus machinery was sold and that capital was put back into the new business as owners share capital. These funds assisted with carry-on finance.
- Appropriate new machinery was purchased under a finance arrangement with a local machinery dealer. Machinery would be turned over every 5 years to take advantage of the efficiencies offered by new technologies.
- The various roles and responsibilities were determined for both the necessary labour and management, and commercial wages and management rates were paid according to the requirements. This meant that John and Robin's skills were identified and used as effectively as possible in the new company. Additional labour and management were hired.

- An advisory board was created and meets four times a year. It put in place the management systems for cropping, finance, grain selling, staffing, machinery maintenance and legal requirements.
- Additional land was leased and share farmed when necessary to reach their targeted size of 4,000ha.
- A 5-year plan was created. Both John and Robin committed to the business for those 5 years, with a right of renewal or exit after that time.
- The financial rewards to John and Robin come from the following income streams:
 - > Leased income from their land provided to the business.
 - > Labour income for the time they provide to the business.
 - > Management fees according to the management that is required. This is paid at a commercial rate, which is higher than labour rates.
 - > Sitting fees paid to board members.
 - > Dividends paid from generated profits.
- Within the first two years of operation, it was obvious that this business model was working successfully, so the board decided to expand. Given the first model of 4,000ha was efficient, any growth would require the establishment of another 4,000ha operation. This is similar management thinking to franchising, where efficiency units are replicated. The business was doubled to generate more profits while maintaining efficiency. The operation is now completing its sixth season and is performing well, even with the normal seasonal and price volatility.

John and Robin describe the benefits of collaborative farming below:

John: 'In 2006, I applied for a Nuffield Scholarship, and was really fortunate to be able to travel the world – I went looking for the silver bullet, the model I could pick up and bring back to the northern Mallee that would work right here and what I actually found was that there was no model. My big learning is that there is no model, there are no rules.'

Robin: 'John and I have been friends for a long time. John has always been interested in generating efficiencies and economies of scale. He came to us and said, 'Would you like to join us on a collaborative adventure?' Firstly, we did some figures to see how it would stack up and when we could see it was going to work, then we basically went from there.'

John: 'Our whole approach has been to start off with a blank sheet of paper and say, 'What is it we want to achieve?' If we want to create an efficient farming business in our region, with no preconceptions, what does it look like? How big is it? What are we going to crop? How much machinery do we need? How much labour are we going to need?' And we worked out that the most efficient sized farm for our district was about 4,000ha; the most efficient sized cell to make the best utilisation of machinery, labour and infrastructure. So we put our two farms together, set up a new business, and leased our properties to that new farm. Then we sourced another 4,000ha to create two cells and put them together.'

Robin: 'There are huge benefits. One is improved return on investment for your business – that's a big one. You're using your machinery better, you're using your staff better.'

John: 'In 'Bulla Burra', we're using all equipment that's under three years of age and we're using the most modern technology that we possibly can – precision agriculture technology as well. What we actually discovered, in 2010, was that if we had been on our own in that particular year, our cost of production would have been \$204/t to produce one tonne of wheat. Within 'Bulla Burra', it was \$171 – a huge, significant difference. Basically, it's the same crop, on the same land, but it's costing us \$30 less a tonne to grow it. That's one of the huge efficiency advantages of collaboration.'

Robin: 'A lot of people talk about farmers being the 'jack of all trades and the master of none' and I think in modern farming businesses, you can no longer afford to be that. You need to be a lot more specialised, and what this model allows you to do is work in the area you really enjoy, that you're really passionate about and where your skills are the greatest. If you have a number of people doing that, it makes the business a whole lot stronger'.

John: 'I take responsibility for the business management side of the company and the strategic direction of the finances, whereas Robin is more on the agronomy side, the practical operations of the farm. Then we put in a farm manager who is responsible for the employees and the daily operations of the business. It's actually not as much about the model, it's actually about principles. It's about being professional, it's about being transparent, it's about being accountable. The model itself can be massaged to suit your own environment, which is why we went to this whole idea of starting off with a clean sheet of paper and saying, 'OK. What is the ideal sized farm? What does it look like?' Putting the principles over it, and as long as it's professional, accountable and transparent, then you can certainly make it work.'

John Gladigau and Robin Schaeffer,
'Bulla Burra', Allawoona

- **Increase in discipline** – Increased effort and resources are needed for planning and monitoring a successful collaborative farming operation. This may take greater discipline than required in a family farm.
- **Increased cost of management** – The cost of an advisory board, creating and maintenance of legal structures and paying management are added costs above those normally experienced in a family farm. These costs need to be managed.

