

19 June 2019

THE WORLD IS AN INTERESTING PLACE - MR TRUMP, MR XI, BREXIT, MR PUTIN, TRADE WARS, BUDGET FOR WELLBEING, CLIMATE CONTROL, INEQUALITY OF INCOME, INEQUALITY OF ASSETS, ELECTIONS THAT START 18 MONTHS EARLY, LOW INFLATION, LOW UNEMPLOYMENT, LOW INTEREST RATES, SHORTAGE OF HOUSES, LIVING LONGER, EVER RISING HEALTH COSTS, SWINE FLU IN CHINA, ELECTRIC CARS, COAL AND OIL, MELTING ICE, 1,000,000,000 TREES, AND MANY POLITICIANS AROUND THE WORLD WHO COULD NEVER RUN A BUSINESS ON THEIR OWN

THE WORLD IS GETTING MORE COMPLICATED

Every week, somebody asks me something about one or more of these issues referred to above and I am sure you will be finding this also. What I have found that may help with the above - twenty thoughts and comments:

- (1) You and I need to have at least one skill that is top class and have several other skills that are soundly useful and tap into top advice for everything else that we require for our business life - there is no half way house to top advice.
- (2) Develop a passion regarding your business career - expect highs and lows, expect the odd loss, expect that overnight successes can easily become overnight losses, and expect that not everybody will cope and understand your approach, persistence and 'grit' - it will be essential though that your lifetime partner will very much need to cope with all this.
- (3) Keep your emotional actions and financial actions on the same page - a broken marriage will absorb sometimes five years of your financial life - take your time - in my case, I didn't get married until I was 29 years old - but I still ended up with a cracker jack.
- (4) If ever there is a time to live well within your income, then this it is - let us look at a reasonably typical situation for a couple with two children who have a gross combined income of, say, \$120,000 and a house mortgage of, say, \$200,000:

<u>Gross Income</u>	\$120,000	<u>Percentage</u> (2)
<u>Less:</u> Income Tax	\$22,020	18.35%
Personal Drawings (including rates, health insurance, food, car, house costs, family, power, phone etc) say, \$6,000 per month	\$72,000	60.0%
Allowance for Car Replacement (2) every few years	\$5,000	4.17%
Allowance for Unforeseen	\$2,400	2.00%
House mortgage Interest	\$9,000	7.50%
House mortgage Principal (2%)	\$4,000	3.33%
Estimate 'Free Cash' (1)	\$5,580	4.65%
	\$120,000	100.00%
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(Notes (1): Estimated 'Free Cash' for mortgage reduction and/or investment.
(2): Percentage of Gross Income)

- (5) Build your financial reserves, if not every year, then at every opportunity - the USA is a big powerful economy, but a recent survey suggested that if their population received a \$400 unforeseen cost in the mail, that 40% of USA people would struggle with it - you and I need at least 10%, preferably 20%, of our gross income as reserves - today, a hip operation is close to \$19,000 and the annual rest home cost (single) is just on \$52,000.
- (6) Plan on working well beyond 65 years of age - the combined husband and wife gross national superannuation income is presently around \$35,000 which gets you away to a good start but it's almost certainly a long way short of what you will need to live on - a few reminders of annual expenses over and above normal personal drawings will be on average approximately:

Rates	\$2,500
House Insurance	\$2,500
Car Replacement (1)	\$3,000
House Repairs and Maintenance	\$1,500
Travelling	\$6,000
Health Insurance	\$5,000
	\$20,500
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In the USA, the figure they suggest a couple use as their gross retirement annual income is 70% of what their pre-retirement income was - this figure always seemed relatively high to me, but the message probably is not to go below, say, 65%.

