

Farm and Risk Management FOCUS

A University of Wisconsin – Extension FARM Program Team Publication

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Greetings from the UW-Extension FARM Program Team!

Welcome back to the FOCUS!

In this issue of the FOCUS, UW-Madison's Ed Jesse and UW-River Falls' Brenda Boetel discuss the spring and summer happenings concerning the dairy, livestock and corn markets. Plus, they let us in on what to expect the next few months.

Do you have clients who want to bring their son or daughter back to their farm? In this issue's FOCUS on Management Education, the Center for Dairy Profitability's Joy Kirkpatrick informs us of the Returning to the Farm program, which will be held at UW-Madison and UW-River Falls this winter. This program is designed to get the different generations together to learn about and discuss farm succession issues.

UW-Platteville's Kevin Bernhardt writes about "passive" and "active" marketing concepts and exposes us to a new marketing education spreadsheet tool in this issue's FOCUS on Management Principles.

This issue could be dubbed the "Joy Kirkpatrick Issue" as she has not one but two articles in this issue. In FOCUS on Management Research, Joy shows us a summary of the results of a survey she conducted concerning farmer retirement and farm successions issues.

We hope you enjoy this issue of the UW-Extension Farm and Risk Management FOCUS.

- Gregg Hadley
- Carl Duley
- FOCUS Co-Editors

The FOCUS wants to share your Farm and Risk Management, research, educational program, or idea with the FARM Program Team's clientele!

Call for Farm and Risk Management Articles

Are you a UW-Extension employee? Have you:

- ✓ completed an interesting farm or risk management research project;
- ✓ developed a unique farm or risk management educational program; or,
- ✓ thought of a new way to look at farm and risk management?

The FOCUS would like to hear about it!

The FARM Program Team would like to invite their UW-Extension colleagues to submit articles concerning farm and risk management research, education, or idea/program synthesis and integration. Articles should be no longer than 3 pages in length. If interested, please contact Gregg Hadley at gregg.hadley@uwrf.edu or 715-425-3188 or Carl Duley at carl.duley@ces.uwex.edu or 608-685-6256.

... While some of the bloom is off the 2007 milk price rose, the rose is still a grand prize-winner...

Focus on Milk Markets with Ed Jesse

Mid-Year Dairy Outlook

At mid-year, the prospect for milk prices through the rest of 2007 can best be described as nervously optimistic. Class III milk prices rose rapidly during the first half of the year, from \$13.56 per hundredweight in January to \$20.17 in June. In mid-June, Class III futures prices from July through September were all well over \$20 — \$8-10 above levels experienced in 2006. But since then, the cheese market has shown some erratic behavior, making price forecasts for the rest of the year more uncertain.

High and rising Class III futures prices were mainly the result of strong cheese prices. Block cheese on the CME gained more than 70 cents per pound from January through late June. Whey prices — another factor in the Class III milk pricing formula gained 30 cents per pound in the first quarter before tailing off slightly in the second quarter.

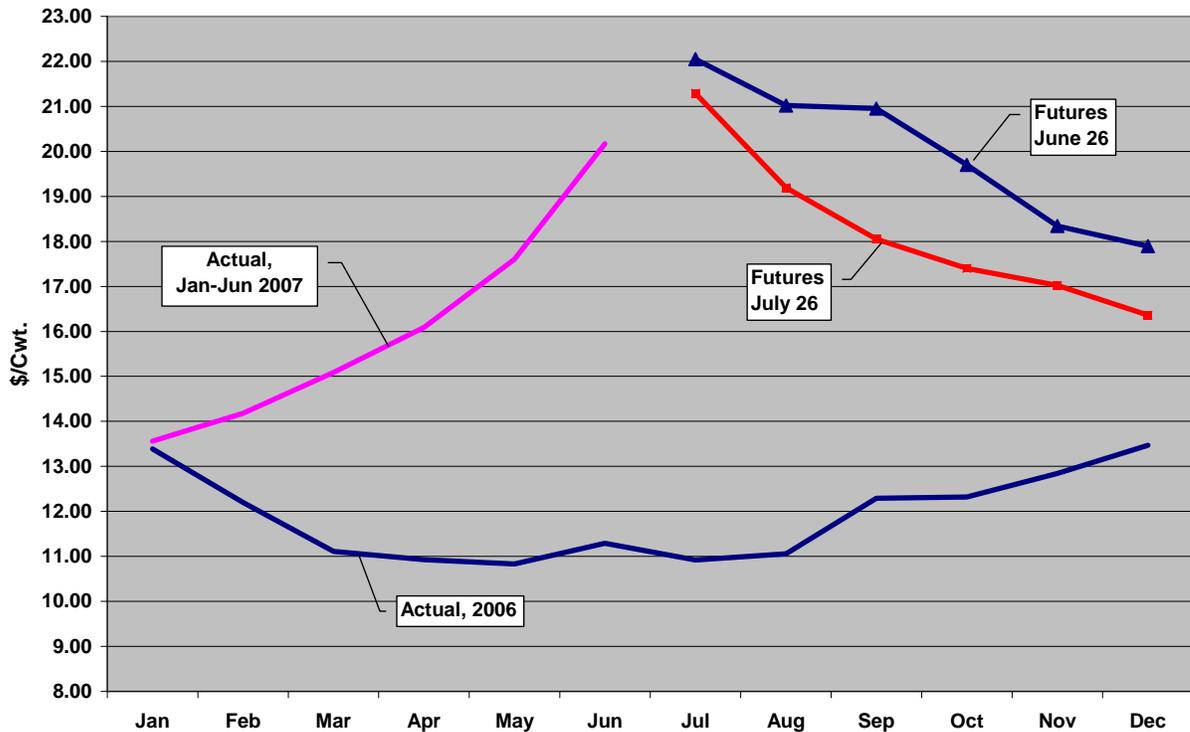
Strong cheese prices were related to trade apprehension about milk production tailing off in the face of escalating feed prices caused by exceptional demand for corn to feed ethanol plants. Cheese users bid up prices to acquire supplies before anticipated shortages and even higher prices occurred.