9.1.3 The corporate farming model

The corporate business model also has a long history in Australia. Some are privately owned and others publicly listed. They are generally governed by a board of management and operate under corporate management structures. In recent years, superannuation funds have also been investing in corporate farming businesses.

These operations are managed similarly to large corporate businesses where a board of management is used for strategic planning and monitoring the progress of the business. Management are hired to manage the tactical and operational aspects of the business. Budgets are put in place, monitored as the season unfolds and the board receive regular reports from management so that transparency and performance are continually and closely monitored. Business cases are put to the board before any new projects are undertaken. This means new projects need to fit within the strategic direction and pass profitability tests. As these organisations have shareholders, their objective is to provide competitive dividends to their shareholders. This means they are strongly focused on financial performance regardless of seasonal and commodity price conditions. These operations have a strong culture of efficiency and financial performance.

Advantages

- **Corporate governance** – As these companies come under the regulations of the Australian Securities and Investment Commission (ASIC), they have to maintain a high level of governance and management, and strict financial reporting and business decision making. This is to ensure that the interests of the shareholders are maintained.
- **Economies of scale (efficiency)** – Generally, these companies have access to larger amounts of capital than the family farm and so can develop business operations that achieve high levels of efficiency due to economies of scale.
- **Accountability** – As they are required to maintain a high level of financial management and governance, there is clearer communication to ensure accountability to their shareholders. This is generally done through a series of reports and annual shareholder meetings.
- **Professionalism** – The high level of governance, financial planning and control, means a high level of professionalism is required in their operations. As they employ a larger workforce, they tend to have higher levels of occupation, health and safety standards (OH&S) to maintain.
- **Diversification** – Another advantage of having access to larger amounts of capital is that these businesses can manage properties in different geographic locations and spread climatic risks. They can also take advantage of vertical integration or diversification by having operations

in many primary industries, such as cropping, grazing livestock, horticulture and intensive livestock production.

Disadvantages

- **Financial targets** – The higher financial targets of these businesses mean there is greater financial pressure on performance. Prolonged periods of poor financial performance brought on by drought and market downturn are not tolerated well by the shareholder/owner and these businesses often exit the industry during difficult periods.
- **Tend to have less financial flexibility** - Due to the corporate management structure and reporting requirements, the flexibility of decision making can be slower than in a family farm business.
- **Cost of governance** - As high levels of management are required for the governance responsibilities of these businesses, their management and governance structure can be significantly more expensive than in a family farm.

9.2 CHANGING COMPONENTS OF YOUR FARM BUSINESS MODEL TO IMPROVE FINANCIAL PERFORMANCE

The previous section provided an overview of significantly different business models used in Australian agriculture. In practice, there can be many variations of these models and the following section provides a checklist of the various strategies and tactical methods that have been used in components of the farm business. The important point is that once the strategic direction of your business is clear, your goals are set and you understand the resources you have available, you are in an excellent position to assess which part of your business model can be tweaked. Table 9.1 lists strategies that can be used to improve the financial performance of your farm business.

9.2.1 The strategy of leasing and share farming land

Co-contributor to this section: Tony Hudson, Hudson Facilitation.

A proven strategy to decrease the cost of production is to farm more land. Leasing and share farming additional land offer alternatives to buying land.

The desire to increase profitability tends to drive thoughts around business expansion. However, many farmers are unsure of the most appropriate way to expand their business. The three most common options for expansion include:

1. Purchase additional land,
2. Lease additional land, or
3. Enter a share farming agreement.

Before entering an agreement to lease or share farm land, farmers need to consider the benefits of each of these options.

Leasing land has historically come with significant risks for both the lessee (tenant) and the lessor (landowner). Land which has been leased for extended periods and to a variety of lessees, can become run down, with poor soil fertility,

