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Producing hogs under contract

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Abstract

Recently, there has been a renewed interest in contract hog production. Contractors are looking for an effective means to expand production or utilize excess feed production capacity. Producers enter contracts to minimize input cost and market risks or to obtain financing for buildings and equipment. Provisions vary from contract to contract. Producers that are making the decision whether to produce hogs under contract should calculate expected returns for a range of production and cost scenarios. Whatever the contract provisions, producers and contractors should make sure that the contract rewards them for what they do best.; Swine Day, Manhattan, KS, November 21, 1991

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PRODUCING HOGS UNDER CONTRACT

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Summary

Recently, there has been a renewed interest in contract hog production. Contractors are looking for an effective means to expand production or utilize excess feed production capacity. Producers enter contracts to minimize input cost and market risks or to obtain financing for buildings and equipment. Provisions vary from contract to contract. Producers that are making the decision whether to produce hogs under contract should calculate expected returns for a range of production and cost scenarios. Whatever the contract provisions, producers and contractors should make sure that the contract rewards them for what they do best.

(Key Words: Contract, Program, Economics.)

Introduction

There has been an increasing interest in contract hog production in recent years. One of the primary reasons for this is the availability of financing through contracting. In 1988, about 10 to 12 percent of U.S. slaughter was accounted for by contract operations. Glenn Grimes, from the University of Missouri, estimates that the number of contract hogs will increase about 6 to 10 percent annually. Using these estimates contract hog production is expected to account for 23 to 35 percent of U.S. slaughter by the year 2000.

Traditionally, most of the contract production has been concentrated in the East Coast region. There are some indications that contract hog production is becoming more prevalent in the North Central region. For example, an estimated 250,000 hogs will be fed by Murphy Farms alone in north central Iowa this year.

Advantages and Disadvantages of Hog Contracts

Potential contractors include investors, feed dealers, and farmers. Contractors find contract arrangements appealing for several reasons. For example, a contractor may have a large feed production capacity that is currently being less than fully utilized. Contractors may also find contract hog production to be a more effective means of expanding their total hog production. Because the producer (contractee) typically is responsible for facility costs, a contractor can effectively mitigate the financial risk associated with owning facilities. Other reasons why a contractor may find contract hog production appealing relate to the economies of size associated with buying and selling breeding stock and market hogs.

Producers enter a production contract for various reasons. One of the primary reasons is to obtain financing for buildings and equipment. This aspect of production contracts is particularly attractive to young or financially strapped producers with a limited access to capital. Many contractors build the facilities and then provide a loan to the producer. Because feed and pigs are provided by the contractor, producers do not face the risks

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associated with feed cost and feeder pig changes. In addition, market risk is eliminated because the contractor owns the hogs. Of course, producers that custom feed hogs will not be able to take advantage of high hog prices or low feeder pig and feed costs. The fixed payment aspect of most contracts reduces profit and cash flow uncertainty. Production contracts are also attractive to producers that do not want to make the management decisions required to buy inputs and market hogs.

There are disadvantages to hog contracting from both a contractor's and producer's perspective. Contractors that choose the wrong producers may lose a substantial number of hogs or waste an enormous amount of time before the problem is corrected. Producers may find it difficult to save enough money from the fixed payment to build their own facilities. In addition, the contract length may be substantially shorter than the time it takes to pay for the facilities. Producers need to think about how they will pay for the facilities if the contract is terminated.

Types of Contracts

There are many different types of contracts. Payment method, cost sharing, and production bonuses vary from one contract to another. Whatever the contract provisions, producers and contractors should make sure that the contract rewards them for what they do best. For example, production bonuses that are too optimistic will not benefit an above average producer. This producer should seek a contract in which bonuses are paid when production is above average.

Hog finishing contracts are more predominate than contracts for feeder pig and farrow-to-finish production. According to a survey conducted in 1988 by V. James Rhodes at the University of Missouri, 87 percent of contractors contracted pig finishing, 21 percent contracted pig producing, 15 percent contracted farrow-to-finish production, and 3 percent contracted the production of breeding stock.

Many hog finishing contracts guarantee a producer a fixed payment and add or subtract bonuses and discounts from this payment. Bonuses are typically paid for keeping death losses low and feed efficiency high. Discounts are sometimes imposed for high death losses and unmarketable animals. Contract payments can be on a per head basis, a per day basis, or on a per square foot of pig space basis. A common per head payment is $12. Payments on a per day basis typically range from $0.07 to $0.10. Payments on a per square foot of pig space basis may range from $30 to $40 per pig space per year. Payments based on a per pig space basis are attractive from the producer's perspective because, under this contract, less than fully utilized facilities will not add to his/her fixed costs per head.

Under a fixed payment contract for finishing hogs, the producer typically provides the building and equipment, labor, utilities, and insurance. Utilities and insurance are typically around a $1.50 and $0.25 per head, respectively. Assuming an investment cost of $100 per pig space, a facility with a 1,000-pig capacity would cost $100,000. If 2,500 pigs are produced and the interest rate is 11 percent, the annual payment per pig will be about $6.75. If more pigs are produced, the annual payment will be lower. The annual payment will be higher, if less pigs are produced. If the payment is $12 per head, the producer, in this example, will have a return to labor and management of $3.50 per head after subtracting costs.

Characteristics of a Good Contract

Before considering the details of a contract, both parties should consider the reputation of the other party involved in the contract. Some contracts are not easily broken. Thus, it is important to obtain this information before a contract is considered. Like all contracts, the contract should be in written form. Also, the advice of an expert or a lawyer may be useful in evaluating the contract provisions. Contract provisions should include the following:

- the names of both parties;
- the rights and responsibilities of both parties;
- the number of pigs involved;
- the duration of the contract;
- the method and timing of payment;
- the costs to be paid by each party;
- the brands of the feed and supplement;
- a clear statement of how bonuses and discounts will be handled;
- the methods used to calculate performance guidelines;
- how and when the contract may be terminated by either party.