- (7) Who would have thought that New Zealand (and the world for that matter) was going to have ten years of low inflation and ten years of low interest rates - Australia though now controls around 85% of the New Zealand banking industry - in any stress testing they tend to suggest you use an interest rate of 6.5% - 7% and a definite annual term debt reduction of perhaps 1.5% - 2.5% a year - if you take the middle road here, then you arrive at an interest and principal figure here each year of 8.75% (6.75% + 2%) - this overall is not too different to what just the interest rates were some 10-12 years ago - make sure when you multiply your term debt by 8.75% that you can still cover the annual cash cost - just when and whether this all comes about is another question again, but do the mathematics, at least, in your head every year.
- (8) You are responsible for your children until, in most cases, they reach, say, 20 years of age - after that, they may stand on their own feet to some degree but that point probably won't apply regarding tertiary education, cars with ABS brakes and air bags, houses and sections. Education is just as important as fertiliser, there is nothing wrong with a \$15,000 - \$25,000 student loan providing they finish the course. Grandparents are usually keen to help with education costs - the key regarding their education is what they learn mainly across the kitchen table - keep your children off motorbikes on the open road - lending your children \$10,000 - \$20,000 when they are in those education years of 18 - 25 years is worth a lot more to them than leaving them \$100,000 - \$200,000 each when you disappear at 90 - 95 years of age.
- (9) Around 25% (my son Paul feels more like 35%) of New Zealand people are poor with their money management - this is a very serious issue and wrecks a lot of lives, not just theirs - our children are coming out of school in many cases with little idea about how financial management and money really work in the real world. Compound interest is much more important than Shakespeare - being on the wrong side of compound interest for any length of time is very unsatisfactory, but we are not doing much about this - our education system just does not seem to cope with it or learn from it - 80% of the retired accountants, financial planners and bank managers in New Zealand could mentor small groups on a regular basis around every secondary school in the country. The writer handles a few business liquidations each year - in many cases, a liquidation also involves a marriage break up at the same time. The importance of sound financial management is very close behind breathing.
- (10) Listen to the good operators, learn from them, invest in their experience - the 'why' they did things is more important than the 'how' they did things. Many years ago, the writer spent most of three years 'troubleshooting' farming couple financial problems - the first issue I had to deal with was that I was about half their age - I was the boy. The second issue was that in many cases they did not listen and did not want to listen - I developed several key approaches to these two issues, but for some their way was how dad and grandad did it, they blamed their stock firm manager and the bank manager for the present financial mess they were in (at that point, there was a lot of joint lending by banks and stock firms). They often had 'iron disease', were poor with money, didn't like farm advisors or accountants or solicitors. Many of these operators went to the wall and I couldn't do anything about it - in many cases, their wives were much more realistic and prepared to listen.

Many people in business can talk the talk well, but much fewer can actually walk the walk well - be prepared to listen to the right people at all times and question them - some good farmers are not articulate, but can answer questions very well. Recently in a trip in Texas, an old farmer at a farm machinery sale said 'the machinery owner is all hat and no cattle' - a saying that has been around for a long time.

- (11) Some expenses are increasing each year at a much higher rate than the inflation rate - such as health insurance, general insurance and rates - not much you and I can do about this except be constantly aware of it - if these cost increases average, say, 6% a year on a compound basis, this means in 12 years, the whole annual cost has doubled - we need to have our insurance costs probably requoted every two years. Government charges, council charges and regulatory charges all increase each year at a higher rate than inflation - this is another bad feature.
- (12) It is all very well for the science fraternity to keep hammering on about the escalating and enormous potential cost of climate change - an equally important issue is who is going to pay for it all - recently I noted a figure of \$100 billion being broadly referred to as a New Zealand cost - sooner or later, it will end up being funded mainly from increased income taxes. These are around 1,500,000 households in New Zealand - let's say 750,000 of those households could never cope with a major tax increase - this leaves \$100,000,000,000 to spend amongst 750,000 households of around \$133,000 each. Spreading the cost somehow over, say, ten years would ease the pain, but could still be unworkable - it is no wonder that when one talks to politicians about it, they just keep adding to the noise - certainly it may come about, but blindsiding the financial side is not an approach - the first political party that starts talking potential truth like this will probably be out of business by nightfall.
- (13) The central Plain Irrigation Scheme is an impressive piece of engineering measured from any point of view. But the annual water cost including some ongoing consent and monitoring is getting close to \$1,000 per ha each year which is beyond sheep and beef and many cropping operations from a whole farm perspective - certainly irrigating a smaller area still has a value and a place, but it is a little like the saying that 'the operation was successful but the patient died'.

