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Pork Information Gateway

Evaluating the Contract Finishing Opportunity - Part 1
Is Contract Swine Production Good for You?

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Increasing numbers of farmers, aspiring farmers and rural landowners are considering a contract hog finishing enterprise as a way to enter agriculture or expand or diversify their current operation. This publication is in response to questions and issues related to this decision and is intended to help with the decision process. Every person, opportunity and situation is different in one way or the other, and the following discussion is more about helping you ask the right questions than giving generalized answers. Even for farmers with substantial operations the decision to enter contract production is one of the biggest decisions they will ever make. It involves a set of decisions related to farm business strategy, investment analysis and personal/family issues. Like any business venture, it is best to go in with "both eyes open" in order to be satisfied in the long run. The best possible situation for contracting firms and growers is that expectations and reality are in line over the life of the contract and beyond.

What is Contract Finishing?

Contract finishing is an enterprise where two or more parties share the risks, rewards and responsibilities of producing market hogs. For this discussion we refer to the two parties as the "grower" and the "contractor". The grower typically makes the investment in buildings and a site, maintains the facilities and provides labor and management associated with caring for the animals, manure hauling and certain record-keeping functions. The contractor typically provides all the inventory items such as animals, feed ingredients as well as technical support, vet services and transportation of pigs to and from producer buildings. The contractor usually specifies a recording keeping system and may provide that as a part of the overall arrangement.

A primary reason that contract production works is that it allows the contractor and grower(s) as a team to spread risk while achieving a higher level of per hog profit because of scale and specialization. By working together a contractor and grower(s) can create a "bigger pie" than either might be able (capital & labor) or willing (risk) to create on their own. It is an shared risk enterprise between the grower and contractor where both bring resources to the table, each is shouldering some of the risk, and each is sharing in the overall returns.

Nationwide, approximately 47 percent of all hogs produced are finished under production contracts. In 2003 the University of Missouri surveyed contract growers nationwide and found that a large majority of growers and contractors were fairly well satisfied with the arrangement and 80 percent of growers planned to continue with their current contractor.

Why Choose Contract Production?

A major reason why many consider contract finishing is that it tends to fit well into the resource base of the typical farmer/land owner and often offers an income opportunity with more quantifiable risks. The financial returns of most farming enterprises come with significant production, price and financial risks. With contract swine production, price risk is typically eliminated and depending on the arrangement, production risk is primarily assumed by the contractor. Increasingly in the Midwest, contract payment is made on a flat annual dollar amount for each pig space in the building, regardless if the contractor utilizes the space. However, contracts offering payment based on a per-pig delivered out of the building have been common in the past and are still prevalent in certain areas.

For farmers with cropland, the second major incentive to consider contract production is the nutrient value of the manure. This benefit can have significant impact on the cost-side of the overall farming operation in the seemingly permanent environment of high fertilizer prices. A 2012 study by the University of Missouri Commercial Agriculture Program estimated that a 4,000 head grow-finish operation on a 1,000 acre corn-soybean rotation, would annually generate nutrients valued at almost $60,000 net of spreading costs based on $0.62/lb N, $0.53/lb$P_2O_5$ and $0.50/lb K_2O.

Relative to non-contract swine production, the amount of capital required can be substantially less under contract production. The primary difference is that little or no operating capital is need by the contract grower. Consequently a balance sheet which is not able to support the full amount of borrowing necessary to engage in farrow-to-finish production may very well support contract production. Contract finishing is also generally considered to be lower risk by lenders and thus the debt capital may be easier to obtain.

Many small to medium sized farrow-to-finish operators that are at a crossroads with their operations are moving into contract finishing. Many of these farmers are at a stage where they know investment in farrow-to-finish facilities commits them to dealing with the work of farrowing for a longer period than they desire, given their stage in life. Given modern production technology such as automatic sorting, contract finishing is a way to utilize resources while creating work they can envision doing for a longer period of time.

Contract finishing also can provide a means for new producers, especially young people, to enter swine production and establish their first farm business. Many of the young farmers who got their start contracting in the 1990's have their first buildings paid for and are expanding their farms with additional free cash flow.

Often there is excess labor on the farm and contract finishing may provide an opportunity to utilize labor and generate income for that labor when few other alternatives exist in the local community. The additional cash flow from the contract operation can help smooth the up and down income from cropping productions or other activities.

The Market for Growers

Contract growers and prospective growers should think in terms of a "market for growers". Like any market situation, there is supply and demand. In any given area, there is a demand for growers and a supply of growers. How strong demand is depends several factors such as the presence of contractor operations including sow farms and/or slaughter facilities. Everything else equal, factors that will enhance the demand for growers include access to relatively cheap corn and soybean meal, the presence of feed milling infrastructure, good roads, and not too many people. The demand for growers will also tend to be stronger in areas that have established numbers of contract growers. This sounds obvious but the point is that unless a contractor is up against some other constraint, the contractor will be willing to pay more to establish a grower relationship that is near the other growers as acquiring another grower relationship nearby may lower the average cost of doing business with all the other growers.

