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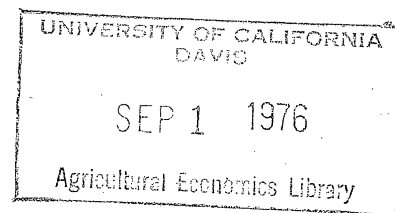
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Partnerships



ABSTRACT

NEW EQUITY: A LOOK AT TEXAS AGRICULTURAL LIMITED PARTNERSHIPS AND THE INVESTORS WHO FUND THEM

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and Donald R. Levi*

Data drawn from certificates of limited partnership and two independent surveys relate the number, kind and character of limited partnerships investing in Texas agriculture. Also set forth is a socio-economic profile of limited partners investing in such funds as well as an overview of their investment objectives.

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NEW EQUITY: A LOOK AT TEXAS AGRICULTURAL LIMITED
PARTNERSHIPS AND THE INVESTORS WHO FUND THEM

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Although the statutory origins of the limited partnership have been well founded in the United States since the 1820's, the use of the limited partnership as a business organizational form remained relatively obscure until after World War II. Since the mid-1960's the limited partnership has been an increasingly popular and important vehicle for the investment of "outside" equity capital in agriculture. The empirical research results set forth in this paper attempt to (1) define the number, kind, and character of agricultural limited partnerships in the State of Texas, and (2) determine the socio-economic profile of the limited partners as well as their objectives in funding various Texas agricultural enterprises.

The data used in this analysis are drawn from three sources. First, the information relating to the partnership itself was drawn from the certificates of limited partnership on file with the Texas Secretary of State. Two independently administered questionnaires provided the basis for the data relating to the limited partner investors. The first questionnaire, referred to hereafter as the primary survey or questionnaire, was mailed to all limited partners investing in Texas agricultural limited partnerships (including cattle feeding partnerships) from 1966 through 1974. The secondary questionnaire, much like the primary in structure and content, was mailed to a representative sample of limited partners contributing to Texas cattle feeding operations from 1972 through 1974.

Year of Investment

Over 75 percent of the respondents to the primary questionnaire

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indicated one of the years 1970-74 as being the date of their first limited partnership investment. Likewise, although respondents to the cattle feeding fund questionnaire described investments in feeding operations as early as 1951, over 98 percent began funding feed lots after 1970.

Certificates of limited partnership on file with the Secretary of State reflect a general increasing trend in the number of agricultural limited partnerships formed annually from 1966 to 1974. The number of certificates filed rose from a 1966 total of nine to a high of 60 in 1972 before falling to 52 in 1973 and only 41 in 1974. This trend was paralleled by the fall in the annual number of cattle feeding fund subscribers from 198 in 1973 to only 37 respondents who began in 1974. The sudden down turn in the general upward trend is attributed to adverse market conditions and spiraling feed prices which forced the liquidation of many custom feeders and discouraged investment in breeding and feeding operations which compose a majority of Texas agricultural limited partnership operations.

Current Participation

Over 91 percent of the respondents to the primary survey who had invested between 1966 and 1975 were currently participating in at least one limited partnership syndication. (About nine percent had liquidated or otherwise disposed of their limited partnership investment(s) at the time of the survey.) Of the 429 cattle feeding fund contributors responding to the questionnaire, only 66 percent or two-thirds of the 1972-1974 consignors continue to feed cattle under a limited partnership arrangement indicating that the termination rate was considerably higher for feeder operation contributors than for funders of the broader range of agricultural partnerships sampled by the primary questionnaire. Forty-four percent of the primary

survey respondents were participating in more than one agricultural limited partnership whereas only 22.2 percent of the cattle feeding partners were participating in more than one feeding fund.

The Prospectus

Seventy-two percent of the partners returning the primary questionnaire and 82.5 percent of the feeding fund contributors deemed the information provided in the prospectus sufficient to allow them to make informed investment decisions. Among the most frequently mentioned shortcomings of prospectuses presented to fund contributors were:

- 1) The inadequate or misleading representation of the financial risk inherent with the business.
- 2) The inadequate explanation as to the nature and limits of the enterprise being undertaken.
- 3) The lack of limitations on the power of the general partners.

Partner Satisfaction and Future Investment Plans

When asked to express the relative degree to which partnership investments fulfilled their portfolio needs and financial expectations, 37 percent of the investors responded with "satisfactorily" or "very satisfactorily". Nineteen percent of the respondents to the primary survey classified their respective ventures as "fairly" satisfactory while 35.1 percent rated their limited partnership investments as either "rather" unsatisfactory or very unsatisfactory.

The investors' plans to continue current programs were directly contingent upon the degree to which the investment fulfilled the partners' investment needs and expectations. Too, limited partnership contributors indicated that future investment plans would be highly sensitive to any changes in

federal tax regulation. Questionnaire responses indicated that over 50 percent of the partners plan to maintain their partnership investment under current Internal Revenue Service regulations. Only 30.9 percent, however, would retain their interest in the funds should the Revenue Service implement limitations on artificial accounting losses such that losses derived from agriculture could not be deducted from non-agricultural income for tax purposes. These survey results strongly suggest that the tax benefits available through the limited partnership structure are major criteria for investment.