While there was some evidence supporting possible supply shortages, it was also clear that dairy markets were becoming overheated. The first related hiccup occurred during the last week of June, when CME block and barrel cheddar prices dropped 6 percent in a single day's trading and all 2007 Class III futures contracts fell their limit (\$0.75/cwt.) in

two consecutive days of trading. The second hiccup occurred three weeks later, when CME cheese prices fell another 5 percent. As of late July, CME cheese was trading about 22 cents per pound under month-earlier levels and the September 2007 Class III futures price was almost \$3 per cwt. lower.

Is the shakeout over? Can producers use current Class III futures prices (see chart) as reasonably accurate forecasts through year-end? The answer to both questions is, "Maybe, but maybe not."

Class III Milk Prices



Current spot market cheese prices seem better-aligned with market fundamentals than before the market adjustments. Cheese production has about matched commercial use — cheese stocks are neither tight nor excessive. Demand for cheese and most other dairy products have remained very good despite higher retail prices, but consumer resistance could increase with further price gains. Global markets for dry milk and whey show no indication of weakening. The biggest uncertainty is milk production. So far, production has stayed above last year, and is not showing any clear signs of tapering off, especially in bellwether states like California and Idaho as well as Wisconsin and other Midwestern states. The milk-feed price ratio for June was only 2.76, not high enough to signal a major expansion, but recent moderation in feed prices and gains in milk prices could change that.

While some of the bloom is off the 2007 milk price rose, the rose is still a grand prize-winner. Using actual Class III prices for January-June and Class III futures settlement prices on July 26 for July-December yields an annual average Class III price of more than \$17 per cwt. This compares to the previous record of \$15.39 set in 2004.

Focus on Cattle and Corn Markets with Brenda Boetel

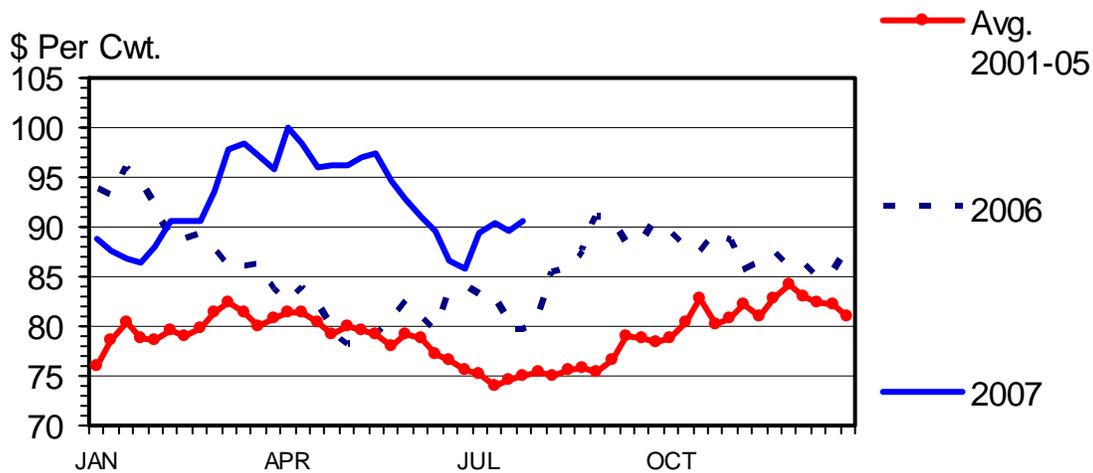
... In spite of near record selling prices, feedlots have lost money on cattle

...

Is There Relief in Sight for Poor Feeding Margins?

Despite improved fed cattle prices, cattle feeding margins have been poor. Cattle prices have been stronger than expected given that 2006 ended with record cattle on feed at record steer carcass weights. Five Market 65-80% Choice steer prices averaged \$92.86 through mid-July of 2007. This was \$7.27/cwt higher than the same period in 2006 and on pace for another record high average price for the year, as slaughter was down for five consecutive months. Slaughter prices in Wisconsin are up slightly, over 10%, for this same period for the Wisconsin weighted average.

