factsheet

Pork Information Gateway

Evaluating the Contract Finishing Opportunity - Part 2
Key Factors in Evaluating a Production Agreement

Author
Chrisian Boessen, University of Missouri

Reviewers
Dr. Gordon Groover, Virginia Tech University

This publication is a follow-up to the Pig Information Gateway publication “Evaluating the Contract Finishing Opportunity Part 1 - Is Contract Swine Production Right for You?”, which mainly examines non-economic issues related to the decision to grow hogs under production contract. This article is intended to assist with actually evaluating economic and legal aspects of the document that establishes a relationship with a contractor.

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.

Practically speaking, a prospective grower has two broad concerns when evaluating a contract. Usually, the grower wants to understand the economics or profit potential of the arrangement. If the economics make sense, the prospective grower must then delve into and understand the “fine print” which typically make up the bulk of a contract and these sections and clauses govern the relationship between the grower and contractor..

Cash Flow

Understanding the cash flows, both income and expenses associated with any contract finishing opportunity is the number one priority in the decision making process. Projecting cash flows will help avoid financial problems that could arise from periods of negative cash flow. Also, it is very useful to do your own cash flow budgeting and not to rely solely on the individual cash flow sample budgets provided by the contractor. Contractor supplied projections may represent ideal conditions or average conditions. For example, a quarterly cash flow projection might show positive cash flow in all quarters but in reality, there could be one or two months in the quarters where there is not sufficient cash available to pay bills.

Inflows of cash may be based on a fixed dollar amount per pig space per year or as a payment for pigs delivered from the facility. Cash outflow in a normal operating year will be associated with expenses such as maintenance, utilities, taxes, manure management and hired labor. The difference between the inflows and outflows associated with operating the contract finishing enterprise is called net cash flow and represents the return to the grower’s investment of land, labor and capital. Getting a good idea of the average annual net cash flow will help you compare the contract enterprise to other investments and uses of your time/labor. It is also important to take the cash flow projection another step and ask “What if?” This exercise is called sensitivity analysis and is done by “shocking” expense categories if analyzing a payment per pig space contract. With a payment per pig shipped contract, the sensitivity of the revenue side should be examined by reducing the assumed/average level of animal performance or changing other variables to see how cash flow holds up under less than optimal conditions. Think about what expenses could fluctuate significantly, for example utility expense due to extreme cold and/or rising LP gas prices. If you do not remember, ask your local LP supplier how high gas prices have been in the last 10 years. Also, some expenses will simply increase with inflation. Evaluate the implications of cash expense items increasing two or three percent per year over the life of the contract. Be aware that contracts rarely provide for inflation or cost spikes.

If the estimated net cash flow from operating the contract enterprise seems acceptable it is imperative that you understand the cash outflows associated with the startup period. The start-up period includes the first expenses associated with the facility such as engineering or consulting and site preparation. There will be several months of severely negative cash flow during construction. It is also important to know when the first cash inflows will occur relative to the completion of the facilities.

Ask the contractor about any "lumpy" or unusual cash flows that will likely occur over the life of the contract. This could include lagoon pump downs, lagoon cover replacement or equipment replacement (feeders, waterers, gates, fans). It is also imperative that the long term cash flow adequately covers maintenance, repairs and ordinary equipment replacement. You do not want to get to the end of a contract with worn out equipment and a facility that has not been maintained. In that situation you will be negotiating from a weak position and are unlikely to attract the interest of other contractors.

Another major cash flow issue is related to debt service requirements. You need to know how much of your net cash flow is going to be required each year to cover principal and interest. It is usually best if the contract payments and loan payments match over the course of the year. Monthly contract and loan payments are ideal for matching cashflows and will minimize interest expenses. Quarterly payments are more common and the next best alternative. As for loan maturity, most lenders require that building financing is repaid in 7 to 10 years. Attempting to repay the loan in a shorter period may leave little cash flow for family living expenses.

The consequences of not being able to pay principal and interest on time, mean that it is imperative to evaluate possible scenarios where cash inflow could fall short or be delayed. When the contract payment is based on pigs spaces provided, this is basically evaluating the contractor's financial strength. When the contract is based on head shipped, payment could fluctuate for a number of reasons. Pigs can die or the contractor may not place pigs to capacity in a timely fashion. If the contractor can cause cash inflow to fluctuate, the grower should expect some minimum guaranteed cash flow that is related to the principal and interest payments.