Advantages of Limited Partnership Organization

Tax ramifications were also cited most often as the advantage limited partnerships held over other organizational structures. Over 40 percent of the investors surveyed considered the tax savings opportunities to be an organizational advantage unique to limited partnerships. Other advantages particularly appealing to investors included characteristics of 1) limited liability, 2) ability of fund to pool capital, 3) simplicity of fund formation, 4) lack of limited partners management responsibility, and 5) facilitation of family property holdings.

Investment Criteria

Respondents to both questionnaires were asked to rank those characteristics of the limited partnership in the order of their importance as they related to their investment requirements. The relative ranking of those investment criteria describe the objectives of the limited partners as well as their motives in selecting the limited partnership organization.

In the primary survey, potential return on investment proved to be the single most important investment criterion. Potential return was followed closely by tax considerations and limited liability.

The secondary survey results were similar to those of the primary questionnaire. In the case of the cattle feeding partners, "tax considerations" exceeded "potential for return to net income" in importance as a criterion for investment. In both studies, the characteristics of "limited liability" and "ability to pool capital" ranked third and fourth respectively in the aggregate analysis.

Frequency distributions relating investment criteria by investor income reflect the increasing importance of tax considerations as incomes rise. The questionnaire administered to all agricultural limited partners revealed that only 21 percent of the partners with incomes under \$40,000 listed tax considerations as their number one investment criterion. Nearly 86 percent of the respondents, however, earning \$200,000 and over, tagged tax incentives as their first consideration. Cattle feeding fund contributors classifying the tax incentive as most important ranged from about 43 percent for the "under \$40,000" income group to nearly 87 percent for those investors earning \$200,000 and over.

Investor Income

Because of the nature of the investments themselves and the investment incentives provided by the progressive income tax structures, limited partnerships tend to attract contributors from high income brackets. Only 16.8 percent of the cattle feeding limited partners and 26.6 percent of the agricultural limited partnership respondents earned gross incomes of less than \$40,000 annually. Most of the investors fell into the \$40,000-\$120,000 annual income range while less than 20 percent of the respondents to either survey earned over \$120,000 per year.

Limited Partner's Age and Investment Experience

The age distribution of the respondents was nearly identical for both

groups of partners surveyed. As was expected and consistent with the tax shelter motive for investment, the largest group of investors were aged 45 to 64, the age at which incomes tend to be highest and limited partnership tax shelters are, therefore, most attractive. Nearly 70 percent of all the investors were age 45 or older.

Bearing a positive and direct relationship to the partner's age was the partner's degree of experience in managing personal investments. Over 60 percent of the partners responding to the primary questionnaire had 10 or more years of experience in maintaining personal investment portfolios. Nearly 31 percent had maintained investments (other than savings accounts) for more than 20 years. Less than 20 percent of the partners had held portfolios for fewer than five years. Although the empirical evidence does not establish these partnership contributors as skilled investors, it does indicate that these persons, for the most part, are not investors without experience in management of personal investment portfolios.

Investor Occupation and Investment Advisor

The surveys of Texas agricultural limited partners and cattle feeding fund subscribers both revealed that medical practitioners comprised the largest single occupational category among investors. Physicians and dentists made up 18.2 percent and 19.3 percent of the respondents to the respective primary and secondary surveys and outnumbered investors in all other occupations participating in feeding funds by a two to one margin. Among other groups who subscribed heavily to agricultural partnerships were farmers and ranchers who comprised 17.6 percent of the respondents and represented the only major group of "blue collar" workers in funds heavily dominated by white collar and professional people. In the case of the

feeding fund subscribers, no single occupational category other than medical practitioners composed more than 10 percent of the total.

Evidence indicates that the most sought after advice when considering an agricultural limited partnership investment was that of a stockbroker. Over 58 percent of the cattle feeders and 41 percent of the primary survey respondents consulted their stockbroker before investing. Financial investment firms advised 22 percent and 19.5 percent of the respective groups of limited partners. Attorneys and CPA's were also among the professional financial advisors frequently consulted.

Nearly half of the contributors to agricultural limited partnerships consulted more than one financial advisor prior to investing. Over 11 percent of the primary survey respondents relied totally on their own investment analysis and did not seek professional advice before initiating their partnership venture.

Return on Investment

The anticipation of any economic return to a partner was dependent to some degree on the business enterprise in which the partnership engaged. A large portion (85.7 percent) of the partners engaged in diversified farming activities were anticipating a positive net return whereas only 31.4 percent of the contributors to cattle breeding and stocker operations expected an annual net profit. Less than half (49 percent) of the total number of investors in agricultural limited partnerships were anticipating a positive net return. In addition, 20.8 percent of the total number of partners were expecting a return of not more than 10 percent. The fact that nearly 70 percent of the partners anticipated little or no net return from their investment (while only 39.5 percent of the contributors felt the partnership unsatisfactory in fulfilling their portfolio needs and financial expectations) should again

suggest tax shelter ramifications as the motive for investment.

