Horticulture Australia

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Horticulture Australia Limited

BUSINESS CASE

Property Relocation. Part B

Horticulture Australia

"The Vegetable Industry Development Program is funded by HAL using the vegetable levy and matched funds from the Australian Government".

Content

Business Case
PROPERTY RELOCATION. PART B

What is a business case?

A business case is a formal process of planning to provide the decision-maker with useful information to help them make a decision. You will have greater confidence in your decision, if you use a formal process and make sure you count the right things the right way, whilst also considering the things that cannot be counted.

Thinking about expanding or relocating the farm?

In many parts of Australia, vegetable growers are faced with a difficult decision. Whether they should sell the property and buy another property because their properties are often crowded out by residential subdivision.

From time to time, vegetable growers contemplate expanding the farm or relocating the farm, or sometimes a combination of both with an additional farm at a different location.
The reasons for this occurring are numerous and include: difficulties at the existing location, accessing different soil and water resources, or simply expanding production.

It is important to carefully consider the question of 'why?' you are expanding or relocating, and ensure that your decision helps achieve that purpose.

What is the decision?

The decision is to expand production to a new area or to relocate the existing farming activities to a new property.

This decision needs to be made in two stages and is outlined in the PART A and PART B components of this business case. This first component or PART A is a checklist of the issues involved in moving or expanding to a new location.

The PART B component of the business case provides an indication of how much land can be purchased for the sale value. For example, a grower said "I could buy ten hectares for one sold here". However, if new infrastructure is required, or the productivity of the new farm is not as good or needs to be improved, the decision needs to be carefully considered. A full business case may also be needed to obtain finance for the property.

What do you have to count?

Depreciation

An investment in new infrastructure will increase the grower's depreciation. This is not a cash cost, but a critical allowance to make when calculating profit. If you do not account for depreciation, then you will not have any money available to maintain or replace the infrastructure when needed.

Cost of capital

An investment in new infrastructure also means that the grower will need to use spare cash or increase borrowings to pay for the land, development and machinery. Thus, they need to consider the cost of capital. The cost of borrowed capital is obvious (i.e. the interest cost), but the cost of your own capital is less so. Why should you value it any less? If you spend money on developing a new block, then there will be other things you cannot do with that money, e.g. employ someone to do your marketing, pay less overdraft interest, improve existing irrigation systems. Thus, your own capital has a value too. It is known as its opportunity cost.

Productivity advantages and disadvantages

The grower needs to consider the agricultural productivity when moving a production system to a new area or soil type. This may mean that more crop is able to be grown on the land due to increased sunshine or lower water salinity at the new site. Alternatively, it could mean less productivity due to soil management problems.

Likely income and costs

It is important that the grower really understands the income and costs of the existing enterprise to determine the financial impact of expansion or relocation. Many of the costs will be similar to the existing production system, however some of the income (productivity) may change to produce a different financial result.

The scenarios

There are many considerations for vegetable growers when contemplating a move or expansion to a new area.

This business case examines two separate scenarios relating to property relocation.

Scenario A: a grower who currently has 20ha of productive land and looks to relocate to an 80ha parcel of land further out from the urban fringe.

Scenario B: a grower who currently has 20ha of productive land and looks to purchase an additional 30ha of land to make a combined land area of 50ha for vegetable production.

How do you calculate it?

The following tables show how you can calculate the decision. The information you need is:

- The land values of the existing property and the new property
- The selling costs and buying costs
- The cost of developing the new property
- The likely productivity and income achievable from the new property.
- The interest costs or cost of capital that applies to the new property.
- The depreciation component of the improvements on the new property.

If you estimate each of these then you can make a quick assessment.

Scenario A:

This table outlines the capital costs associated with Scenario A; where a grower sells the existing property and moves to a new location.

PROPERTY RELOCATION			
CAPITAL	CURRENT	NEW	CHANGE
Area (ha)	20	80	60
Value per hectare ($/ha)	50,000	15,000	-35,000
Total value ($)	1,000,000	1,200,000	200,000
Transaction Costs			
Selling ($) Buying ($)		30,000 36,000	
Development cost ($)		500,000	500,000
Total capital value ($)	1,000,000	1,766,000	766,000
Extra capital required ($)		766,000	766,000

The assessment of Scenario A Capital describes:

- Land costs of $50,000 per hectare for the existing property and a purchase price of $15,000 for the new property.
- A total land value at sale/purchase price of $1,000,000 and $1,200,000 for the existing and new properties respectively.
- Land transaction costs of $30,000 for selling the existing property and $36,000 for purchasing the new property.
- A capital requirement of $500,000 for developing the new property with irrigation and shedding infrastructure.
- A requirement for an additional $766,000 of funds to complete the transaction and have the new property ready for cropping.

A requirement for an additional $766,000 of funds to complete the transaction and have the new property ready for cropping.

The next table demonstrates how to calculate the profitability of the transition to the new property.

