Cash poor, asset-rich dairy farmers picked to reinvest

Retiring debt or moving up to the next level are among their options

Mark Peart

In some parts of New Zealand society, stereotypes abound of dairy farmers as greedy, profligate spenders whose idea of a bad year is only being able to buy one BMW instead of two.

Rabobank New Zealand general manager Ben Russell, who has a more balanced and intimate knowledge than those who perpetuate these stereotypes, rejects them.

Reports of soaring international commodity prices and forecasts by dairy giant Fonterra of increased payouts to suppliers help fuel the stereotype, which Mr Russell says couldn't be more inaccurate.

"Dairy farming over a number of years has been very tight. Dairy farmers have been the classic asset-rich, cash poor farmers."

Mr Russell says this means they are sitting on assets that are worth a lot of money but don't have the capability to be frivolous with their cash.

BEN RUSSELL: 'Who would begrudge them an overseas holiday or upgrading the car? They work bloody hard'

Since 2002 milk payouts have consistently been at a level where dairy farms have only just broken even.

This is the first "good year" in quite a while, where farmers have the prospect of good profits, Mr Russell says.

They have "a couple" of options as to how they manage that profit. Much depends on where they want the excess to go.

"If they're happy with the current size of their business and they're really just looking to maximise their profits into the future, the smartest thing they could do would be to retire some debt," Mr Russell said.

"That will lower their interest costs and it will leave more money for them to spend on whatever they want to, or to invest."

"If on the other hand, they're looking to continue to expand their business, then they should certainly consider investing the profits in either lifting the productivity of their current farm, or possibly borrowing further and increase the scale of their existing business," Mr Russell says.

Some Rabobank clients are using their profits to retire debt, while others are using their windfall to improve their on-farm profitability, through regrassing of pasture, improving herd quality, or increasing fertiliser application.

One Rabobank client, a dairy farmer in the southern Waikato, has recently brought in an equity partner and bought three dairy farms adjoining their existing property.

"They're going to the next level in terms of scale and size," Mr Russell says.

There was no "one-size-fits-all" about what dairy farmers were going to do with their increased payout.

He was adamant Rabobank saw few instances of dairy farmers spending it in a profligate way.

"By and large they invest in pretty responsible ways. And to be honest, who would begrudge them an overseas holiday or upgrading the car? They work bloody hard and they deserve the success they get as far as I'm concerned."

"Dairy farmers didn't just wake up in the morning and be wealthy dairy farmers."

"They've borrowed money, they've invested large amounts of capital in most cases, and they've worked really hard."

"There's been plenty of years where for all that work they've got either a zero return or a negative return," Mr Russell said.

"We wish them all the best in terms in terms of having a couple of good years."

Mr Russell says Rabobank expects the strong commodity cycle will continue to produce favourable conditions for dairying for some time.

"We also think there's a reasonable expectation that New Zealand dairy prices will ease over the next couple of years."

"Perhaps this year and next year they'll be close to the levels they are now but beyond that our general expectation is that they'll come back a little – they won't stay high for ever."

Fonterra said in December it was lifting its forecast payout for the current season by 50c, from $6.40 to $6.90 per kilogram of milksolids. The new forecast comprises an increased milk price of $6.70 and the value component remains at 20c.

Fonterra chief executive Andrew Ferrier said the co-operative was just beginning to see signs of some of the expected supply response to the record commodity prices.

"In particular we're seeing growth in US skim milk powder production. We think this will factor into the market over the short to medium term and will bring a gradual softening to the market," Mr Ferrier said.

However, structurally the market is much stronger than it has been, he said.

"There is a very strong global demand for grains, in particular the large amounts of grains going into biofuels. This is putting upward pressure on global farming costs, which in turn is pushing up global food prices, including dairy," Mr Ferrier said.

"Combine this with the weak US dollar and we believe the long-term outlook for dairy prices will be well above traditional averages," he said..

Mr Russell said farm input prices have definitely increased: "World fertiliser prices have soared, fuel prices are very high, and there is ongoing wages growth."

While industry fortunes were "not quite as rosy" as they were being portrayed in some quarters, what farmers were spending was largely circulating in the New Zealand economy, Mr Russell said.

"That's good for everyone."

PIEs keep those bears at bay

Duncan Bridgeman

High-net-worth investors should be reaping the benefits of the new Portfolio Income Equity (PIE) regime, introduced last October.

Eligible PIEs such as unit trusts and superannuation schemes have now become much more competitive, as alternative means of accessing securities.

"The changes are significant," Elevation Capital Management managing director Christopher Swasbrook said.

In particular, PIEs will be limited to tax on interest and dividend income at 33c, falling to 30c on April 1, 2008; and will collect and pay income tax at that rate or lower on behalf of their investors.