SLAUGHTER STEER PRICES 5 Market Weighted Average, Weekly



Not only is the supply of slaughter cattle down 3% from 2006, but beef production is down 4% from 2006. Live cattle weights are also down 14 pounds from 2006. Carcass weights have been lower than 2006 levels since January and are expected to remain lower than the carcass weights of a year earlier for the remainder of the year. According to John Lawrence at Iowa State University, three factors contributed to this carcass weight decline. First, weights in 2006 were, at times, record high. Second, the rough winter weather stressed cattle leading to poorer performance and lower weights. Third, higher corn prices will discourage overfeeding of cattle.

Boxed beef prices softened following the week of August 13, but they were virtually the same as the previous year. Note that the slaughter prices are up while the boxed beef price is down. This separation of slaughter and boxed beef prices implies that cattle feeders have leverage from the low slaughter supplies. One key concept in the cattle feeder leverage is the number of slaughter cattle relative to processing capacity. The processing sector is currently scrambling to keep numbers high enough to operate efficiently. The situation is exacerbated by Swift trying to increase capacity in Colorado. When this happens, processing margins get taken away and cattle feeders benefit in the

short-term. Typically, cattle feeders are the beneficiaries when capacity is greater than supplies. This situation will likely continue for the rest of 2007 and 2008.

In spite of near record selling prices, feedlots have lost money on cattle. Since 2006 there have been 32 out of 81 weeks in which fed cattle prices were above breakeven levels. Cattle-Fax reported that in 2005 cattle feeders made \$10 per head on average, lost about \$31 per head in 2006, and the 2007 year-to-date numbers indicate a negative margin of approximately \$35 per head. The negative margin is due to the volatility of corn and feeder cattle prices. When cattle have been profitable, there have only been slim margins, but when cattle feeders are suffering losses, these losses have been more severe.

June and July were the two months that have had the lowest fed-cattle breakeven prices this year, but they have increased significantly since then. Breakevens will climb steadily from now into the fall. Assuming corn costs at today's value on a US average basis, breakevens will climb into the high \$90s on average. The highest breakevens in history occurred during the first quarter of 2007 when breakevens on cattle sold during that time were on average between \$100 and \$103/cwt.

Are current prices sustainable in the long run? Unfortunately, the answer is probably not. As average processor margins are relatively tight, the only way to have price increase is if the boxed beef price increases. Currently boxed beef is in the low \$140s. At this level, we shouldn't expect cattle prices to be sustainable at prices over \$90. If additional strength in cattle prices is to be achieved, we need strength in these boxed beef prices. We will see soon if the Labor Day holiday purchases affect these prices.

Feeder cattle prices have rebounded since last fall as fed cattle prices increased and corn prices decreased. Prices for feeder cattle are sensitive to corn prices. As corn prices decrease, feeder cattle trade benefits. Can feeders go higher? Or maybe a better question is, is there still downward price risk in corn? If corn price can decrease more, there is potential for feeder prices to increase minimally. I believe this is the case, but much depends on the weather and corn yields. We will know more after the August USDA World Agriculture Supply and Demand Estimate (WASDE) updates the corn yields estimates for the U.S.

According to the July USDA reports and as expected, there has been an increase in corn planted acreage this year. The bulk of this increase in corn acreage came from soybeans, but cotton acreage also showed a decrease. While the increase in corn production was expected, what wasn't expected was the magnitude of adjustments on the demand side, which was shown in the July WASDE. WASDE showed a 100 million bushel reduction in the feed number and a 50 million bushel reduction in exports of corn. This 150 million bushel change plus the 380 million bushel increase in projected 07/08 crop year production has pushed the estimated ending corn stock number up from 1 billion to 1.5 billion.

The size of the corn crop will have an impact on corn price. USDA is currently estimating an average 150.3 bushel per acre yield, while some price forecasters have estimated average corn yield to be as high as 160 bushels per acre. A 150 bushel per acre yield with the reduction in demand for feed and exports would result in ending stocks of approximately 1.3 billion bushels. This carryover level is about 10% of total use and is considered to be a "tight" ending supply. In this scenario, we could expect prices to be in the \$3.35 or above range. If national average corn yield reaches 160 bushels per acre, production would increase to 13.5 billion bushels and carryover would

jump to 2 billion bushels, or about 16% of usage. This is larger than the industry has been expecting, so average price could drop below the \$3.00 level.

... Returning to the Farm's goal is to provide farms considering a multiple generation business the opportunity to begin the conversation and investigate the possibilities of farming together. ...

Focus on Management Education Programs with Joy Kirkpatrick

Returning to the Farm Provides Framework for Farm Succession Planning

The average age of Wisconsin farmers is 53 years old (2005 Wisconsin State Agriculture Overview, WASS). Recent research indicates a majority of farmers have not identified a successor for their farm business. Even those who have identified successors have not discussed their retirement or succession plans with their family or advisors. The generation of farmers approaching retirement represents a generation with fewer children who have the opportunity of other life choices, perhaps more than any previous generation in history. Consequently, fewer numbers of farm families have children who want to or are able to take over the family farm. In past generations, there was nearly always someone in the family to take over the farm and carry it into the next generation. These changing demographics have an impact not only on the availability of young people to take over; they also mean that farmers in the older generation may put off making plans for retirement simply because that son or daughter is not there to take over the reins to the operation. Families looking toward the future of their farming operations have many issues to consider. Two issues of extreme importance to the future life of the business are the development of a son, daughter or partner to be the future manager of the business and the creation of a management succession plan.