Table 9.1: Strategies for improving your business model and containing costs

Items	Strategy	Comment
Assets		
Land	The business owns all its land	The business benefits from any growth in land values but is liable for the associated debt repayments.
	Share farm additional land	Assists with economies of scale without taking on more land related debt. Depending on the agreement, the risk is shared between farmer and land owner.
	Lease additional land	Assists with economies of scale without taking on land debt. The farmer takes all the risk as repayments remain the same, regardless of the type of seasons.
Livestock	The business owns all the livestock	The business benefits from any asset value change, but is also liable for any stock related debt.
	Livestock is share farmed	This is not common but livestock can be jointly owned with other parties, with the income and costs shared.
	Livestock is agisted	Here the farmer receives a rent for their grazing and takes no risks of livestock loss or changes in commodity prices.
Machinery	The business owns all the machinery	The business benefits from the full use of the machinery but experiences machinery depreciation and is liable for any associated machinery debt.
	Machinery is share-owned, perhaps with a neighbour	The business shares the costs of repairs and maintenance and depreciation, but needs to manage timeliness as both may wish to use the machine at the same time.
	Machinery contractors are used	The farmer does not have repairs and maintenance, labour or depreciation costs, but has contract costs. The farm may wear a timeliness opportunity cost as the contractors may not arrive when optimally needed, which may result in some yield loss.
Liabilities		
Lending	Farmer uses a bank or stock firm to fund the various capital and overdraft requirements	The farmer is liable for all the debt and associated repayments.
Shareholder equity	Equity from shareholders can be used to fund carry-on finance, machinery ownership, land ownership and/or livestock	The farmer needs to have appropriate legal arrangements put in place to protect shareholders interests and will be required to pay a shareholder dividend.
Income		
Farm enterprises	Sale of commodities	Farm income derived from selling grain, livestock and wool.
Expertise	Management	If the farm has surplus management resources, management services can be provided to other farms or in consultancy opportunities.
Labour	Sell surplus labour capacity	Labour can be sold to other farmers, such as for shearing, fencing and tractor driving.
Machinery	Contract out surplus machinery capacity	Surplus machinery capacity can be contracted out to other farmers such as for hay making, spraying and harvesting.
Costs		
Variable costs	Farm enterprises	All inputs are purchased from local distributors.
	Freight rates	Freight rates may be negotiable.
	Selling costs	Selling costs may be negotiable.
	Use buying groups	Distributors have been known to give discounts to groups of farmers buying collectively and in bulk.
Overhead costs	Accountants	Accountants' fees may be negotiable.
	Energy suppliers	Cheaper energy suppliers may be selected.
	Telephone and internet suppliers	Cheaper telephone and internet suppliers may be selected.
	Consultant fees	Consultants' fees maybe negotiable.
	Insurance	Cheaper insurance cover may be selected.
	Labour costs	Assess if the available labour is fully utilised and adjust accordingly.
Finance costs	Interest rates	Cheaper interest rates and bank charges may be negotiable.

Source: P2PAgri Pty Ltd

weeds, and poorly maintained infrastructure due to lack of investment by the lessee in someone else's land. Despite the risks, leasing can and should be a positive experience for both parties if appropriate measures are taken. Leasing can provide a steady income to the landowner from land they no longer wish to farm, and offers greater scale for the lessee without the capital cost/debt of purchasing land.

Similarly, share farming provides an opportunity for land expansion, but with a different risk profile depending on the agreed share farming arrangement. By definition, share farming means that both the share farmer and the land owner share in the risks of farming. Whoever has the greater share of costs takes the greater risk and thereby takes a greater share of income. As with leasing land, a formal share farming agreement is recommended to manage the operations of the share farming, where all parties understand what has been agreed to and have their interests protected. An essential element of share farming agreements is the detail of responsibilities for management and costs.

The arguments for and against leasing

Table 9.2 outlines many of the advantages and the potential downside risks of entering a land leasing agreement for both the lessor and the lessee.

Table 9.2 can also be read as being similar for share farming, except for the first point, as both land owner and share farmer share the risks of climate and markets. Otherwise, the majority of the agreement is very similar.

Economies of scale

The key driver behind a decision to increase farm area is usually the desire to improve profitability. The key to any improvement in profitability is gaining economies of scale. This refers to a reduction in costs per hectare by defraying costs - particularly overhead costs - over a greater number of hectares. Although total overhead costs may increase when taking on a lease, the overhead cost per hectare should be lower, resulting in a lower cost of production. This can be well illustrated when considering machinery costs, which include depreciation, finance costs and insurance – costs which relate to the machine itself, rather than the number of hours it works. This assumes that there is surplus capacity of

'I was working in a mine in this area and we were having so many strikes I was getting bored, so I approached a fella and got some share farming, and it went from there. We put our agreement together. Perhaps the biggest challenge in the early days was that land was mostly covered in scrub. We carried on share farming up the road and slowly got this one under production. It was a fair old job clearing all the trees out.'

Brian Gregg, 'Kolora',
'Emerald', Qld

machinery, so farming additional land allows for more of the machinery capacity to be used.

Owners /managers of smaller scale operations tend to find it difficult to justify the purchase of large scale and technologically advanced equipment as they may risk becoming over-capitalised. While using less efficient machinery has the benefit of lower machinery costs, it may also have an adverse effect on yield. Increasing scale through leasing or purchasing additional land can justify the decision to purchase larger, more reliable, efficient, and technologically advanced equipment which may result in improved yields or cost efficiencies.

