The Rewards of Financial Discipline

Leonie and Kieran Guiney

Family Time – priceless!

I'd like to leave you with 2 things

- The principles that have driven our progress from both a farm management perspective and a use of capital perspective
- But more importantly the why behind what we do

I will explain briefly our business growth but only as the evidence that the principles work if you are really clear about why you are implementing them!

This why. Here is a picture of one of the great rewards of financial discipline. It is our family climbing the Iparla ridge in the Pyrenees till we reached the border of France and Spain.

In 2003 while in the cowshed on our sharemilking job we decided one day we would have someone else do this for us and go live in Europe with the kids for a year. 10 years later we left capable people on 4 dairy farms and did it.

We wrote a statement in 2002 about prioritising a secure family and marriage relationship , about deliberately gathering positive and inspirational people around ourselves , about financial and time freedom, living in paradise and giving something back

The creation of opportunities for young people to get ahead.

Another reward is to see the number of jobs our business alone has created for people, and the affect it has on local businesses and the community.

Look at this line up of educated energetic young people hungry to come to NZ to learn to farm pasture.

Financial discipline, and some luck, has delivered for myself and Kieran the means and time to live how we choose with wonderful people around us. Profitable farming allows you to share the profits with motivated people who are getting ahead themselves. That's what delivers our time freedom.

Financial discipline encompasses understanding the intrinsic value of things. This comes with the regular habit of doing a simplified budget for everything Kieran considers could be for sale! This means you have to

a) Know how to estimate the right price

b) Refuse to overcapitalise in the development process

c) Know you have a farm system and the management that can deliver consistent profit, at volatile milk prices

But I don't believe you will embrace financial discipline unless you:

1. See the choices and opportunities that being a sound financial manager creates

2. Stop doing all the things that you don't need to be doing and do the ones that relate directly to achieving your vision.

I think of budget discipline like physical exercise discipline – if you believe in the rewards of being physically fit you will prioritise time for exercise. I really want to be able to ski with Kieran when we are 75, and so I get up very early to fit my exercise in today. If you don't want the results enough, you will be 'too busy' for exercise.

It's the same with discipline with capital. If you don't want the results enough you will trot out the clichés that justify your overspending – like 'do it once and do it right' – to justify the 1.5M rotary with all the bells and whistles when you could have extracted the milk from the cows in an $800,000 rotary.

In relation to dairy farming, in addition to our clear reason for being in business the goal from farming is very clear. And I must credit Murphy for the words that capture

this. I was firing warnings to farmers about the risks of chasing output and the consequent capital expenditure that goes hand in hand with it in the 1990s. He defined it better with these simple words (which I have put a kiwi slant on)

Slides

If you chase yield, say yield per cow – that's what you'll get. Yield per cow . You will go looking for a cow that can give you that (she'll be a monster of a Holstein that's hard to get in calf and goes lame often). You will put a system in place around her to make sure she gets in calf and doesn't go lame, and then you will have to employ the expert able to keep this high output machine going – a phd in nutrition will help.

What outcome? Yield per cow. Guaranteed. Profit (or otherwise) is just a consequence. Investment in infrastructure escalates to sustain the system – concrete to ensure better supplementary feed utilisation, bigger tractors, bigger wagons, more flexible means of feeding, bigger effluent handling facilities …….

Alternatively, what we do **is target profitability with a deliberate target of low ongoing capital reinvestment**. In so doing you will first put a system in place that can deliver that – farming the pasture curve. That's about matching stocking rate and calving date and spread to the growth curve as McMeekan and Bryant observed 5 decades ago.

You will then go find a cow that can get in calf every 365 days , bounce back if she's had to go on once a day through a dry spell – she's a high BW kiwi cross with a high fertility index.

Then you go train someone who can implement some terribly simple rules that maximise pasture utilisation. No phd required, just a business like attitude – and people management skills because this will be so effective they will want to grow it and replicate it.

What outcome ? Just what you targeted – profit is guaranteed, production per cow will be a consequence (and variable). Free cash that's generated isn't sucked back into the system to 'improve the utilisation of the supplementary feed' or – here' s a classic to 'increase the output to spread the overheads/lower the cost per unit ' . UK salesmen are masters of the 'margin over feed and fert' calculation that conveniently ignores the fact all your profits will be sucked back in to sustaining the high input systems they peddle. Company CEOS are good at making similar use of gross margins.