UW-Extension county faculty and specialists adapted a successful educational program from Nebraska and Iowa to address the needs of Wisconsin families considering farm succession. *Returning to the Farm* targets college juniors and seniors, and their families, who are considering entering a multiple generation farm business. The program addresses the financial, communication, planning, tax and legal concerns that farm succession brings to farm families.

While agriculture students have many opportunities for careers off the farm in the agricultural services sector, these young people may also have strong desires to return to the family farm. However, they may have concerns about making that return and being treated as an employee for too long, or as a child, rather than a fully invested farming partner. *Returning to the Farm's* goal is to provide farms considering a multiple generation business the opportunity to begin the conversation and investigate the possibilities of farming together.

The *Returning to the Farm* program is divided into multiple sessions with the expectation that families will participate in all sessions. Through this program, families:

- Discover how to address major issues that can lead to failure in a multiple generation farm business;
- Learn about estate planning tools;

- Find out whether an existing operation is large enough to support an additional partner;
- Uncover alternatives for transfer of farm assets;
- Get the most recently published resources for those considering a multiple generation farm business.



A family works on their own succession plan at the UW-Platteville session of *Returning to the Farm*.

The *Returning to the Farm* sessions are hands-on and activity oriented. They include a resource packet with worksheets, exercises and reference materials. They also provide an opportunity for students and their families to discuss individual issues related to their farm transfer. Upon completion of the sessions, participants have an action plan for their next steps in the process and access to specialists and county faculty for continuing support with their families' farm succession.

- Sixty-eight people representing 23 farm families have participated in a *Returning to the Farm* workshop since 2005. Evaluations from the workshops indicate participants used the tools provided to help analyze their farms and develop farm succession plans.
- 100% of respondents to a one-year follow-up evaluation of the UW-Platteville program indicated they increased their knowledge and skills in strategic planning.
- 79% increased their communication skills.
- 71% of respondents felt the program assisted them with financial analysis and the difficult issue of treating heirs fairly.
- 94% of the respondents to the follow-up evaluation "agreed" or "strongly agreed" that they had analyzed the financial capacity of the farm to carry multiple families after participating in the workshops, while only 28% felt they had analyzed their financial situation before the workshops.
- 60% have taken the first steps in developing their written succession plans
- 56% have successfully transferred at least one aspect of the management of the farm to the next generation.

Two *Returning to the Farm* programs will be held in Wisconsin this winter. The UW-Madison program will be at the Friedrich Center on three Saturdays (December 1, January 12 and March 1). Contact Joy Kirkpatrick at the Center for Dairy Profitability 608.263.3485 for information and registration. The other *Returning to the Farm* program will be held at UW-River Falls in two, two-day sessions. The first session will be held on

January 25 and 26. The second session will be February 15 and 16. For information concerning the UW-River Falls program, contact Gregg Hadley at 715.425.3188.

Focus on Management Principles with Kevin Bernhardt

... Jack's confusion may be a disconnect between what he says, assuring a price level, versus what he really wants, a higher price! ...

Milk Marketing – What is Your Goal?

Jack listened intently to the Extension marketing specialist as he showed the historical Class III milk price levels. He thought that a marketing strategy that locked in the historical top 25th percentile price might make sense. He thought back to April 2003 when the announced price was \$9.41. If he had locked-in the top 25th percentile price for April of \$13.34 then he would have gained \$3.93 per cwt. That put a smile on Jack's face! However, then he remembered April of 2004 when the April Class III price turned out to be \$19.66, which would have resulted in a \$6.32 loss from marketing. The smile faded! Jack thought that maybe he should consider PUT options instead, which would leave open the upside. Argh! Jack was confused!

Jack's confusion might be all too familiar. First, Jack needs to determine his goal for marketing. Does he want to reduce the variability of prices (price risk) and be assured what price he will receive; or does he want to increase the price he will receive to something above the no-marketing cash price? These are two very different goals. Jack's confusion may be a disconnect between what he says, assuring a price level, versus what he really wants, a higher price!

It may be helpful for Jack to think of marketing in two distinct steps. The first step has as its main goal reducing the risk of price variability, especially the risk of low prices. Receiving a higher price is not the goal and in-fact some revenue or price might be sacrificed in order to insure against lower prices. This goal is analogous to paying a premium to insure against a barn fire. You don't pay that premium to make money; you pay it to secure your assets against a disaster.

The goal of the second step is to increase price. Some producers may be happy with the first step only, while others have their sights set on receiving a higher price through marketing. Is it possible to receive a higher price from marketing? Yes. Is it possible to continuously receive a higher price from marketing over a long-run period of time? Perhaps, but this is certainly much more difficult, and you are now the manager of two businesses – a dairy farm and a marketing business.