Partnership Activities

A study of the certificates of limited partnership filed in Texas from 1966 through 1974 revealed that nearly 70 percent of agricultural limited partnerships established in those years are engaged in cattle feeding or cattle breeding and stocker operations. A total of 25 limited partnerships or 9.3 percent were classified as diversified farming operations while 3.7 percent engaged primarily in the production of grain crops. All other enterprises constituted less than 18 percent of the total number of partnerships established during that nine year period.

Number of Partners and Value of Funds

Nearly half (48.7 percent) of the limited partnerships studied had five or fewer limited partners. An additional 17.9 percent had 10 or fewer. Analysis also reveals a significant difference in the mean number of limited partners in varying enterprises. Grain production and animal specialities, for example, averaged only 2.5 and 2.3 limited partners respectively per fund. Fruit and tree nut operations, on the other hand, averaged 12.4 contributors per partnership while cattle feeding funds attracted an average of 38.8 investors each. (The broad range of these figures stems primarily from the varying capital requirements of each enterprise as are often dictated by efficiencies of operation associated with economies of size.) Despite this variability, a large portion of the partnerships have a relatively small number of limited partners.

There is also evidence to support the assumption that there exists both a positive and direct correlation between the number of contributors and the value of the fund. The capital contributions to each fund ranged from \$40 to over seven and one quarter million dollars. The combined partnership

Investments over the 1966-1974 period totaled approximately \$110 million.¹ The average value of all partnership funds was \$414,083. The mean values ranged, by enterprise, from \$400 (horticultural crops) to over \$789,000 for businesses engaged in fruit and tree nut operations. Also among the largest funds were those dealing in cattle feeding. Those 90 partnerships arranged total capital contributions of approximately \$746,400. Nearly 60 percent of the partnerships fell into either the \$25,000-\$100,000 or the \$100,000-\$500,000 category. Twenty percent of the organizations held capital contributions of \$25,000 or less. Composing only about 20 percent of the total partnerships but controlling a giant share of the total dollars invested were funds over one half million dollars in value.

Just as most of the partnerships had relatively few limited partners so also did they have relatively few general partners. Over 77 percent of the organizations were managed by only one general partner. An additional 15 percent operated with only two managing parties while only eight percent had three or more. There appears to be no significant relationship between the number of general partners and the value of the fund.

Identity of the Partner

Data were drawn from certificates of limited partnership (1) to determine whether the partnerships' general partners were individual proprietors or corporations or both; (2) to identify the general partners

¹Based on actual contributions as recorded in certificates of 261 partnerships. Missing data on eight funds were developed using the mean fund value of the organizations engaged in that enterprise.

as either Texas residents or nonresidents; and (3) to determine whether general partners were also participating in the same fund as limited partners.

Findings associated with the first objective revealed that 52.6 percent of the participating general partners were individual proprietors and 41.4 percent were corporate partners. In 5.2 percent of the organizations both individuals and corporations were participating as general partners.

The chi-square test detected a positive association between the partnership enterprise and the status of the organization's general partner. The relationship is discernable at the 10 percent level of significance. Those partnership activities which appear to be dominated by funds with individuals as general partners include animal specialities, diversified farming, and enterprises classified as "other nonproduction agricultural activities." Likewise, over 60 percent of the cattle breeding and stocker operations were directed by individuals serving in proprietorship roles. Cattle feeding funds, on the other hand, were dominated by a two to one margin by corporations serving as general partners.

Partnership filings also revealed that more than two-thirds of the funds' general partners were nonresidents. Over 67 percent of the managing partners maintained business and/or residence addresses outside Texas while approximately 23 percent of the partnerships were headed by Texas residents. Composing 5.2 percent of the total were organizations having two or more general partners who were divided as to their residential classification.

Data from certificates of limited partnership show that 65 percent of the general partners directing partnership affairs also participate in those same funds as limited partners. Less than one-third (31.7 percent)

act only in a general partner capacity. The remaining three percent of the organizations have some general partners who participate only in a general partner role and some who also participate as limited partners. Grain producing and cattle breeding and stocker operations had the highest rates of dual participation as 90 percent and 73 percent of their respective general partners also appeared on the certificates as contributing limited partners.

In Conclusion

Although a relatively new equity source in the broad field of agricultural production, the limited partnership has quickly become a very popular and effective medium for investing nonfarm capital in the agricultural sector. This study has attempted to reflect on the nature, number, and size of these organizations as well as the character and objectives of its investors. Still, much study remains before our understanding of the agricultural limited partnerships is adequate to determine its growing role and significance to America's largest industry.