This means 33% and 39% taxpayers will be better off.

Investors also benefit from a safe harbour regime on New Zealand equities and certain listed Australian equities, which exempts investors from any capital gains tax.

Further, all other equities fall under the fair dividend rate (FDR) regime and are effectively taxed on a deemed return of 5% a year – a superior position to the old regime, which taxed all returns.

Mr Swasbrook said the PIE regime suited a wider range of clients including professional investors, trusts and companies, which previously had invested directly on capital account.

This is because they would no longer be tainted by activities within the PIE safe harbour.

"I also strongly believe that the portfolio tax changes will accelerate moves to greater transparency of portfolio performance since the focus of managers will be increasingly shift to net returns.

"I expect more competition in our marketplace, which is positive for investors and the changes will reveal the innovators in our industry.

"Those participants who do not recognise the potential shift in the market will be tomorrow's financial dinosaurs."

Craig Stobo, chairman of fund manager Elevation Capital, who was commissioned by the government in 2004 to review the country's portfolio income taxation system, said the new regime should encourage people to invest at home, a move that would improve the liquidity of New Zealand's financial markets.

The PIE system carried several benefits but the consequences of not complying were harsh, Mr Stobo said.

"If you exceed any of those PIE boundaries, the IRD compliance framework means you suffer. The onus is on the fund managers to stay with the minimum number of stocks and the arms length basis of the fund and the vehicle.

"Breach any of those and you're out of PIE."

Socrates takes a wiser, wider approach to investment

Neville Bennett

Many investment funds prosper only in bull markets. They wither in bear market years. There is a small band of market-savvy funds that accept that markets are cyclical. Their philosophy is to make money irrespective of bull and bear phases.

In New Zealand, the Christchurch-based Socrates (www.investing.co.nz) is delivering: its performance unit trust has an audited 16% gross (12.4% net) growth rate for the year. It is the leading performer when compared to similar funds listed by Morningstar. Its gold and metals unit trust is flourishing as gold hits record heights. It owns physical gold, silver and platinum. Moreover, it has gold in every portfolio, including income.

This turbulent period is therefore proving very profitable for the Socrates stable.

Socrates management anticipated the credit crunch and US recession; and designed suitable funds. Socrate's newsletter in April 2007 boldly said "we expect a recession in the US within 12 months." Not many other investors were picking that. The same newsletter also presciently forecast a falling stock market," set off by the US housing collapse and vast debt underlying it." The Dow Jones was set to burst through 14,000 at the time, and bears were laughed at.

Socrates made other accurate key assumptions:

- the US dollar falling against its competitors
- long-term commodity boom, particularly in gold and metals but also food and materials
- declining equity markets but opportunities in commodities
- be light on stocks, heavy in commodities in this cycle.
- growth switching from US and Europe to Asia and South America
- rising oil prices
- a switch to alternative energy
- opportunities in water
- kiwi dollar weakness

The funds have other strengths. Managing director Charles Drace understands cycles. As a certified financial planner, he has created and retained a large, loyal clientele because he has guided them successfully through more than 30 years of market volatility. None of his clients lost money in the 1987 crash.

Mr Drace recognises the need for the prudent defence of value. In most cases, equities in the fund have stops. If they fall 10-15%, they are sold. This is sometimes profitable as falls are insured by put options. As non-performing shares are dropped, Socrates is rare in that it is does not carry significant unrealised losses.

There are four PIE-compliant units, each with a clear mandate. The income fund performs exceptionally well with a return of 8.72 % gross a year since inception. There is an exciting sustainable and water unit trust designed for long term capital growth. This leaves two fascinating units, both unique.

The gold and metals unit trust is designed to give investors a wide exposure to these commodities. It has a broad-based basket, comprising cash, ETFs (exchange traded funds) and equities. It is unique in holding claims on physical metals. About 42% at present is in gold ETFs. The trader, usually a huge bank, backs each fund with gold. They can be sold at any time in Australia, London or New York. Also there are silver and platinum ETF's. The shares include BHP, Newcrest, and Newmont. The fund returned 10.3% this year.

The performance trust's gross return this year is 16.6%. With little exposure to New Zealand, its assets are under-valued by the current exchange rate. Its assets are in Australia, Asia, Canada, Emerging Europe, the UK and South America. The assets are mostly equities, with a strong portfolio of high-yielding sovereign bonds.

The adviser and broker for many trades is Jyske Bank of Denmark. ABN Amro Craig also act as brokers. The fund is exposed to commodities, especially gold, gas and oil but it also includes shipping and water.

Disclaimer: Neville Bennett is a director of Socrates

ON THE WEB

- www.investing.co.nz