For example, consider justifying the purchase of a larger tractor. The variable running costs, which include fuel, oil, tyres, labour and most servicing requirements, are per hour costs and do not vary with increased machinery use. Therefore only overhead and finance costs need to be considered when assessing the impact of scale on hourly cost.

Table 9.3 (based on figures from the NSW DPI, 2012), shows the estimated overhead costs for a 225HP tractor, valued at \$202,674, and costing the farmer \$111,470 after trade-in of the old tractor and financed at 10% over its working life of 5 years. (In this example, the constant hourly cost of \$46.25 does not alter with increased scale and is therefore not included in this calculation).

Given the data presented in Table 9.3, it becomes clear that a farmer cropping an area which requires 500 hours of tractor use is at a distinct disadvantage to one who requires 2,000 hours work out of the same machine. If the various implements being towed average 4ha/hour, the farmer using the tractor for 1,000 hours per year (averaging about 19 hours per week year round) is \$9.66/ha better off – a significant decrease in cost of production. Scale has its rewards!

Duration of the lease or share farming agreement

A longer lease or share farming agreement is often more suitable for the lessee or share farmer, as it provides surety of access to the land for a number of years and therefore ensures a greater interest in maintaining its productive capacity. Similarly for the landowner, a longer term provides security and avoids the inconvenience of regularly seeking a new tenant or share farmer. However, it may come at the risk of missing an opportunity to increase leasing costs if land values or markets increase significantly. This can be overcome by including a provision for an annual review of leasing or share farming costs in the written agreement. What is important is that both parties have adequate opportunity to benefit from the arrangement.

Budgeting for leasing or share farming

Before discussing lease prices, you should always do some research on past leasing prices or share farming agreements in the area. This should be accompanied by some detailed budgeting prior to entering any negotiation. Preparing a budget will enable you to establish the maximum price you are prepared to pay for the lease or the minimum share of income and cash costs, and ensure your thinking is clear when negotiations begin. Budgeting will also establish the additional working capital required to farm the additional area.

Table 9.2: Advantages and disadvantages of leasing land

	Advantages	Risks/Disadvantages
Lessor (landowner)	No climate/production risk	Maintenance risk (soil health, weeds, infrastructure).
	Reliable income/cash flow	Little/no say in decision making.
	Opportunity for capital gain	Reliant on financial viability of lessee.
	No working capital required	May be more difficult to sell land.
	Little/no labour input required	Dispute with lessee.
	No market risk	
	May continue living on the farm	
	Opportunity to do other things	
Lessee (tenant)	A viable way to expand business without debt/land purchase	No exposure to capital gain.
	Economies of scale in operations	Uncertainty of continuing access to land.
	Reduced cost of production	Machinery may not be adequate to cover increased area.
	Purchase of more efficient equipment is justified	May not gain long-term benefits of investment in land productivity (e.g. weed control, soil amelioration such as liming).
	Increased profitability	Exposed to full production and market risks.
	More attractive to contractors	Dispute with owner.

Source: Hudson Facilitation

Table 9.3: The impact of scale on machinery costs

Annual Overhead Cost:	\$	Annual hours work	Cost per hour
Depreciation:	22,294	500 hours	\$77.09
Interest expense:	14,694	1,000 hours	\$38.46
Insurance:	1,469	1,500 hours	\$25.63
Total Annual Costs:	38,457	2,000 hours	\$19.23

Source: Hudson Facilitation

Consider the following example:

- Lease of 500ha at \$200/ha payable in advance:
\$100,000
- All sown to wheat at a cost of \$300/ha:
\$150,000
- Minimum working capital required:
\$250,000

Will your bank extend your overdraft by \$250,000 to support this venture?

Make sure you can access sufficient working capital to run your desired enterprise mix before entering a lease agreement!

It is also important to establish any capital requirements prior to negotiating a lease or share farming agreement. This should include an assessment of the capacity of existing machinery to cover the additional cropping area. If grazing, can the required livestock be provided from existing numbers, or will purchasing be required? If borrowing is necessary to fund the purchase of machinery, livestock or other assets, this must be taken into account when assessing the economics of the lease or share farming agreement.

Valuing the lease

Historically, the cost of leasing land has been between 4-6% of the value of the land, sometimes higher for cropping land. In some areas, this still holds true. However, a number of factors, including recent increasing land values, means this may no longer be economical for the lessee in many areas.

An alternative means of calculating an appropriate leasing rate is the Percentage of Gross Margin (GM). Any negotiations using this method will require budgeting to be completed.