Passive vs. Active Marketing Strategies

The first step goal of securing against low prices can be accomplished fairly easily and with little time involvement through the use of "passive" marketing strategies. Passive means the use of strategies that are implemented automatically based on preset triggers. The purchase of an \$11.00 PUT option for \$.15 would be an example. Passive strategies are simple, involve little management time, and they are effective at accomplishing the goal of reducing the risk of price variability. While it will occur at

times, passive strategies do not by design result in higher prices, they just assure a price.

The second step goal of increasing prices received is a whole new ballgame. This goal requires a dynamic marketing plan involving “active” marketing strategies. Active strategies involve much more management time, daily involvement, can be complex, may actually increase price risk and success is much less certain. The marketer must pay daily attention to supply and demand conditions, stock reports, trade, weather and production. The marketer must develop strategies that are much more fluid where she/he might have to get in and out of the market and use a variety of more complex marketing tools.

A Spreadsheet Program for Evaluating Passive Milk Marketing Strategies

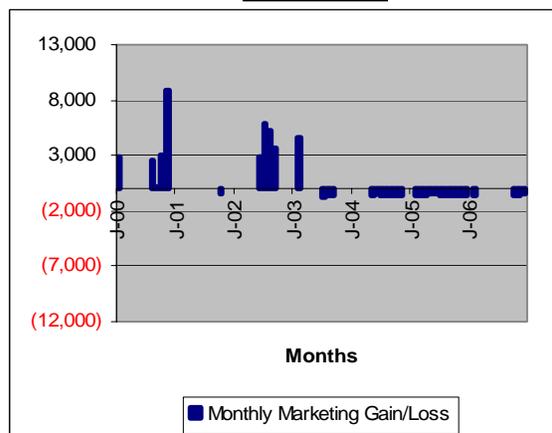
Jack’s early assessment was right in noticing that in some years his strategy would work well (April 2003), while in other years the results would be pretty disappointing (April 2004). What might be helpful to Jack is to see the results of potential strategies over a longer run period of time. This would give him both a sense of how different marketing tools work and their impact over time.

A spreadsheet program has been developed that evaluates the results of passive marketing strategies over the years 2000-2006. The user defines a marketing strategy option that includes the use of PUT options, forward contracts, or a combination of both. The program then employs the strategy for the years 2000-2006 based on what was actually available in the market. The program also allows several other user-defined options including broker’s commissions, forward contract discounts, other contract specifications and the window for marketing.

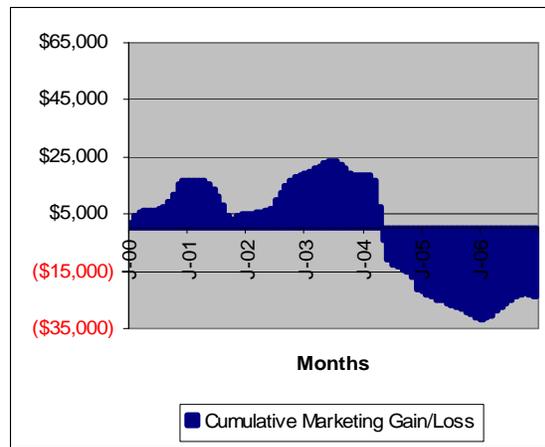
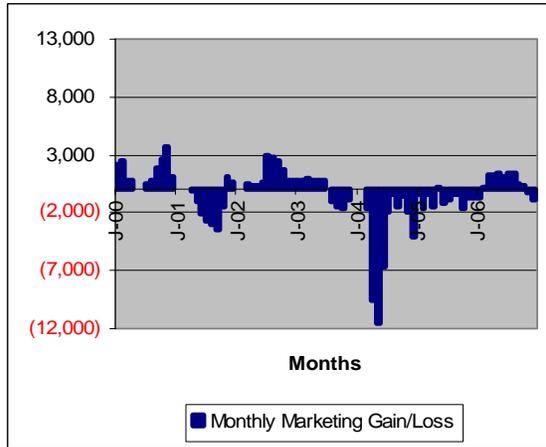
The program is a quick and easy way to see the effectiveness of passive strategies over a longer run time. The following are three examples that show the gain from marketing each month and cumulatively for the seven years. The three examples are:

- Example 1: \$11.00 PUT option for \$.15.
- Example 2: Forward contract 10%, 15% and 25% of production at \$12.00, \$13.00 and \$15.00 per cwt. respectively.
- Example 3: Combination strategy that purchases the \$11.00 PUT option and forward contracts at levels shown in example 2.