In the financial year ending June 2013, with a Fonterra milk price of NZD 6.50 €3.93/kg milk solids (approx. 32 euro cents/litre) our 4 dairy farm companies averaged a cost of milk production including depreciation and management some 40% less than the average irrigated Canterbury dairy farm.

Did this lower cost of production translate to higher profit? Yes, we averaged an economic farm surplus per hectare NZD 1.55 *more* €0.93/kgMS (8 euro c/l) *more* and $1460 /ha *more* €880/ha *more* than the average irrigated Canterbury farm, despite the fact 2 of our farms have no irrigation at all and are at 450m above sea level.

On our 900 cow home farm with a manager on, our cost of production, including staff, manager and depreciation, was $3.33 NZD (€2/kgMS (17 euro c/l) and farm operating profit was NZD 3.61/kg MS €2.17/kgMS or 18 c/l).

What is there to learn here?

We produced less per hectare than average. We produced less per cow 381kg vs 418kgMS average. Our financial reward for all this ordinary output is a consistent ability to service debt, at high and low milk prices. Another way to look at it; over a business of 1 million kgs milk solids, 50% of our turnover was profit that year, compared to 30% of Mr Average.

In the year end 2018 our manager is now one of our sharemilkers. We retained the discipline in our systems, even at the $7 milk price. In high milk price years we don't chase extra milk with supplementary feed. We have no desire to increase our business exposure to the volatile cost of supplementary feed. But how do we resist that?

Terribly simple non negotiables. The first thing our staff learn is what a 1500 residual looks like. The next thing they learn is that we are in the business of generating cash off pasture allowing us service debt and grow the business - not in the business of making milk.

Then they learn this is achieved with about 5 rules

- Go into the winter with 2300 average cover (because we've learnt that will mean we calve with 2600 in Fairlie which gets us to 'magic day' in October on pasture alone
- Run a rotation length planner in spring and stick to it, get tight and uncomfortable just before the spring flush. 1.5 times around the farm before balance date
- The peak per cow doesn't matter, it's the *peak pasture quality* that will optimise your output, help the cows get in calf, and maximise your profitability.
- Dry off cows gradually over autumn to ensure they go into winter at CS 4.5 because they can only gain a half score over winter.
- Spin the round out from February for milking days **

- Don’t ring Kieran and Leonie on their summer holiday asking for supplements in a drought because the answer will be ‘no’. Feeding supplements in summer has an uneconomic substitution effect. Just reduce the intake – with OAD first, then selective culling, then drying off cows. We are farming what the season delivers, not chasing a milk production target. Do ring for a chat though.

That’s it. Same on all 4 farms.

When you have consistent profit you can afford to share it with your partners not with feed salesmen. That is how you then get committed staff in your business – they have a real stake in the performance.

And here’s another advantage. Under plan change 5 in the Canterbury Land and Water plan, a farm without irrigation, and with less than 10% of land area in winter feed, provided its not bringing purchased feed onto the platform between April and September (which of course increases carrying capacity and potential N leaching) does not require a consent to farm – because its not considered a high N leaching risk. So, simplicity is paying off on our dryland farms from an environmental perspective.

In 2018, our system remains the same as 2013 the cost of production on the home farm with a manager on was $3.38 and ebit/ha $ 4507 at a June to June milk price of $5.82 on 315,000 kgMS off 255 ha – of which 15 ha is in winter feed. That’s 1235 milksolids per ha. Get this, our revenue was $1800/ha behind the Canterbury irrigated benchmark, but our ebit per ha is double the benchmark. At 400m above sea level. Don’t ever assume more output means more profitability. Often it’s an inverse relationship.

So, we are rewarded for saying NO. No, we won’t install a grain feeding system to ‘take advantage’ of the current milk price. YES we can offer a percentage to our managers now and make them sharemilkers. YES we have simple enough systems and clear enough policy to go to France for a year with the kids, contribute to the industry, continue investing – whatever our goals with our time are.

Financial discipline gives us those options.

Return on capital, with a margin of safety

All our investment decisions have been driven by a desire for a 15% return on equity. To achieve this you need a return on capital with a decent margin above the cost of capital (the interest rate).

We have made the progress we have because we wrote a plan and then implemented the following investment principle.

Any investment must deliver an estimated 4 percent minimum margin over interest rates at conservative milk prices (we used a $4.50 milk price in the mid 2000’s)

Return on capital = profit (after wage to management and depreciation)

Capital (all the capital invested whether borrowed or not)

Return on equity = profit (after wage to management and depreciation) – interest

Equity (Your bit, excluding the debt)

You need a good return on your capital to drive a good return on your equity. Any return on capital less than the cost of interest will destroy equity.