In the following examples, a rate of 30% of GM has been used, as this tends to be economically viable for many farmers and provides adequate incentive to the landowner:

Wheat: GM of \$600/ha, leased at 30%: \$180/ha

Sheep: GM of \$30/DSE, leased at 30%: \$9/DSE

Table 9.4: Checklist for leasing and share farming agreement

<p>Land Details</p>	<ul style="list-style-type: none"> <input type="checkbox"/> Clear definition of the area of land being leased/share farmed. <input type="checkbox"/> Any inclusions/exclusions beyond the land, particularly water and machinery. <input type="checkbox"/> Agreement on the condition of soils, pastures, weeds and infrastructure prior to commencement of lease. <input type="checkbox"/> Responsibility for repairs and maintenance of infrastructure. <input type="checkbox"/> Requirements of the tenant to maintain soil health, fertiliser applications and weed management. <input type="checkbox"/> Any restrictions, such as stocking rate, type of livestock, chemical use, crop exclusions. <input type="checkbox"/> Agreement on whether pasture areas are to be sown back to pasture at the end of the lease.
<p>Timing</p>	<ul style="list-style-type: none"> <input type="checkbox"/> Start and end date of the lease.
<p>Finances</p>	<ul style="list-style-type: none"> <input type="checkbox"/> Requirements for payment - amount, timing and method of payment. <input type="checkbox"/> In the case of a share farming agreement, the percentage of the income and cash costs to be shared by both parties. <input type="checkbox"/> If for longer than one year, include provision to adjust the leasing rate annually, at least in line with CPI. In the case of a share farming agreement, you may wish to revisit the proportions being shared every few years. <input type="checkbox"/> The bond to be paid, if any. <input type="checkbox"/> Agreement on ownership of capital improvements at the end of the lease or share farming, if any is undertaken. <input type="checkbox"/> Responsibility for payment of rates, insurance, utilities and so on (normally landowner).
<p>Legal Processes</p>	<ul style="list-style-type: none"> <input type="checkbox"/> Agreement on circumstances under which the lease or share farming agreement may be terminated early, or renewed/extended. <input type="checkbox"/> Penalties/actions should any of the following occur: <ul style="list-style-type: none"> • late payment of lease rental or shared income; • late payment of shared cash expenses; • failure to vacate land on agreed date; • failure to pay utility bills; • failure to adequately maintain infrastructure/soils/weeds, and • breaching of any other agreed terms. <input type="checkbox"/> First right of refusal to purchase the property is typically offered to the lessee or share farmer if the property is placed on the market. <input type="checkbox"/> Process to resolve conflict should it arise.

Source: Hudson Facilitation

Tax implications

When considering lease costs, it is important to remember that leasing payments are fully tax deductible for the tenant. For the lessor, lease payments are not considered primary production income for the purpose of income tax averaging. It is important for the landowner to establish how leasing may affect their tax position.

Leasing and share farming checklist

When entering an agreement, covering the following points will more likely result in a successful arrangement for both parties:

- Always have a written agreement signed by both parties. Table 9.4 outlines what your written agreement should include.
- Seek guidance from your solicitor to ensure any agreement is legally binding on both parties.

Family farms are continually challenged to find ways of improving business efficiencies. Considering alternative business models and strategies can strengthen the likelihood of sustainability of the farm business in the long-term.

Action points

- Review your farm business model and list three ways it could be improved.
- What strategies could you implement to improve business profitability?

Robert: 'Scott decided he wanted to come home to the farm and that was when we made the decision that if we were going to continue in farming, we needed more area, more viable country, so we shifted with debt to establish a more viable business. We certainly wouldn't be in the position we're in now if we had stayed (where we were). Farming's all about the business – we don't do it for the fun of it. We've got to make some money at the end of it.'

I've given Scott a pretty free hand since he's come home. He's always been pretty level headed, been able to take on responsibility and have a vision of what he wants to do. I've been quite willing to go along with that and it's worked quite well.'

Scott: 'Currently we own 2,000ha and lease another 1,000ha on top of that, which is located about 15km from here.'

Robert: 'When we first came here, we did increase our farm size – that was one step. But then we wanted to go to the next step, so leasing provides that opportunity where you don't actually have to go to the bank ask for money and fill in a million forms to get to the next level. Leasing was an opportunity for us to go out and get some more country and expand that way.'

Scott: 'Seeing a lot of farms, there's no doubt the family farm is potentially the most productive mix out there as far as efficiencies go.'

Scott and Robert Nicholson,
'Bretton Estate', Campbells Bridge, Victoria