

## *Agricultural Restructuring: The Potential Role of Joint Venture Arrangements*

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### **The Drivers of Agricultural Restructuring**

Farming in the UK is currently undergoing a major transformation, pressurised from a great number of different forces. Over the last few years the industry has been subjected to an unprecedented degree of scrutiny and comment, as the immediate problems resulting from BSE gave way to the economic downturn from 1996/97 (officially recognised as the worst since the 1930s), capped by the FMD epidemic of 2001. All of these major events have had dominantly negative effects on the buoyancy and vitality of the farming sector, both through their direct impacts at farm level (in terms of depressed product prices, actual loss of production and higher costs) and also, though less tangibly, because of their impacts on the people who make their living in farming. Other factors are also having an important effect on the profitability of farming among which the more important are:

- Changes in food marketing chains, which over time increasingly place primary producers at a relative disadvantage in terms of market power.
- Increased consumer concern for food safety and quality, which are having significant farm-level impacts in the short term, though this may provide market opportunities in the longer term.
- The growing pressure for farming to achieve higher environmental standards to ensure long term sustainability.

The farming recession of the last few years, together with the inescapable pressures for change, appear to have had a number of far-reaching effects on the industry. These are becoming evident both in terms of impacts on the current generation of farmers (falling retention in the industry) and through an adverse influence on the career aspirations of many of the next generation of potential farmers. Moreover, in the search for improved competitiveness by the industry it is widely accepted that further significant re-structuring will be necessary. The government's identification of the benefits of greater collaboration among farmers as one of the industry's strategies for future prosperity provides a further driver of the process of restructuring (Cabinet Office, 2002).

This re-structuring will take many forms, among which the trend towards an increased polarisation is one important facet. This duality, with much larger, commercially-focussed businesses able to produce food commodities at competitive prices in co-existence with a greater range of smaller, part-time farming enterprises has been widely anticipated (see, for example, McInerney, 1994). But for those whose interests lie with the smaller and middle range farms,

currently surviving if not prospering, the question must be: ‘What is the future for farmers whose resources do not permit a rebirth as a large business, yet whose aspirations are still to earn a living in farming?’ It was in an attempt to provide at least a partial answer to this question that the research reported here was undertaken.

### **Researching the Potential Role for Joint Ventures in Dairy Farming**

The dairy sector has been particularly hard hit through the farming recession for a number of reasons, one of the most significant of which has been the medium to long term consequences of the deregulation of milk marketing in 1994. This has inevitably accelerated the rate of structural change in this sector, in both the producing and processing industries, through the greater exposure to market forces consequent on deregulation (McInerney et al, 1994).

During 2002/03, Objective 1 Cornwall funded a CRR study which looked at the potential for joint venture arrangements as one way of assisting restructuring among dairy farm businesses in Cornwall, albeit with clearly expected transfer benefits both in the Southwest and more widely. The project aimed to ‘develop and implement a process of dairy farmer joint venturing that will enhance the competitiveness of the industry and lead to its further diversification’. It not only involved research into the drivers and possibilities of joint ventures in the context of agricultural restructuring, but also expected to service the agricultural extension sector so as to provide a wider range of change alternatives (Turner and Hambly, 2005).

This paper draws on some of the findings of the research in discussing the future potential of joint ventures in UK agriculture. While the examples are inevitably drawn from the dairy sector, the potential application of joint ventures in the agricultural sector is clearly much wider.

### **Some of the Benefits of Joint Venture Arrangements**

#### ***More efficient use of ‘fixed costs’***

In the past there has been a tendency for farmers searching for ever better financial performance to focus largely on gross margin improvement, while passively accepting fixed cost inefficiencies. Now that gross margins are actually declining due to reducing commodity prices and a slowing down of technical innovations, farmers seeking to strengthen their farm’s profitability in order to remain competitive must now actively reduce their fixed cost burden. Fixed costs, so called, include labour, machinery, land and general (administrative and service) costs.

Meanwhile the seasonal output of many machines, and thereby the potential labour efficiencies, are increasing faster than it is generally possible for farm units to increase in size. Moreover, the fact that the levels of short term land rentals are not declining relative to margins illustrates that farmers' view increasing scale as one solution. Machinery rings have helped enormously in the fixed cost equation and should continue to grow in importance since they have the potential to provide an ideal solution for many farmers. However, there can no doubt that farmers will continue to look for solutions that best suit their own individual circumstances.