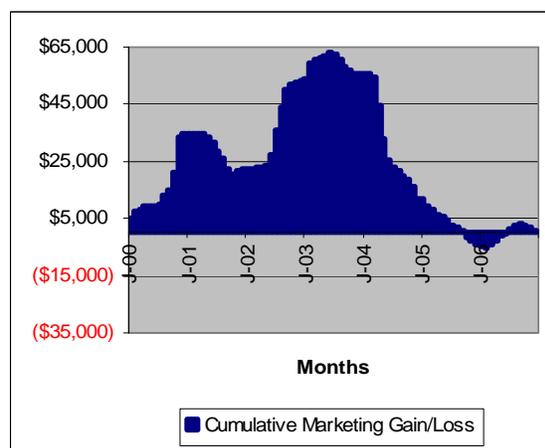
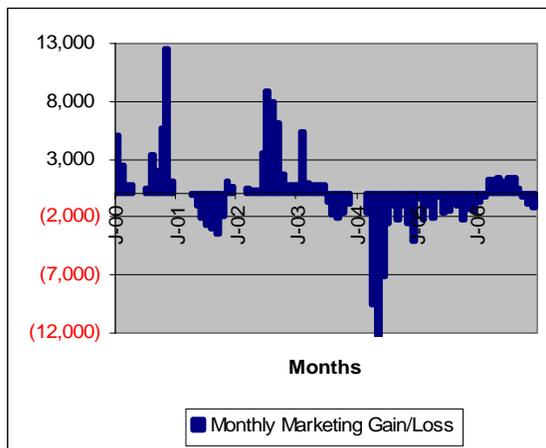
Example 1: \$11.00 PUT for \$.15 When Available



Example 2: Forward Contract 10%, 15% and 25% at \$12.00, \$13.00 and \$15.00 When Available



Example 3: Combination \$11.00 PUT for \$.15 and Forward Contracting as in Example 2



Warning: The program works very well in showing the impact of different passive strategies as they would have occurred during the years 2000-2006. However, research by Cheol and Irwin is fairly convincing that strategies that have worked in the past may not be highly correlated with those that will work in the future!

This is a learning program that should be used to see the long run impact of passive strategies and how the different tools of marketing work over a long run time period. It is not a management tool that indicates what strategy will work best in the future.

For more information on the spreadsheet or to get a copy for your own use, contact Kevin Bernhardt at bernhark@uwplatt.edu or phone 608 342-1365.

References: Park, Cheol Ho and Scott H. Irwin. "The Profitability of Technical Trading Rules in US Futures Markets: A Data Snooping Free Test." AgMAS Project Research Report 2005-04, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, May 2005.

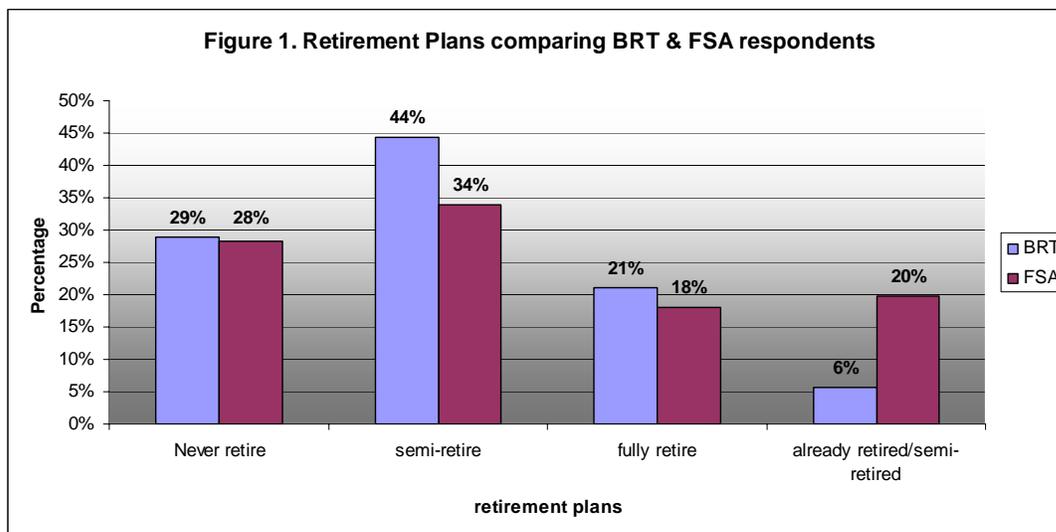
... A startling sixty-eight percent of the respondents have not identified a successor ...