Finally, understand the income tax cash flows over the life of the contract. The trap to avoid, especially if the contracting arrangement is a primary source of income, is the "phantom income" situation. Phantom income refers to the situation when your depreciation deduction runs out and even though your gross income does not change, the income and self-employment tax bill related to the enterprise spikes dramatically. This situation can be devastating if the facility loan is amortized over a period longer than the period used for the depreciation method. When the depreciation runs out, cash available for debt service can drop significantly. Visit with a tax professional and go over the cash flow projections to avoid or plan for the phantom income stage in the life of a contract production enterprise.

Understanding the Contract

Once you are have evaluated the feasibility of a contract enterprise on your farm and you are comfortable with the prospect of a relationship with the contractor, you should invest the time and money needed to closely evaluate and understand the contract. This means having a legal, written contract that you fully understand. Have an attorney review the contract and have that attorney advise you on every provision before you sign it. You will also want to seek financial and tax advice to help evaluate whole farm business financial implications and tax management strategies.

The first big issue is understanding what type of facilities the contract requires and exactly how they get built. Ask the contractor if their firm helps in arranging bids and can assist in buying materials to obtain the best possible pricing. Know if the contractor has a list of building firms that can bid on your facilities. Talk with other growers about their experience with the construction process.

Evaluate the specified building design and ask a local engineer familiar with swine finishing buildings to look over the plans. Is the design appropriate for winds and snow loads in your area? Are the buildings of a standard design that might work for multiple contractors? You want a facility that will appeal to other contractors in order to assure there is demand for your enterprise down the road. You should also consider future expansion. Often contractors specify building capacities just below that requiring concentrated animal feeding permits and engineer certification. If your initial finishing enterprise is sized below permitting requirements, the building design may not be certified by a licensed engineer. If you decide to build a second building in the future which would likely put you in a permitting situation, you may face a regulatory requirement that the structures have engineering certification. At a minimum make sure any manure storage structures, such as pits, lagoons or slurry storage are certified by an engineer. Getting certification on an existing building can be expensive at best and at worst impossible if the contractor employs a poorly designed building.

Contract maturity is an important consideration. Is the contract duration at least as long as your real estate loan on the facility? To minimize any difficulties in obtaining financing, know exactly what the contract payments will be over the life of the loan. Conversely, make sure you are working with a lender that can make a loan that does not mature before the loan is paid off. Avoid loans requiring a "balloon payment" at maturity unless there are other significant sources of liquidity. You do not want to have to "re-qualify" for the loan in 5 years. Sometimes contracts are of shorter maturity or renew whenever a new group of hogs are moved into the facility. Shorter contracts will typically pay higher returns as the risk is higher to the grower and lower to the contractor. If you are in a situation where you can assume more risk, for example if you are moving existing, paid off buildings into a contract relationship, higher returns might be possible.

Be sure to understand how and when payment will be determined and remitted. If it is a per pig space payment, know when it will be paid. Will you receive scheduled (e.g. quarterly) payments or will it hinge on when the pigs are finished and they are completely loaded out of the building or will you received payment at some intermediate point before the pigs are completely finished? This will be especially important in terms of timing of cash flows, specifically to time receipts when loan payments are due.

If the contract is not based on a per pig space payment, are there any guarantees in the contract? You tend to see more of this type of language in contracts that make payments on some variable factor such as pigs placed or pigs shipped or on pounds of gain. Contracts that pay based on the number of animals placed in the building will often guarantee 70 – 80 percent of capacity per turn. These types of minimums are often designed around the principal and interest payments on the buildings. If the contractor has the option of not filling the building, know the guaranteed minimum you will receive if anything. Understand that in a minimum stocking situation returns to labor, management and your capital may be zero or negative. It will typically be difficult to obtain a high level of debt financing without corresponding minimum payment clause. Regardless of financing, as a grower you are accepting significantly more risk relative to a guaranteed per pig space contract and should expect higher annual returns.

Understand if there are any incentives clauses in the contract. Many contracts which pay per animal placed/shipped, also have incentives to encourage you to do the best possible job. These incentives are often based on achieving minimum death losses, or levels of average daily gain or feed efficiency. Another frequent incentive item is based on minimizing sort loss to ensure you ship out a uniform truckload of market animals. Realize that efficiency related incentives are largely determined by the quality of feed and the genetics of the pigs. Visit with other growers to determine if incentives will result in a meaningful expected increase in returns above a base payment.

Know if the contract is for feeder pig-to-finish or wean-to-finish pigs. If a contractor brings you feeder pigs (40-50 pounds) to stock your wean-to-finish barn, that would typically mean less work for you. If you have a feeder-to-finishing barn and the contractor has the option of bringing you weaner pigs (just weaned) then the nature of the contract could change dramatically, particularly in terms of labor and utilities. Contracts also often contain a clause that requires the grower to invest in equipment or technology in the future in order to keep the building up to certain standard required by the contractor. While typically related to feeders, waterers or sorting equipment, such a provision may also be used in combination with a strategic shift from feeder pig to weaner pig finishing. Similarly, if you are not interested in raising breeding animals, which typically end up larger and harder on facilities, be sure your contract precludes that use of the facility. If the contract does not specify the size of pigs coming in or going out, be sure you have thought through what might emerge, and make sure you are comfortable with those possibilities.