Year one is always messy and must be budgeted, but it's the status quo picture we make the investment choice on.

For example, Kieran and I will do very fast maths on a new farm purchase by knowing our cost of production in $/kgMS. Say $3.40/kgMS. Assume a milk price $5.50 and add 50c for stock income. So that gives us a net per kg before interest and tax of $2.60/kgMS. Because we get 1400kg MS/ha off pasture (wintered off) there's an average ebit of $3640. That's the conservative number we would value dairy land on. We know we will spend est $7000 per ha on stock and plant so, in terribly simple terms

-if you know you have an ebit of $3640 per ha, and you want 10% on your money you wouldn't pay more than $36400 for land stock and plant. If stock and plant are are 7K/ha then you'd need to be paying $29400 or less /ha .

If you can tolerate a 5% return on capital (we wouldn't) then you can double that purchase price – brag about your increased 'enterprise value' and likely end up using your profitable businesses to subsidise the one you just overpaid for. Why would you? Get a whole lot busier to make your good businesses smaller?

At 4% interest rates we need to see a margin over that of at least 4% to bother. That's exactly the math we did when we bought our first farm, in 2005. Interest rates were 10% then and we saw that the Fairlie property, having sharemilked it so knowing its ability, could make 14% because of its gravity fed water under our simple pasture based system. So we bought it, with only 23 percent equity at the time.

What bits have you control of that would make this margin better, or make leasing a better option?

You have control of top line of the equation - you have control of your production costs

The capital employed (on the bottom line) is also up to you – you write the cheque, you say yes or no to the asking price, you decide how much capital MUST be invested in a conversion scenario. The less you put on the bottom line, and the

more you extract on the top line, the higher the return on capital. The higher the return on capital, the increased chance you can safely do it with debt. You can make rapid financial progress when you get positive leverage - a return on capital significantly higher than interest cost. With a return on capital too close to interest rates, you run the risk of negative leverage and you can destroy capital equally rapidly.

Minimising the bottom line of the ROC calculation, maximising the net profit on the top line delivers real returns and really gives you options when you keep repeating that behaviour.

The temptation to justify bells and whistles in capital investment just ignores the very real fact that ALL capital has an alternative use. It's nearly always better going into the next opportunity than embellishing the existing one if you have a replicable model.

We built Wimborne's rotary cowshed with ACRs for $800,000. You could argue the other $700,000 we didn't spend bought the next farm, in the same year. It was $700,000 of equity from surplus stock we used to do the Greenburn partnership.

Being driven by expansion in itself is dangerous. Our progress was driven by a hunger for return on equity. We weren't targeting land purchase, it showed up at the right price in the right location offering the right margin of safety. Then it kept showing up before others saw its value, or understood how to mitigate the special risks the region has.

The same principles were used when we, with the kids, decided to buy and expand the Fairlie Bakehouse, naming the site that now bustles with 7 other tenants "Bobby Square" after the equity they had accumulated rearing bobby calves. Rent less costs, over capital invested is just called yield in commercial property circles. It's the pie bakers reputation and work ethic we actually invested in in Fairlie.

Investment decisions must always be your own. But the principles that drive equity growth must be understood. The decisions you make with capital will determine your freedom long term, **especially the first one**. Its starts with knowing your own capability in terms of cost structures.

So here's what the discipline with capital has done for us, in conjunction with a strong cooperative prioritising our milk price, and a fortuitous Global financial crisis that plummeted interest rates in 2009 (luck)

Growth slides.

Finally, Kieran and I aren't particularly special or clever. We just sorted out our priorities then implemented some sound principles we learned off people we admire.

What a fabulous opportunity lies in front of today's young farmers in an environment when some cost structures are unsustainable. That creates opportunites for the next generation to get in there and simplify those systems back to grass and back to profitability. GO FOR IT.

*If you want detailed analysis by example look up the paper of this same title in positive farmers conference , 2014 for an analysis of the Kilkenny farm investment

** We do use supplementary feed in early autumn with maximum 300kgDM per cow to lengthen rotation so we can extend our milk on grass later in autumn. Under a $5 milk price we don't use any, just dry off earlier. In 2014 with both drought (our irrigation dam ran dry) and a $4.40 milk price we dried off all 3000 cows on the 4th of March. That way we still serviced our debt, supplemented our sharemilkers' incomes and broke even. That has been our worst extreme. Had we tried to make milk with no grass we would have run at a loss and our sharemilkers would have been working for nothing