Focus on Management Research with Joy Kirkpatrick

Executive Summary of Farm Retirement and Succession in Southwest Wisconsin

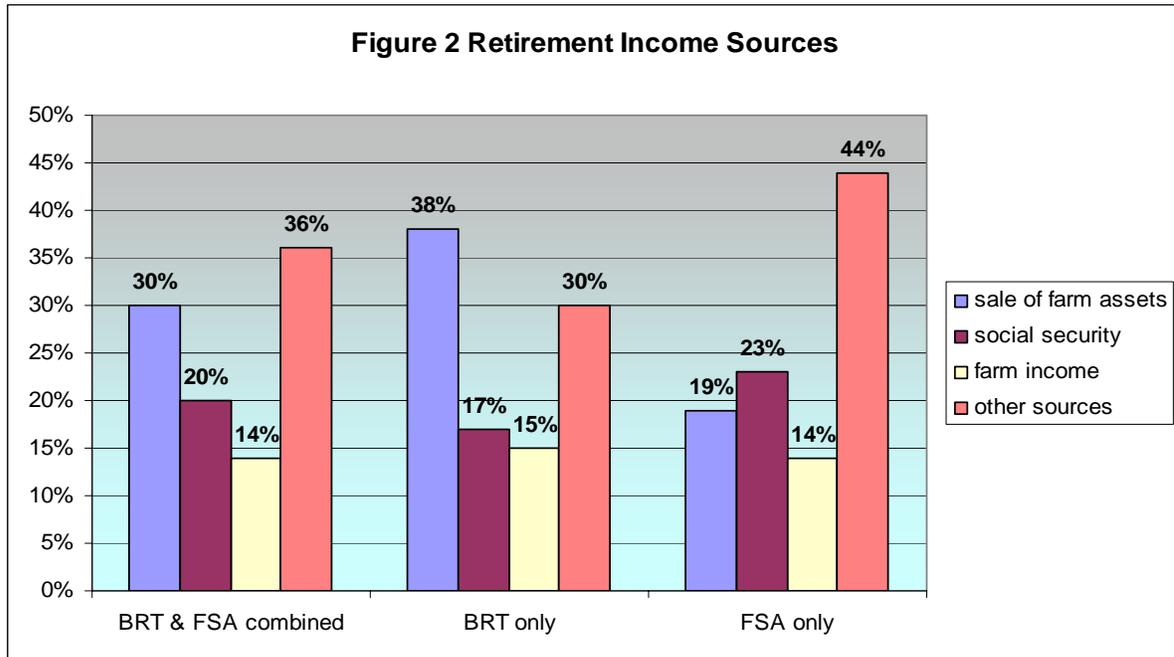
In March and April of 2006, the UW Center for Dairy Profitability, with the help of the UW-River Falls Survey Research Center, surveyed 2,587 farmers in the counties of Crawford, Grant, Iowa and Richland to discover the retirement and succession plans in the southwestern corner of Wisconsin. Five hundred eighty-nine viable responses (a 23 percent response rate) were returned and analyzed. This survey is a part of the International FARMTRANSFERS Succession survey. Similar studies have been conducted in seven countries and eight states. The Wisconsin survey used two populations in the survey. The first was the current Brucellosis Ring Test (BRT) list, which contains all farms with current BRT data with the Wisconsin Department of Agriculture, Trade and Consumer Protection. The second population included anyone who received a Farm Service Agency (FSA) payment and had a residential zip code within the four counties.

The four county Wisconsin survey suggests, as predicted, a high number of farmers plan to never retire or only semi-retire. Seventy-three percent of BRT respondents indicate they either will never retire or only semi-retire, while 20% of the FSA respondents are already retired/semi-retired (Figure 1). Those who are planning on retiring or semi-retiring indicate they plan on retiring at 65. Given the median age of respondents is 53 years old, this provides 12 years to plan and implement a retirement and at least partial succession plan, depending on their level of retirement plans.



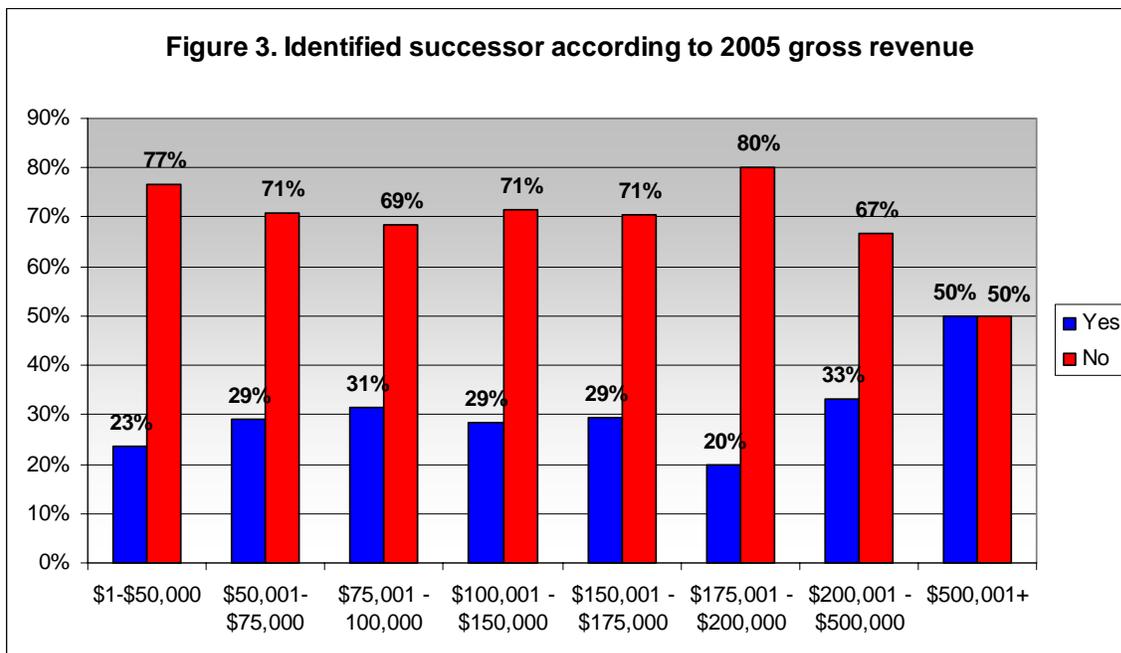
The survey allowed respondents to report with whom they had discussed their retirement plans; options were: family, lawyer, banker, farm consultant, accountant, others, or they could choose "have not discussed with anyone." Of those who indicated they were going

to semi-retire, forty-three percent have yet to discuss their semi-retirement plans with anyone. Sixty-nine percent do not plan on moving from their current home.