PROFIT/LOSS	CURRENT	NEW	CHANGE
Income per hectare ($/ha)	20,000	15,000	-5,000
Total income ($)	400,000	1,200,000	800,000
Operating costs (% of income)	60%	60%	0%
Operating costs ($)	240,000	720,000	480,000
Operating surplus ($)	160,000	480,000	320,000
Extra interest @ 8% ($)		61,280	61,280
Depreciation on improvements ($)	30,000	50,000	20,000
Cash surplus/deficit ($)	**130,000**	**368,720**	**238,720**
Return on capital	**13%**	**21%**	**8%**

The Profit/Loss calculations for Scenario A describe:

- An income per hectare of $15,000 for the new property compared with $20,000 for the existing property – this is the assessment of the productivity on the new site.
- A total income of $1,200,000 for the new property compared with $400,000 for the existing property.
- An assessment of operating (variable and overhead) costs at 60% of income achieved in an average year.
- An operating surplus (income minus costs) at $480,000 for the new property and $160,000 for the existing property.
- The interest or cost of capital component of the new property, which is $61,280 – this is 8% of $766,000, taken from the capital table.
- The depreciation component of infrastructure at $50,000 for the new property and $30,000 for the existing property.

The analysis demonstrates that:

- A surplus (after extra interest and depreciation) of $368,720 can be achieved on the new property compared to the current amount of $130,000 on the existing property.
- A return on Capital from 13% to 21%, or an improvement of 8% will be realised from the current to new property. This figure is calculated by dividing the cash surplus by the total capital value figure from the capital table.

Scenario B:

The following table outlines the capital costs associated with Scenario B; where a grower who has an existing property looks to purchase additional land and expand their business.

PROPERTY EXPANSION			
CAPITAL	CURRENT	NEW	COMBINED
Area (ha)	20	30	50
Value per hectare ($/ha)	50,000	15,000	
Total value ($)	1,000,000	450,000	1,450,000
Transaction Costs			
Buying ($)		13,500	
Development cost ($)		200,000	200,000
Total capital value ($)	1,000,000	663,500	1,663,500
Extra capital required ($)		663,500	663,500

The assessment of Scenario B Capital describes:

- Land costs of $50,000 per hectare for the existing property and a purchase price of $15,000 per hectare for the new property.
- A total land value of $1,450,000 for the existing and new property combined.
- Land transaction costs of $13,500 for purchasing the new property.
- A capital requirement of $200,000 to develop the new property with irrigation and shedding infrastructure.
- A requirement for an additional $663,500 of funds to complete the transaction and have both properties ready for cropping.

The next table demonstrates how to calculate the profitability of expanding the enterprise with the new property.

PROFIT/LOSS	CURRENT	NEW	COMBINED
Income per hectare ($/ha)	20,000	15,000	17,000
Total income ($)	400,000	450,000	850,000
Operating costs (% of income)	60%	60%	60%
Operating costs ($)	240,000	270,000	510,000
Operating surplus ($)	160,000	180,000	340,000
Extra interest @ 8% ($)		53,080	53,080
Depreciation on improvements ($)	30,000	20,000	50,000
Cash surplus/deficit ($)	**130,000**	**106,920**	**236,920**
Return on capital	**13%**	**16%**	**14%**

The Profit/Loss calculations for Scenario B describe:

- An income per hectare of $15,000 for the new property compared to $20,000 per hectare for the existing property, resulting in an average of $17,000 per hectare.
- A total income of $850,000 across both properties.
- An assessment of operating (variable and overhead) costs at 60% of income achieved in an average year.
- An operating surplus (income minus costs) of $340,000 across both properties.
- The interest or cost of capital component for the new property, which is $53,080 – this is 8% of $663,500, taken from the capital table.
- The depreciation component of infrastructure at $50,000 across both properties.

The analysis demonstrates that:

- A surplus (after extra interest and depreciation) of $236,920 can be achieved compared to the current amount of $130,000.
- The return on capital will change from 13% (current) to 16% (new), or an average of 14% across both properties. This figure is calculated by dividing the cash surplus by the total capital value figure from the capital table.

What else is important?

Unmeasurable benefits and costs

Markets – growers were very reluctant to move to a larger property unless they were very clear that they had a market for the extra produce.

Cost of improvements – the cost of developing a new property can be significant. It is important to estimate all of the costs carefully. Remember, that it is likely that those extra improvements on the existing property will become difficult to justify, if the land is not going to be used for vegetable production.

Moving away from community – sometimes when a grower sells and buys a new property, they move away from family and friends and will find adjusting to the new community difficult.

A more detailed business case

If the quick calculation you do, using this business case, is positive, then the next step is to produce a more detailed business case. The extra information you will need to produce this business case includes, but may not be limited to:

- An estimate of income and expenditure for 5 years
- A more detailed assessment of the development costs
- Discussions with people who know the area you are moving to well and can advise you of the risks
- Discussions with your financier to establish financing terms
- Consideration of labour requirements and decisions about who will manage the property and how it will be managed.

All of this information can be put into a business plan, which will assist in obtaining finance if required. Refer to PART A of this business case for a checklist of the issues involved in moving or expanding to a new location.

Disclaimer

This business case was produced and edited by RMCG (ph: 03 9882 2670). RMCG produces these business cases with the expectation that users exercise their own skill and care with respect to its use. Before relying on or altering any business practices, users should carefully evaluate the accuracy and relevance of the information for their purpose and should obtain appropriate professional advice relevant to their particular circumstances.

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