Let's take a look at a 300 ha cropping farm with 280 ha irrigated from the scheme with a mortgage of, say, \$5,000,000 and a company structure - what does the income and expenses look like?

<u>Income</u>			
280 ha at, say, an average of \$4,500 per ha		\$1,260,000	
Plus some sheep/cattle net income (say)		\$50,000	
			\$1,310,000
<u>Expenses</u>			
Farm Working Expenses (41.6% of Gross Farm Income)	} 63% of GFI	\$545,300	
Water charges (\$1,000 per ha)		\$280,000	
Interest: Current Account		\$10,000	
Interest: Term Loan		\$225,000	
Depreciation/Replacement (Vehicles and Plant only)		\$78,750	
			\$1,139,050
<i>Estimated Management Net Profit (\$570 per ha)</i>			\$170,950

Estimated Disposition of Net Management Profit

Shareholder Salaries (say)	\$100,000	
Income Tax: Company	\$19,870	
Income Tax: Shareholders	\$21,590	
Allowance for Unforeseen	\$6,000	
Term Debt reduction (say)	\$20,000	
Estimated 'free cash'	\$3,490	
		\$170,950

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What is the bottom line here?

- (a) There is around \$12,000,000 of gross assets involved.
 - (b) The return on total farm capital employed is around 2.54%.
 - (c) The Company is a fair way short of covering, say, a 1% - 2% annual mortgage repayment of \$50,000 or \$100,000 which could start to become a minimum in practice.
 - (d) The mortgage interest rate used is 4.5%.
 - (e) With a net equity of around \$7,000,000, there is nothing like enough falling out the bottom here.
- (14) Are you and your spouse getting job satisfaction - if not, why not? Whose fault is it? Some farming couples can get job satisfaction even when they are making losses - this is a real test - it is not something that would apply in many urban type businesses. If you are not getting job satisfaction then what are you doing about it?
- This is important because an absence of job satisfaction and profits don't travel together well.
 - Are you working in the business or on the business?
 - Are you always busy, busy, busy?
 - Can you contract out part of the business that you don't enjoy and probably as a result you don't do well?
 - Can you reduce the scale of the business?
 - Can you leave out parts of the operation?
 - Could you lease out the whole operation?
 - Could you use contractors a lot more?
 - Could you sell the farm but retain the house and, say, 4 ha and both get jobs locally?
 - Could you lease the farm but retain the house and, say, 4 ha and both get a job locally?
 - Could you sell the farm, purchase a house in town and both get jobs locally?
 - If everything was sold, does the idea of purchasing or building up a business from scratch appeal?

Not getting job satisfaction for a large section of your life will be frustrating for you, hard on family and will mean that you will certainly not reach your potential.

- (15) If the world climate heats up in some major populated areas, which is predicted, then that will create violence, anger, reduce food availability, promote fighting and there could be major famine issues and major civil unrest. New Zealand can produce enough food for maybe ten times our present population, that is 50,000,000 people - where is all of this leading to?
- Immigration issues will intensify
 - Fresh water will be gold
 - Growing own vegetables will come again
 - Protectionism in trade will come again
 - You can forget about wellbeing - just being will be enough
 - Seeds will become more important
 - Keeping old gear going will be a new skill
 - World trade growth will reduce sharply
 - Every backyard will have poultry running in it

Is all of this a bit extreme? Probably yes, but much of Africa is going through this right now - the international monetary fund lists around 12 countries where civil unrest is close to the surface, food is short, profitability is weak, fresh water is an ongoing issue, there are many more guns than toilets, health problems never cease, population pressure is never-ending and good political management is in very short supply and almost certainly corrupt as well - the population of China, India and Africa is increasing at a rate close to the whole of Auckland's population every week.

