Student 1: Low Excellence
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Bill and Nancy XXX currently own a sheep and beef farm in a 50:50 partnership. They are looking at converting their farm to a dairy farm and bringing their daughter Emily into the partnership, changing the share to 45:45:10. The total cost for the conversion will be $4,030,000. When they sell their old stock they will get $400,000 and Emily is bringing an additional $400,000, leaving a balance to be funded of $3,230,000. The projected profit of their dairy farm is $324,500. Bill and Nancy have stated that they have two financing options: a mortgage and creating an equity partnership.

A mortgage is an option where a bank lends to a customer to purchase land and/or buildings, using the new
asset as security, for a term of up to 30 years. If the customer defaults on payments the bank can take action to get 1
their money back. Following reminders, the bank could take over ownership of the security, in this case the farm itself, that was specified in the mortgage agreement. Banks are currently offering mortgages at up to 5%. The table below shows the cost of the loan over three repayment terms.

[Table deleted from this exemplar for space reasons.]

The table indicates that the mortgage cost is increasing by roughly $1 million every ten years, proving that the
best course of action is to repay the mortgage as quickly as possible. The projected profit for Nancy and Bill's 2
farm is $324,500 per year which is the *maximum* they wish to use to repay their loan each year. If this profit was spread over 12 monthly payments of $27,041 per month, they could repay the loan in 13 years and 10 months. However, this is the best scenario. They would not want to use all their projected profits on mortgage repayments. Over that period the business would pay interest of $1,247,960 and have a total loan cost of $4,477,960. The XXXs would need to consider the security they would need for the loan, a tangible asset worth at
least $3,230,000. The security would need to be their farm as it is valued at $4,000,000. As the finance is needed to 3
convert from sheep and beef to dairy, the value of the buildings and equipment might not be able to be accurately valued until the conversion is complete. So the security would need to be the land.

A benefit for the XXXs getting a mortgage is that they will get to retain full ownership of their farm. Another benefit is that providing they meet the lending criteria and are accepted for the mortgage, the total amount of $3,230,000 would be guaranteed and it would be available to them as soon as the mortgage is approved so the
conversion could start immediately. However, there are also negatives associated with the mortgage. One of the 3
disadvantages will be having a large amount of interest to pay back to the bank even though the interest decreases as the principal is repaid. Another negative is the potential of losing their farm. If the price of milk solids drops (as seen in stress testing below), then the profit XXXs will be making might not be enough to pay the loan payments for the month. If they cannot keep up with mortgage repayments then the bank may take control over their security, the farm, and sell it to get their money back.

An **equity partnership** is a financing option for rural businesses. In an equity partnership, one of the XXXs (as the original shareholders of the farm) would become the equity manager and would prepare an information
memorandum about the farm and use it to advertise for an equity partner or investor. If they manage to attract an 1
equity partner this person (or business) would become a shareholder and would join the board of directors. A legal contract that is acceptable to both parties' lawyers would be drawn up and signed. It would cover things like the shareholding percentages, how profits will be distributed, how decisions will be made and what happens if the equity partner wants to sell their shareholding. The size of the shareholding would be calculated using the value of the farm and how much capital the investor is contributing to the partnership. The farm has a current
valuation of $4,000,000 and they need $3,230,000 to do the conversion, bringing the new valuation to $7,230,000. 2
Bill and Nancy's equity value of the converted farm would be 55.3% if an equity partner could contribute the $3,230,000 they need.

These are my recommendations for Bill and Nancy if they were to take on one or more equity partners.

- They would eventually regain full ownership of their farm by buying out the equity partner(s).
- They will have repaid the partner(s) before 20 years is up, it can be fully repaid earlier but not later.
- The minimum an investor can invest is $1,000,000. It would be easiest if there was only one equity partner (an individual or a business, such as another farm), but it might be difficult to attract one partner with $3,230,000 to invest.
- Decisions for what happens on the farm is based upon what share of the farm they have, so the XXXs having a 55.3% share of the farm will still make the final decisions as they have the majority share of the farm.