The contract will invariably say that the grower is responsible for managing manure and following environmental regulation. Be sure you understand what this entails. Know what equipment you will need to buy to deal with manure or be aware of custom rates for pumping, hauling and application. Do you have enough land? Can you spread on a neighbor's land and will you always be able to do so? The same situation applies to mortalities (dead pigs). Know the regulations and methods that are allowable and what each costs for the size of operation under consideration.

Default provisions are often the most surprising and/or troubling to prospective growers. What are your obligations under default and what constitutes default? What is likely to happen or could happen to the building? A default is typically related to poor performance or actions that endanger the animals. In these instances the contractor reserves the right to occupy and manage the building, typically suspending some or all payments to the grower. These clauses are unsettling but when you consider that the contractor owns the animals, it is not unreasonable for the contractor to create a mechanism to protect the animals. Often, lenders will require similar clauses in financing terms that allow them to take over the building in a delinquency situation. Conversely you should understand what happens if the contractor defaults? Do you have any special rights within the contract to choose another party to continue to use the building? Be sure your attorney explains the implications of any clauses related to dispute resolution.

Understand if there will be any assignment of contract proceeds? This is often done when there is significant financing. Proceeds refers to the contract payments, which under assignment, go directly to the lender with any left over proceeds after payment of principal and interest returned to you.

If the contract payment is based on animals placed/shipped and/or if substantial incentives are based on animal performance or death loss, you need to know if you can reject poor animals at delivery and if you can replace them with high quality replacements. If you reject an animal, will your building be allowed to run partially empty, and that animal will not be replaced. Also, know who's responsible for providing each input, and for taking care of environmental concerns, for instance dead animal disposal which normally falls to the grower.

What are the Alternatives?

When a grower chooses to enter into a contract arrangement s/he is making a commitment of both capital and labor. Once committed, the hours needed to care for the animals and maintain buildings can not be "sold" to another enterprise or employer. Likewise the money invested, whether debt or equity will be extremely difficult to get back out of this enterprise to invest elsewhere, on or off the farm. Prospective growers should consider their investment alternatives to the swine facility to assure that you are most satisfied with your investment and relationship with a contractor in the future. Investment alternatives include other contract opportunities, other farm related investments and off-farm investments. Similarly, if the prospective grower is actually going to supply their personal labor, consider the "wage" the enterprise is paying for your labor and management. If the contracting enterprise is part of a larger farming operation that can capture the value of the manure, be sure to consider this cost savings in the returns.

A final and important note about comparing returns to a contract enterprise. Breaking the cash flows down is a start, but making proper comparisons is still tricky for a number of reasons. One of the biggest issues when comparing alternatives is that many contract growers attach a non-monetary value to being able to create "paying work" on the farm, to not having to spend time commuting, doing a type of work they prefer or allowing a family member to stay on the farm. These non-monetary returns are real but can make comparisons difficult. A second issue is comparing returns on investments that are of different risks. The risk associated with a given contract finishing arrangement will be hard to quantify, as there are many forces involved. But make a conscious effort to consider return and risk before accepting or rejecting a major investment—think about how you will sleep with one investment versus the other. Contract finishing returns may be lower than other possible investments on the farm, but with out much of the risk that many traditional enterprises carry.

Summary

This discussion has covered many of the most important considerations in evaluating a contract finishing arrangement. A prospective grower must thoroughly understand the expected net cashflows of contract arrangements and risks associated with the cashflows. The contract will typically spell out the type of facilities built and how they will be operated and managed. Every situation is different and you should thoroughly evaluate the opportunity, both the good and the bad. An investment in a contract finishing enterprise can be a profitable long-term venture and a win-win arrangement for everyone involved, but it is best if a grower enters the arrangement, totally informed, having thoroughly analyzed the financial, cashflow, and legal,   implications and risk of each potential contractual arrangement.

If you're offered a contract opportunity and would like professional help, contact your local extension office. Your extension profession in farm management, animal sciences and agricultural engineering will be glad to assist you as you work through your decision. A financial/tax advisor may be advisable to totally understand the projected cashflows and anticipate changes that will occur over the life of the arrangement. Also, do not think twice about hiring an attorney to review the contract, it is imperative that you fully understand all aspects of the contract.