(16) Sooner or later, New Zealand's politicians will come to realise that not everyone in New Zealand will be able to own their own house and section or apartment or cottage - to date, it has not been PC to say or talk like this. There will always be about 25% - 33% of New Zealanders that will always be long term renters - we need to plan for this and make sure that tenants are protected, like Germany, with sensible and reasonable rental laws regarding security of tenure and rent etc. By all means, let's help New Zealand people purchase their own homes because history would suggest it is a very good move - there are 1,500,000 households in New Zealand - about 550,000 (37%) of these households at the moment are renters. Right now in the New York state of USA, there is major laws being passed affecting approximately 1,000,000 apartments - all towards giving tenants more security or tenure and limiting landlord's power, etc.

(17) It is interesting how the life longevity for New Zealand people and most other developed countries has gradually crept up - close to two months a year for many years now. What country has the highest life expectancy at birth - Monaco, at 89.52 years (New Zealand is 81.61 years). What country is the lowest - Chad at 49.81 years. If a man reaches 75 years, he has further expectancy of approximately 11 years. If a woman reaches 75 years, she has further expectancy of approximately 13 years. If you look at your life history and how it is split - it could be something like this:

(a)	From birth to, say, 20 years of age	23.26%
(b)	From 20 years of age until 70 years of age	58.14%
(c)	After 70 years of age to, say, 86 years	18.60%
		100.00%
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That is:	23.26%	getting warmed up and learning
	58.14%	in work
	18.60%	in play and pain
		100.00%
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On the basis of the above, a New Zealand couple from 65 years of age to 86 years of age are going to pull (in today's dollars) some \$735,000 gross from the New Zealand National Superannuation Scheme - maybe the value of a moderate Auckland house.

(18) Where are you likely to get the most productive efficient service from - from someone who has significant 'skin in the game' - if someone or some business with skin in the game makes a loss - they have to cover the loss themselves - not the Government or Council or some regulatory authority - there are a few things the government and their swamp can do better than private businesses - but not many. Competition tends to keep good businesses and good business people honest, efficient and sustainable.

What will the media be pushing hard at you over the next 12 months:

- Irrigation issues
- Lack of Income at the point of retirement
- Trump, Trump, Trump
- Rising sea levels
- The costs of climate control
- The costs of not doing much re climate control
- Electric cars
- Inequality of income
- Inequality of assets
- China, Iran, Venezuela, UK, EU and Italy
- Trade wars and protection
- Carbon credits
- Africa - worst drought ever
- Budget Wellbeing is starting to show that being good with money is second only to breathing
- Trees and sheep - which do you want
- Hemp
- Universal basic income

(19) A few thoughts and comments regarding present and possible future issues:

- (a) When something like housing becomes, for example, uninsurable in, say, low lying coastal areas, it will then become non-bankable - this is coming in some key areas around the world.
- (b) I am surprised that our Reserve Bank wants to increase the financial reserves for all banks to cope with a one in 200 event - perhaps the best outcome of this, if it must happen, would be to spread the increased cost of our bank's building these reserves over, say, a ten year period.
- (c) New Zealand needs an inflation rate of somewhere around 2% a year - the present rate is 1.5% - over the period from 2000 to 2019 the CPI (Consumers Price Index) has averaged 2.7%. What country has presently the highest inflation rate - Venezuela at 653%. Quite a number of countries are below zero as an inflation rate - China is around 3% - Singapore is below 1% . Residential rent have been increasing at a faster rate than inflation - presently at around 3.4% a year.

Current world wide central bank interest rates:

USA	2.5%
UK	0.75%
Australia	1.25%
Brazil	6.5%
Canada	1.75%
China	4.35%
Europe EU	0.00%
India	5.75%
Japan	0.1%
Mexico	8.25%
Russia	7.5%
Turkey	24.0%
New Zealand	1.5%
Norway	1.0%
Sweden	-0.25%
South Africa	6.75%
Saudi Arabia	3.0%

Probably the interesting point here is that eight of these central banks (47%) have an interest rate below 2.0% such that in the situation of another worldwide recession, they would have very little room to move regarding a drop in their interest rates - the EU rate is nil.