The supply of growers in any given area will be largely fixed in the near term and determined by factors such as the number of landowners and farmers in the area, demographics including age and wealth of farmers/land owners, availability of capital, environmental regulations and opportunities for other employment in the area. The supply of contract growers seems to be greater in areas where there is a history of contract production.

For the individual considering a contract finishing enterprise, the takeaway of this analogy is that almost everything is easier and the returns may be higher and more stable if you are operating in an area of strong demand for contract growers. In general, it will be easier to start a contract enterprise, have a successful contractual relationship and should you choose to, sell your operation in an area of strong demand for contract production. For example, in an area where there are multiple contractors working with growers, lenders are more comfortable with the long term prospects for the business, will know more about the business and will be more willing to lend money for contract startups. Operating costs can be lower in areas where there is substantial contract production. For example, in areas of significant pro-

duction there are more likely to be custom manure applicators and custom building cleaning crews which can eliminate equipment costs and reduce labor requirements. Conversely, as you move away from the areas of strong demand, you may have a harder time getting started, receive less for your pig spaces, incur higher costs and face faster depreciation of asset values.

Is Contract Finishing Right for Your Situation?

For producers that have existing facilities that are moving to contract finishing, the primary questions are most likely related to specific contract terms and contract negotiations. If you are starting from scratch and have read this far, it probably means you recognize the potential advantages, but know there is a great deal of analysis left to do in order to make an informed decision about a contract enterprise.

The first thing that should make it clear that this is a big decision is the size of the investment. Unless you've been involved in confinement livestock production, the investment may seem shockingly large. Expect to spend $200-$250 per pig space to build facilities in addition to development of the building site (roads, grading, electric, water supply etc.). Most contractors seeking new growers expect the grower to build at least 2,000 to 2,400 spaces. Like many investments in farming, this one is a single purpose asset. Again, like many other investments on the farm, it is illiquid—which is a fancy way of saying it will be really expensive to change your mind. The contract is a long term commitment. The whole endeavor couldn't be more unlike the "old days" of getting in the hog business—stringing woven wire on the hillside, sticking a couple thousand dollars in some A-frame huts etc. Before you can decide if it is the right move for you, there are four key issues that you can sort through relatively quickly before you get bogged down in details of contract and investment analysis: know yourself, know your farm, know your financial condition and know the contractor.

Know Yourself: The first hurdle you have to get over is making sure you are personally comfortable with a contract relationship. A certain level of trust is critical in the contract relationship, as the contractor will be in control of many factors that affect the returns to and value of your investment. It is very important for you to understand how much managerial control you will have in a contract arrangement. Most management decisions will be made by the contractor.

The contractor will expect you to follow very specific instructions within the contractor's system for producing pigs. You may or may not agree with inputs being used or practices prescribed, especially if you have your own ideas or if you have raised pigs before. Many growers consider this a positive aspect of contract finishing as they have plenty of other things to worry about, and not making a lot of decisions on the contract enterprise is one less headache. Visit with other growers that work with the prospective contractor, not only to learn how they feel about the contractor but about what they are expected to do and not do under their arrangement. You simply do not want to get into a situation where you disagree or second guess your contractor as it will only cause problems down the road.

Other issues that warrant considerations are generational transfer and retirement. In some ways a contract finishing operation can work well with the next generation coming on the farm and many farmers retiring from farrow-to-finish operations do contract finishing. With retirement and or generational transfer, it is important to draw out a timeline of loan payments and retirement or transfer horizon so all parties understand the arrangement. This especially true if there will be a buyout and/or financing. As with any business investment, you should consider your "exit strategy" which involves answering the question: "How can I get my investment back out of this facility?" A confinement hog building is not an easy asset to sell, particularly if manure spreading acres are an issue. If you think you may want to sell out of the investment in the future, it is best to plan for that from the start. For example, consider building the facility on land you would be willing to sell. Make sure the sale of the parcel would not disrupt the rest of the farming business.

At this point, you might say: "I wouldn't mind XYZ if the financial returns are adequate." If that is the case, you should circle back to this question after you have done the cash flow analysis described in the Pig Information Gateway publication "Evaluating the Contract Finishing Opportunity Part 2: "Key Factors in Evaluating a Production Agreement."

Know Your Farm: Some farming operations are a great match for contract finishing while others are not. Before you get too far into the analysis of a contract finishing opportunity or evaluating alternatives, be sure that a confinement enterprise fits into your situation. The primary considerations relate to the site, the neighborhood and environmental issues and labor availability. Topography and local infrastructure are also fundamental requirements. Contractors generally require that sites can be accessed by tractor-trailer rigs for feed delivery and market hog shipping.