Sharing machines and labour has been an on-going, and in some cases workable, method to spread costs. There is considerable anecdotal evidence, however, that machine sharing in practice is far from perfect. One common problem is that arguments or tensions arise over issues related to machine maintenance, frequently involving the most basic servicing routines such as machines not being cleaned, greased, or properly repaired. Further, the sense of ownership can become vague over time and neglect may ensue. In any case, sharing a larger machine only reduces depreciation per hectare, a relatively small proportion of the cost burden. Fuel efficiencies on per hectare basis are not improved to any significant degree, and a reduction of repair costs per hectare is also unlikely, some would say impossible, when ownership is shared through a machinery ring or similar. The largest cost advantage arising from shared machinery is likely, therefore, to be the cost of labour per hectare since the larger machine will allow for greater efficiencies of use.

### **Better use of farmers' skills and specialisms**

Fixed cost reduction is only part of the story. There is widespread recognition of different skill sets with considerable evidence that at least some of the differences between the financial performance of bottom third and top third enterprises can be attributed to particular skills and attention to detail. How do we find a mechanism which increases farm income by using the available skills to better effect? One route to improvement has been the trend towards using specialised contractors, evident in a range of specialisms from agronomy to sheep shearing. Though there may be a range of drivers for these trends, one result should be the more effective use of specialist skills.

Joint ventures provide an opportunity to apply this approach more widely within the farm business. Typically, within any group of farmers one may be an excellent stockman, one may have first class arable production abilities, one may have excellent grassland management skills, one may be a very good business manager, and so on. Some farmers, of course, may excel in more than one area. But, in the context of independently managed mixed farms, it is likely that at least one enterprise or supporting activity in each is under-performing because of lower skills or relative indifference. Most farmers know which are their stronger interests and may have to live with their weaker areas. Often, this shows up in

the financial performance of the different areas of the farm business. In principle, joint ventures between separate farm businesses could provide the ideal mechanism, through providing a means by which the machines, labour and production specialisms and skills of each may be utilised for the good of all while leaving a high level of autonomy with each individual farm business.

The main purpose of setting up such joint ventures is that 'economies of scale' should be applied to the production process but with individual producers retaining their own autonomy, albeit within defined parameters. It is in effect horizontal collaboration as distinct from vertical integration, and it has the potential to provide for the participants economies of scale and a better use of resources, most notably the sharing of managerial skills. Joint ventures of the sort studied represent collaboration in production rather than in marketing, processing or the purchasing of inputs, although there may well be potential benefits for some farmers in applying the principles more widely. The process of forming a joint venture is very much from the bottom-up; that is, the commercial and other objectives of the parties lead the process until a detailed commercial framework is identified. An appropriate form of legal structure can then be produced, or it may be simply purchased as in the case of a limited company. Whatever the structure, it should aid the aspirations of the parties, whilst limiting the risks having regard to the extent and nature of their respective involvements.

### *The Principles of a Joint Venture Arrangement*

The principles of a simple joint venture are depicted in Figure 1. Although in this diagram a service company is the unifying infrastructure, any appropriate structure can be adopted depending on the circumstances. The principle is common to all dairy farms, with the exception of farms with 'flying' herds, in that there is one *profit centre*, namely the milking herd and its milk sales, and two *cost centres*. One cost centre includes the management of dry cows, the calving of cows, the rearing of calves and dairy followers as herd replacements; and the other is the production and provision of feed, typically grass and forage production with purchased concentrates. When two dairy farms are amalgamated under a legal umbrella, which in turn does the farming, then the cost centres are transformed into profit centres since the legal entity pays one of the farmers to provide that service.

### *Fine Tuning a Joint Venture Agreement to Suit Different Circumstances*

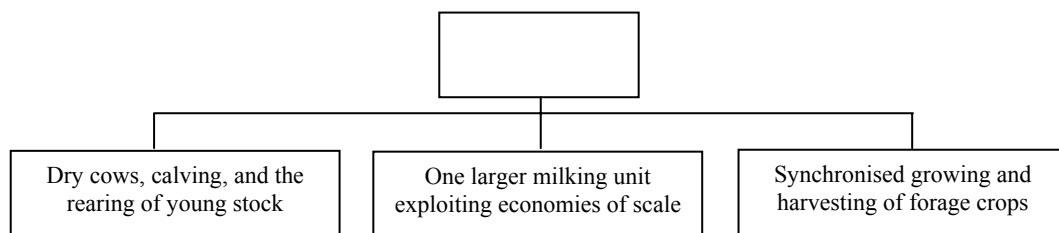
During the project five existing joint ventures among dairy farmers, situated throughout the country, were visited. Although showing some common features, which involve most of not all of the principles of joint ventures, each one had its own distinctive features.