- (d) Lending money to your bank is fine because you will almost certainly get your principal back, but your interest return is very marginal - it would look as follows with, say, a \$100,000 deposit for a 12 month term:

Interest return (\$100,000 at 3.2%)		\$3,200
Less: Income Tax (say 20%)	\$640	
Less: Inflation Loss on Capital Involved of, say, 2%	\$2,000	
		<hr/>
		\$2,640
		<hr/>
Estimated 'real' return (0.56%)		\$560
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Anything you lend to your bank like this should only be short term - debt reduction is a much better investment because you are probably saving between 5.5%.

- (e) The average Auckland house in 2018 cost \$862,000. The average New Zealand house in 2018 cost \$560,000. Around 25% of New Zealand house sales/purchases take place in Auckland. By deduction, the average New Zealand section value involved with the house cost of \$560,000 is around \$214,000. While there may need to be an improvement in tenant security of tenure etc I don't feel Government or Councils should get involved in housing - let the private investors fund own and maintain the New Zealand house rental stock - owners with 100% skin in the game will handle this much better than Government and Councils.
- (f) The two biggest trading risks for New Zealand are Australia and China - they take 14.8% and 24.9% respectively (\$5.7 billion plus \$9.6 billion) of New Zealand's exports - the next biggest is the USA at \$3.7 billion (9.6%). Both Australia and China are a little bit accident prone from a New Zealand perspective, hence my risk comment.

- (g) Interest rates will turn upwards in due course as will pressure from our Australian banking masters to start repaying our mortgage principal on a regular annual - if not monthly - basis. Hopefully nothing significant will alter here over the next few years, but when it does, make sure you can service about 8.75% a year regarding your bank debt - that is, say, 6.75% interest and, say, 2% loan principal.
- (h) It is hard to see anything, but a rise in New Zealand Income Tax rates over the next few years - the hardest workers and the highest earners will end up paying more, although politically this will be well camouflaged.
- (i) The business returns on total business capital employed in agriculture needs to be a minimum of 5% - this allows for interest paid and a market value for the manager's input - not many farming couples presently reach this figure - what is required to achieve this given, say, a gross income generated of \$1,000,000 and a gross asset value of around \$6,000,000 with a \$3,000,000 Bank Term Debt:

<u>% of GFI</u>	Gross Income (say)		\$1,000,000
55.0%	Less: Farm Working Expenses (Note (1))	\$550,000	
14.0%	Less: Interest (say)	\$140,000	
4.5%	Less: Depreciation Vehicles and Plant (say)	\$45,000	
7.5%	Less: Management Input (say)	\$75,000	
		<hr/>	\$810,000
19.0%	Net Management Profit/Surplus		<hr/>
			\$190,000
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100.0%			
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(Note (1) This is a key issue as this figure is currently around 63% for most farm types.)

On this basis, the return on capital is just on 5%, but it would want to be with \$6,000,000 of assets employed - inject your own most recent data and see how you compare, particularly with the left lane percentage column.

- (j) When a person's down in the world, an ounce of help is better than a pound of preaching.
- (k) Sometimes people who need help look nothing like people who need help.
- (l) Often the best way to lift yourself up is to lift someone else up.
- (m) The USA and China are at war (trade-wise). In 2017 the USA had 2,500 of its McDonald's quick service restaurants in China - another 300 were added in 2018, bringing up a total of 2,800 stores - their plan is to get to 4,500 stores in China and Hong Kong by 2022 - another four years. China presently takes 36% of New Zealand's beef tonnage exports.
- (n) Never forget that with agriculture, "production is vanity and profit is sanity". At around 93% of your potential productivity, you will find you have reached a maximum sustainable profitability - beyond this, there is a very good chance your last 7% of marginal income will be matched or more than matched by that last 7% of marginal expenses - operating at 100% of everything is asking for trouble even for the very top operators - stress, strain, errors and people errors start to set in around 93%.



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- PS: (1) If in doubt deposit in your own bank and dance.
(2) Kick first, kick fast, kick hard and kick last – it sounds like Trump.