

MANAGING THE MARGIN
Profit Strategies for Volatile Times
UW-EXTENSION

(Kevin Bernhardt, UW-Extension and Center for Dairy Profitability)

Assumption

Agriculture has entered a new price environment where 1) the average price may be higher for commodity sales, 2) the average price will likely be higher for input costs and 3) the volatility of price movement for output and input prices are both very likely to be greater.

Implications of this Assumption

1. Need for greater cash management
 - a. More cash coming in, more cash going out, and thus greater need to understand and manage cash flow
 - i. For short-term borrowing
 - ii. For short-term investment
2. Need to manage more volatile profit margins
 - a. Swings between high profits, zero profits, and very negative profits could be more often and greater
 - i. The cost of making a mistake will be less forgiving
3. Greater and more unpredictable change. Changes (prices and those factors that cause price changes) will happen faster and with less ability to forecast causing the “out-guessing-the-market” strategy to work even less often with more negative consequences.
4. The meaning (level) of breakeven has changed.
5. Cash and carry input purchases. Loss of ability to forward buy inputs or buy on credit.
6. Lenders may have tighter lending policies, more emphasis on cash flow, more requirements to manage risk.
7. Heterogeneity: Producers with similar production abilities and sizes of operations who normally would have similar income statements may now be very different due to the type and timing of their marketing decisions.
8. Need for a marketing psychiatrist.

Food For Thought

Lenders: If a producer keeps good records and uses those records to make sound and documented risk management decisions that focus on profitable returns, then is not your risk lower?

- a. If your risk is lower then should those producers be rewarded with a cheaper interest rate?
- b. Will producers respond to the opportunity for a lower rate?

Strategies

1. Be a commodity business and prepare to “Manage the Margin.” So, what is the new tool, spreadsheet, or marketing strategy? There isn’t one! The answer is back to the basics of sound business management - ***keeping good records, knowing your costs of production, and focusing on managing the profit margin with all the tools available!*** Perhaps the difference is that ignoring this basic of management may be more costly in the future.
 - a. Having a record-keeping system.
 - b. Using the records
 - c. Information on alternative input sources and prices (creating a brokerage function to provide access to available information)
 - d. Continued work on production practices that conserve on inputs, gain production.
 - e. Marketing tools that secure costs and output prices
2. New generation business structures (cooperative idea)
 - a. Aligned networks of grain and livestock producers
 - b. Marketing cooperatives
 - i. Purchasing inputs, selling outputs (marketing clubs), lower production costs through machinery specialization, etc.
3. Value added (branded) producer.
 - c. Get off the commodity treadmill and its associated uncertainty and volatility and instead grow, process, and sell value-added (branded) products where the individual business markets and sets its price. Input costs will still be a challenge.
 - i. Ag entrepreneurship, Direct marketing, B2B marketing (to wholesalers, retailers, etc.), Market connections, etc.
4. Aid, push, be a catalyst for the industry to develop new margin management tools
 - a. LGM-Dairy is an example
 - b. Risk sharing PUT Options (really just brainstorming here)

What if our assumption is wrong?

What if we see the years ahead being no different with respect to average prices and input costs, that is, everything goes back to “normal”?

So what, if producers employ any of the listed strategies what have they lost?

Ag Lender 2008 powerpoint presentation at: <http://cdp.wisc.edu/> then follow links to “papers, publications, and presentations” then “Milk Marketing”