One was set up as a farming partnership, another was a type of share farming arrangement, yet another was a contract farming arrangement and there were two

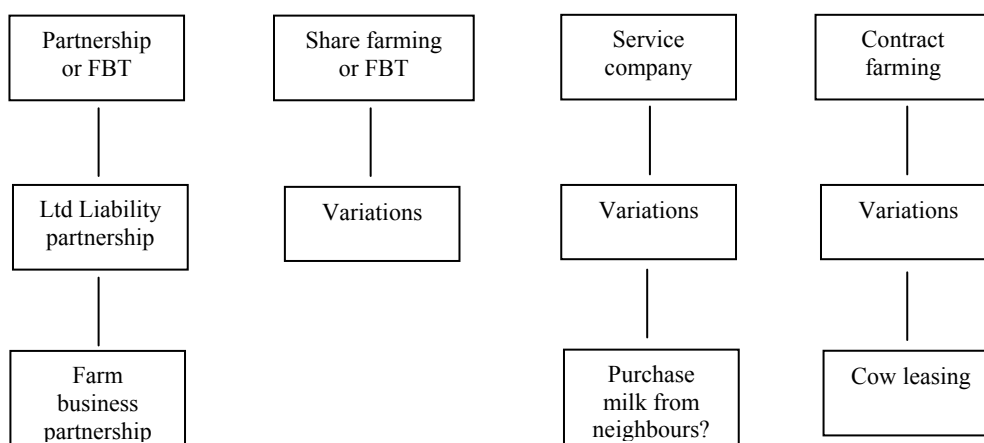
farming companies. Some other arrangements have sometimes been called joint ventures, for example farm business tenancies, machinery sharing, and share milking, but these seem to us to be distinct because they do not generate immediate economies of scale for the whole combined farming enterprise nor necessarily involve the degree of skills sharing possible under a true joint venture.

**Figure 1: Simple model for a joint venture**

1. Two or more dairy farmers set up a company
2. Most dairy farms have 1 profit and 2 cost centres
3. Cost centres of 'young stock' and 'forage production' become profit centres
4. Company Directors plan work schedule
5. Company contracts work via purchase orders to provide income to the farmer directors
6. Instead of 1 profit centre and 2 cost centres, company structure provides 3 profit centres
7. Result is the farm is more profitable through achieving economies of scale, and better use of resources.
8. Three layered agreements needed, comprising management and purchasing rules



**Figure 2: Types of models to use as a basis for joint venturing**



Most joint ventures are not simple ‘off-the-shelf’ agreements but involve fine tuning the circumstances of the farm businesses, the aspirations of the farmers involved and are often facilitated by farm business tenancies (FBTs) as can be seen in Figure 2. The principal models identified by the research are partnerships, share-farming, and the use of a service company.

### **Partnership between two tenants**

In this example two neighbouring tenant farmers rent land from the same landlord and have roughly the same assets, although one partner has more hectares and a larger milking parlour. Because of the difference in their respective contributions, an unequal partnership was formed with the smaller party owning 40% of the partnership. The two herds were amalgamated (with a new BCMS herd number) and, in order to avoid a non-producing quota holder (NPQH) situation arising a new Rural Payments Agency (RPA) number was ascribed to the partnership. This arrangement satisfies the RPA although from a legal position the quota holding is not a partnership asset as quota is tied to the land. Likewise, to maintain a sound legal footing, two FBTs were established to allow both farmers to farm each other’s land. Economies of scale are clearly demonstrated through a larger herd of 150 cows and one set of larger machinery which replaces two smaller sets of farm equipment.

An important feature of any joint venture is the sharing of the manual workload and the more effective utilisation of management skills. In this case the routine daily commitment of milking is halved, one party choosing to undertake most of the work associated with machinery (including field operations and routine maintenance), whilst the other rears the calves through to dairy replacements. Partnership profits are shared equally up to an agreed threshold (about £10,000) and over this on a 40:60 basis. Because of the partnership arrangement both parties are jointly and severally liable and therefore share all of the business risks.

