The good, the bad and the ugly debt

(Courtesy of NZ Farmer)

Pita Alexander discusses debt and observes that a farm is a bottomless pit that will absorb as much cash as can be bulldozed into it.

HERE are some wonderful agricultural four-letter words – rain, work, soil, cash, wife and debt.
At the risk of repeating myself, farmers owe it to themselves to be level-headed about their debt and tuck away some of their earnings each year for a rainy or dry day.
Debt is king. There is good debt, bad debt and ugly debt.
You will never make money without it.
Do not be afraid of debt because liabilities drive you to the most amazing efforts, but be respectful of it and always keep an eye on your cash management.
The best business risk management is having sound, sustainable, bankable profits – nothing, but nothing, comes even close to that.
For a dairy farmer looking at a milk payment of $8.40 a kilogram of milksolids in the 2013-14 season the temptation might be to go on a nice shopping excursion.
Resist this urge and at the very least do your homework and triple quote before spending your hard-earned cash. Don't spend anything until you understand the cost and the probable result.
Remember that people listen much better when they are in a down-cycle than an up-cycle.
When you receive an unexpected windfall, don't waste it. This might be commonsense, but in my experience many do waste it.
Already we are seeing the official cash rate rise and that will have implications on mortgages and the dollar.
The commodity milk price horizon for the 2014-15 payment is not crystal clear and at this stage farmers are looking at a $7/kg start.
Every farmer knows they are exposed to constant market and weather cycles. The experts tell us the market shifts will come and go faster, harder and sharper.
Furthermore, old age is creeping along for many of our grey-haired farmers and there will come a day when the knees will tell them it's time to stop.
Farming couples and anyone servicing farming must build their financial reserves almost before anything else. Why? Because of these severe and regular agricultural commodity cycles, because of overseas issues, because of prices and because of business volatility.
You need 20 per cent of your gross farm income in reserves – it may take some time to do this but do not fight this concept. The absolute minimum must be 10 per cent.
Generally, the people and companies that you will have the most trouble with will themselves have poor or weak balance sheets – burn this into your memory bank.
In my mind the most serious ongoing problem inside the farmgate is the never-ending relentless upward creep in farm working expenses.
Inside our farm accounting practice, the average varies depending on the farm, but increases over the past five years would be in the order of 4-6 per cent each year. That is compound annual increase year on year.
It's all the more sobering when you realise that your farm working expenses will double every 14 or so years.
It's never been more important than now to keep a firm hand on these expenses.

Earlier in the year, clients of mine asked me what I thought their full cost of production might be for the year ending May 2015, based on their financial performance just about to end.
They are capable people and run an irrigated dairy farm of 410,000 kilograms of milksolids.
My suggested figures for each kilogram of milksolids were: farm working expenses $4.20, interest and rent payments $1.40, depreciation/ replacement vehicles and plant $0.30.
Added to this $5.90 sub-total was income tax (based on a payout including dividend of about $6.75kg/ms) of $0.30, personal drawings and allowances of (about $85,000) $0.21.
Their overall costs including income tax and personal drawings was $6.41 per kg/ms.
There will be all sorts of variations here – some higher and some lower – and we have already seen the opening forecast estimate at $7/kg, but this gives them an indication of where they are heading.
Farms are the best bottomless pits you will ever strike.
A farm will absorb as much hard-earned cash as you like to bulldoze into it.
Don't get caught up in this trap. You must manage the farm and not the farm manage you.
Some men are compulsive developers and are very good at it, but sometimes their advisers and spouses would do better to show them a helicopter view of where they are in terms of the farm's maturity which I would argue is, on average, about 93 per cent of its production potential in financial terms.
Are you working in your business or are you working on your business? There is a difference, and there is a need to stand back and also work on the business.
One of the hard lessons I learnt in my troubleshooting days is that a farming family must never let their problems grow. Put the problems on the table early on and never put them in the freezer.
Try to give people in your business responsibility for a division that suits them and not because they have been there the longest.
Generally you are better to have your best employees manage the profit centres while you manage the loss leaders.
On and off the farm, closely analysing your expenses can be an eye-opener.
What might our income and expense budget look like within the next two years for a 45-year-old couple with two late-teenage children, their own home, a mortgage of $150,000, one partner earning $62,000 a year and another $31,000 and both possessing a strong saving habit but wanting to help their children as much as they reasonably can?
They would have gross pre-tax earnings of $93,000 and no IRD family tax credits. Their interest-dividends and other income might be $2000 for a total of $95,000. Their expenses might be $16,415 of income tax (17.3 per cent of total) and the interest on their house mortgage (9.5 per cent) $9000, with annual principal (7.9 per cent) repayments of $7500.
Their personal, rates, insurance, vehicles, holidays, food and repairs and maintenance costs might be $850 a week (46.5 per cent) or $44,200 for the year. Their children's education costs (8.4 per cent) might be $8000, life assurance (2.1 per cent) $2000, family health insurance (1.8 per cent) $1750, car replacement fund (4.2 per cent) $4000, and savings (2.3 per cent) $2135.
What conclusions can we draw from this? It's going to be 20 years before their mortgage is repaid, just as they receive NZ superannuation.
Their personal costs of $44,200 might be on the low side looking ahead two years. Without both spouses working they would run into major problems.
They are living within their income but only just.

In real terms you could argue there are investments here of $7500 (mortgage repayments). In cash terms the whole exercise is tight. Somehow there have to be a lot more savings to provide a capital base for some income after 65, over and above superannuation.

Maybe both spouses intend to work through until they are 68 to 70.

The real point from this is that each of us needs to save more to build up our financial reserves.

Saving 10-15 per cent of your disposable income over your lifetime would be an absolute minimum, with 20 per cent being the figure to aim for.

For our couple this would be $11,787 at 15 per cent and $15,717 at 20 per cent.

This would be impossible for many couples for the first 15 years of their working life, but for the remaining 25 to 30 years they would have to dig it in.

This is the reality of New Zealand household economics for the foreseeable future.

Pita Alexander is a specialist farm accountant at Alexanders.