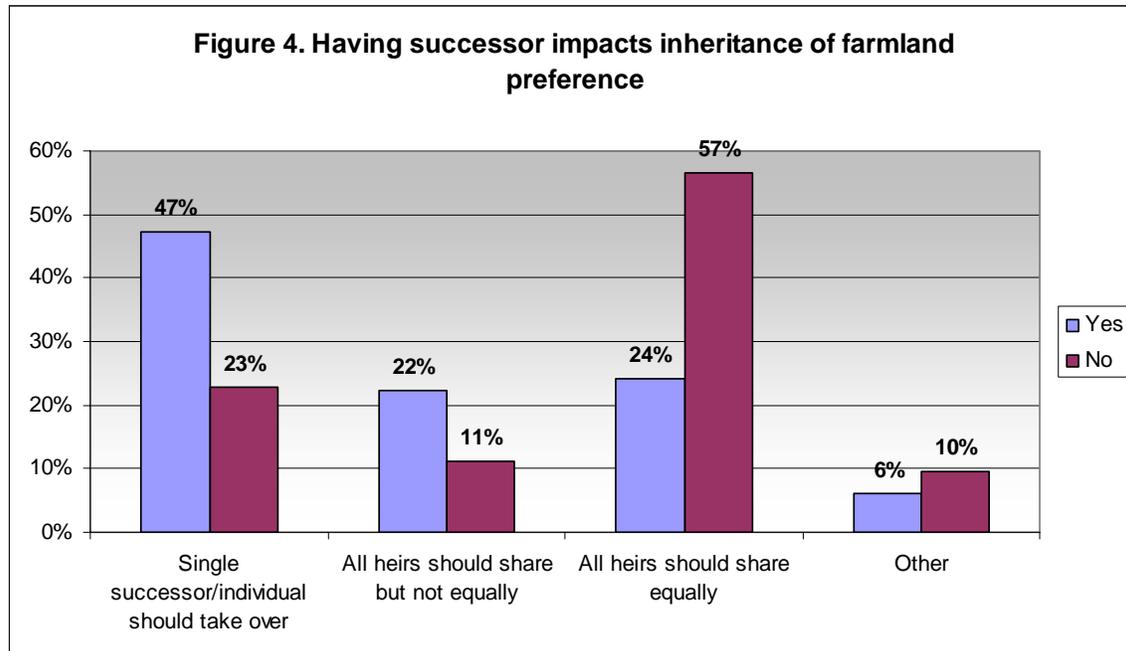


As Figure 2 shows, those who plan to semi or fully retire will depend heavily on the farm assets or income from the farm business for retirement income.

A startling sixty-eight percent of the respondents have not identified a successor (Figure 3). Even more troubling, seventy percent of the respondents 51 – 60 years old have not identified a successor. 2005 gross revenue seems to be a factor to having identified a successor. Those reporting \$200,001 or higher gross revenue were more likely to have identified a successor than farms generating less. However, it is not until gross revenue is \$500,001 or higher that 50% of them answering they have identified a successor.



When asked about preferences for inheriting the farm land, farm house, and non-farm assets – forty-six percent of respondents indicated that all heirs should share equally in the farmland (Figure 4). If an operator had already identified a successor that percentage drops to twenty-four percent. This suggests that almost a quarter of the respondents state that, even though they have identified a successor, the land will be divided equally among the heirs. Depending on the number of heirs and the quality of their relationships, this can have an impact on the successor's ability to maintain control of enough of the farm assets to continue the business.



Summary

The generation of farmers approaching retirement represents a generation with fewer children and whose children have had the benefit of other life choices, perhaps more than any previous generation in history. Consequently, fewer numbers of farm families have children who want to or are able to take over the family farm. In past generations, there was more likely someone in the family to take over the farm and carry it into the next generation. These changing demographics have an impact not only on the availability of young people to take over; they also mean that farmers in the older generation may put off making plans for retirement simply because that son or daughter is not there to take over the reins to the operation. A key factor in having a farming successor is the farm's ability to generate adequate income. As the survey results indicate, as the gross revenue increased, there was an increase in the likelihood of having identified a successor. In addition, the older generation's retirement income sources must be identified so that all parties understand what the farm business will be expected to provide, either through continued income or the sale of the farm assets.

As farmers slow down, the usual progression is to sell the livestock and perhaps rent out the facilities and only crop farm; the second step is to rent out the crop land while still living in the farmhouse. If the sale of the land is not needed for living expenses as the farm couple ages, the land will most likely be divided equally among their heirs. As these once viable farming businesses slow down, their capacity to be economic powerhouses in their rural communities decline as well. Research indicates rural

communities in the four southwestern counties are still heavily dependent on the agriculture industry for their economic viabilities. Estimates indicate \$1.2 billion of economic activity is generated by agriculture in these four counties. (*Value and Economic Impact of Agriculture – Crawford, Grant, Iowa & Richland Counties*) If these trends continue and as the baby boomer farmers age, the loss of farms as viable businesses can potentially cripple already limping rural communities.