### **Share-farming agreement**

Share farming agreements in the UK are normally established in combination with FBTs and the example identified by the project is no exception. Most share farming agreements are between an active farming party on the one hand and a landowner, who takes a management role only, on the other. In our example, however, two owner-occupier neighbours, one party having a greater contribution in terms of assets than the other, had formed a share-farming enterprise. One party is younger and eager to operate a larger business, whilst the other is keen to withdraw from full time farming whilst still retaining a managerial interest. As a result of merging the businesses the younger party gained a larger, more viable business whilst the other party benefited through concentrating on their off farm business interests. It is noted that there is a taxation advantage in operating a share farming arrangement compared to simply letting the land under an FBT, since the non-farming party is taxed under

Schedule D case 1 rather than Schedule A. In this example, a 40:60 profit sharing agreement was established, in accordance with the asset contribution rate, but with the major difference compared with the partnership arrangement that profits are assessed after a contract charge, which in this case amounts to approximately £20,000 per annum, has been levied.

### **Incorporation model using a 'service company'**

During the project two service company arrangements were studied, one operated by two tenants and the other by two owner-occupiers. Taking the tenanted model as an example of incorporation, the background is that two tenants on the same county council estate formed a service company. Both tenants wanted to expand their holdings, and when another council farm became vacant the landlord agreed that both tenants could jointly farm the vacant holding. A service company was the preferred option since, at some time in the future, if required, any new council replacement tenant could purchase the shareholding of the farming company. The advantage to the council estate management was that the estate was not further rationalised in that three holdings remained in place thus not contravening council policy. Yet the combined farming business was likely to be more profitable with two operators rather than three because of the achievable economies of scale. This arrangement provides a number of benefits:

- tenants' capital is released from selling surplus machinery;
- the tenants retain their security of tenure;
- the council is able to concentrate investment on one holding;
- the tenants' succession rights is not compromised; and
- there are gains in terms of the efficiency of labour use.

However, on the negative side there are some initial set-up costs, an extra set of accounts has to be administered and, as with any joint enterprise, there is the potential for disputes. A service company is probably the most flexible of all the options, as in many cases where farmers entered into partnerships, these have developed into company structures over time through the growth of the business, simply because of its advantages in terms of tax efficiency.

### **Some Conclusions about the Potential Role of Joint Ventures**

Joint ventures have the potential to make available to the current generation of dairy farmers in Cornwall the *economies of scale* which other regions, and countries such as New Zealand, currently enjoy. This project focussed on the potential for farmer collaboration in *production* rather than in marketing, processing or the purchasing of inputs, and in that sense it was innovative; but the principles of joint ventures can equally be applied to exploit the benefits of vertical integration or even of diversification.

Because of its potential to assist structural change in the industry, in the right circumstances joint ventures may be seen as an alternative to both expanding the farmer's own herd or, worse, to going out of production. The use of a joint venture arrangement has the potential to provide the following benefits to the participating farmers:

- Lead to better economies of scale.
- Allow the improvement and/or re-deployment of production.
- Promote the development of diversification activities.
- Lead to increased leisure time.
- Makes access easier for new entrants.
- Present an alternative exit strategy.
- Make farming more enterprise-focussed.
- Facilitate more environmentally friendly production units.

Although joint ventures are more common in crop production, the study identified a growing interest in its potential to assist dairy farmers to meet the coming challenges. UK dairying will soon be entering a new phase of reduced intervention support and increased competition from world producers. The availability of information on the rationalisation of dairy farming through joint venturing should be seen as an important contribution to the restructuring of the industry.

However, an effective joint venture requires farmers to do a certain amount of 'thinking outside the box' since as this research shows the possible forms a joint venture might take are not necessarily obvious at the outset. Moreover, many UK farmers are still very strongly focussed on self-reliance and, by its nature, a joint venture involves effective collaboration between the farmers concerned in order to optimise the productivity of the resources available, including the human resource (skills and specialisms, both technical and managerial). It is our belief that this form of business arrangement will become more familiar in the UK's farming sector over the coming years, and will prove to be an important means by which farmers are able to benefit from some of the advantages that increased scale and collaboration bring, thereby maintaining their productive involvement in their industry beyond what would otherwise have been possible.



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