[Some detail omitted from student evidence for space reasons.]

There are a few benefits and disadvantages with of taking on an equity partner. One of the benefits is that Bill and Nancy will get to set the terms of the agreement. Equity partnerships or farm syndicates are quite common in the rural sector because farms operate on such a big scale that they need millions of dollars of capital investment and a wide range of farm management and business skills. While the XXXs are wanting a capital injection from an equity partner, there is also the potential for them to be able to tap into new thinking, ideas and farming or business skills. It would be important for the XXXs to check out a potential investor's business background and reputation. If they do not have more than capital to offer, their decision-making role in the farm could be minimal, but the potential equity partner might not agree to this. 3

One disadvantage is that until they repay the equity partner the XXX family will not have full ownership of their farm. However, they will own most of the equity therefore will have the advantage when it comes to decision-making. 3

Through stress testing, I have found that if the price of milk solids drops to $5.203 or less then the profit being made by Bill and Nancy will be $0 or less. Obviously any decrease in the price of milk solids will be bad as it will decrease the profit made by Bill and Nancy, but $5.203 is the line where they will stop making money from their dairy farm and where it will start costing them money. However any increase in the price of milk solids will result in an increase in profit for Bill and Nancy. If the price of milk solids decreases, then the amount of profit being made by Bill and Nancy will decrease and this could affect their ability to be able to make the required mortgage repayments, and will reduce the ability for shareholders to earn dividends which would be of concern to an equity partner. However, if the price of milk solids increases then they will be making more profit, and they could possibly either save the extra profit (over the projected $324,500) so that if the price of milk solids drop, they will have that money available to help reach the necessary monthly mortgage payments, or they could make larger repayments reducing the loan term and reducing the amount of interest payable. 2

The unpredictability of milk solids price, therefore, profit and the ability to repay is a financial consequence of taking on a mortgage to convert the farm. Another financial consequence is the cost of mortgage interest that must be paid to the bank. The opportunity cost of paying over $1M in interest over the term of the mortgage is that these funds cannot be used for farm expenses, for other capital expenditure or as profits that could be distributed in dividends to the XXXs. Because the equity structure of the farm will be different, it might be difficult for the farm to get debt finance (in addition to the mortgage) for any other capital expenditure, or even short-term finance. 2

A non-financial consequence of the mortgage is the risk of losing control of the farm should the business be unable to complete mortgage repayments and the bank seizes the security to recover what is owing. 3

A financial consequence of taking on one or more equity partners is that dividends for the XXX family members could be reduced as the partner/s will also be entitled to dividends. Also, there will be financial implications for the XXXs if the equity partner/s want to exit the business by selling their shares. 2

A non-financial consequence of taking on equity partners is that the new shareholder/s and the XXXs might not be compatible. They might have different visions for the farm and different decision-making and management styles. Even though Bill or Nancy XXX would be the equity manager, difficulties could arise that could make the shareholder relationships unhappy. 3

I recommend that the XXX family apply to their current bank for a mortgage and negotiate the lowest interest rate they can, fixed for as long as possible. 4

At present mortgage interest rates are at an all-time low so it is a good time for the farm to borrow. A mortgage is a relatively low risk financing option as all the facts and figures for the loan are known for as long as the mortgage is fixed for. Despite having to sacrifice a significant amount of money in interest over a 14-20-year term, ownership of the company and decision-making will not be affected as Bill, Nancy and their daughter will remain the only shareholders. As the farm is a family owned private company this is important because of succession planning where Emily might take over the farm when her parents die, or maybe there are other children who will be left shares in the farm. Although the XXXs would not get the benefit of an outsider's ideas and skills if a mortgage is taken out, there are farm advisors who could help the XXXs to upskill and to learn about dairy farming. 5