Making sure the enterprise fits the neighborhood is an issue that all parties should be concerned about. How close are the nearest neighbors? What is happening in terms of residential development? The type facility type under consideration and manure management practice associated with it affect the neighborhood issues. Environmental concerns primarily relate to how you will store and apply manure and how odors may affect nearby landowners. Some farms have situations such as karst topography where groundwater is easily harmed or land uses that do not utilize nutrients well may be difficult to manage. Farms where there is a row crop operation typically have few problems with manure management and are generally in a good position to capture the value of manure. Farms with little open land and/or land utilization that does not involve crop removal will find manure management more of a challenge. Your Regional Extension Specialist and personnel at the USDA Natural Resource Conservation Service can help you understand the suitability of your farm for a contract finishing enterprise.

Know Your Financial Condition: Before you get too far into the details of a contract opportunity, consider your capability to borrow several hundred thousand dollars. You may or may not know the overall implications for your balance sheet and what additional leverage might mean for you and your farm. This question is more of a "back of the envelope" analysis. Different lenders have different criteria for lending to contract operations and it is best to speak with a lender with a track record of financing contract finishing.

Lenders with experience in this sector of the market will have very good knowledge of the capital necessary and the debt servicing ability of the assets. You will need a up-to-date balance sheet and recent income tax returns. Visiting with a lender with experience in financing contract finishing operations has a number of benefits. The experienced lender can help, early in your decision making process and can help you avoid problems their other customers may have encountered. At worst, the lender might see early on that the enterprise is not feasible for your situation, which may save you considerable time, expense and perhaps even heartbreak.

Know the Contractor: Ideally, if you are considering contract finishing, there is more than one contractor actively seeking growers in your region. But in any case, a crucial aspect of any business decision is knowing the party with whom you are about to do business. This is especially true when there is a long term agreement involved. You must make an assessment of the contracting entity and perhaps the parent company who is offering a contract to you. It may be a large agribusiness firm or a family member or another independent family farm within the region. The following discussion sets out a few questions you should at least ask yourself, and preferably the prospective contractor.

First of all, it's very important to know something about the contractor's financial position. If there is no way to get a feeling for financial strength of the contractor (e.g. privately held firms or individuals), it will be difficult for you to get comfort as to the risk of the arrangement. You are concerned that the contractor will be there five years from now, placing pigs in your building so you may retire the associated debt and achieve other financial goals. Given that the contractor typically assumes all the price risk, could the entity survive a storm like the industry saw in the late 1990's? If your lender does not have an opinion on the strength of the contractor in question, seek out a lender with the resources to have done the due diligence on contractors active in the region. If a lender says their institution is not financing facilities associated with a particular contractor, the message should be clear.

Another set of factors that you must consider relate to the long term strategy of the contractor. The most basic question is their commitment to a contracting strategy. Is it apparent that the contractor is specializing in other facets of hog production and has a significant dependence on contract growers for the firm's success? You would not want to be in a situation where another farmer or entity is contracting the finishing stage in order to cope with a short term situation. A regional commitment is also important. As a general rule, you do not want to be "outside" of the region where the contractor is already established, unless you know there is a significant commitment to a new region. Groups of growers make for much more economical and profitable relationships for the contractor. Growers off by themselves are more expensive to support and to service with baby pigs, feed and hauling of market hogs.

The best source of information about any contractor is other growers. Ask several other growers about their relationship with the contractor. Historically, has the contractor been good in their commitments to others? Do other growers feel their relationship with the contractor has evolved in a positive fashion? Have there ever been operational “changes” that involved an aggressive contract interpretation or a situation not anticipated under the original agreement? Information on past performance is typically the most valuable, and sometimes the easiest information you can obtain when evaluating a contractor.

Learn what you can about the contractor’s swine production system. Visit with Extension Specialists or other knowledgeable individuals familiar with the contractor’s operation. Are they using good genetics for the region? Where do they get their feed? Do they have a health program to ensure that you will receive healthy pigs? Does their building design make sense for your region in terms of manure management, ventilation, winds and snow loads? Make sure the building that the contractor requires is an “industry standard” size. Few contractors want a building that takes another half load of pigs to fill. Learn about the contractors system relative large competitors. If the contractor you are considering is doing something very different, it may be a great opportunity but it could also mean that you are an “odd ball” in terms of finishing operations (remember that you want to be “in demand” as a grower for the long-haul).

If you are new to swine production, you will be especially interested in understanding what if any services or programs the contractor offers in terms of grower support. Contractors that invest in their growers, in terms of educational programs and management assistance demonstrate a long term view of their business relationship.

Summary

Contract swine production can be an attractive opportunity to the right individual, family or operation if it “fits” with the person, the farm and financial situation. This is especially true for those operations that can fully utilize the nutrient benefits of the manure. But it is extremely important to go into the arrangement well informed and with confidence in the counter-party to the grower-contractor relationship. For readers choosing to further explore contract swine production, there is a follow-up to this publication entitled: “Evaluating the Contract Finishing Opportunity Part 2: “Key Factors in Evaluating a Production Agreement” which is available on the Pig Information Gateway.