Managing Risk with Marketing Plans

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If you've heard it once, you've heard it a million times in the last year. Farming is getting more risky. Regardless of how many times it has been said, the fact remains true. More risk translates into more opportunities for profit, more chances to fail and greater demands for management skills. Developing a marketing plan is one of the most critical management activities a farmer can do to successfully deal with market risk.

There are numerous driving forces behind the increased market risk in agriculture. Five of the most obvious are presented here to help insurance providers be prepared to help farmers successfully respond to these changing macro conditions.

1. **World Markets**

   With the passage of recent trade agreements, (NAFTA, GATT, etc.) producers truly operate in an international marketplace. Competitors are not only in neighboring counties and states, but countries and continents as well. As a result, international market conditions will have a greater impact on domestic market prices.

2. **Changing Farm Policy**

   The most dramatic change in government farm policy was signed into law in the spring of 1996. Before the Federal Agricultural Improvement Act (FAIR) was law, farmers made crop production decisions based primarily on target prices and base acreage restrictions. Now market forces, worldwide supply and demand conditions drive market forces. Ultimately the result will be individual producers shouldering more risk.

3. **Changing Weather Patterns**

   Many prominent climatologists conclude that global warming has produced irregular El Nino conditions resulting in unusual and adverse weather patterns. The result is that crop prices will remain extremely sensitive to growing season weather developments. Remember that prices are more sensitive to anticipated weather and crop conditions than current or actual conditions.

4. **Improved Communication and Transportation Technology**

Satellite capabilities make it possible to monitor global weather and crop conditions in real time. Transportation has made it possible to ship commodities in a timely basis to meet market demands. Consequently, international competition has increased.

5. **Industrialization of Agriculture**

As the agricultural sector becomes more industrialized, individual producers face strong dominate competitors. Profit margins become narrower because large industrialized producers often benefit from economies of scale and are better able to develop long-term contractual arrangements. Maintaining a profitable margin long-term is the ultimate management challenge.

Understanding these driving forces behind the increased competition and risk of agriculture is critical to designing farm level management strategies that take advantage of the increased opportunity for profit and avoid the increased chance of failure. To survive, farm producers need to continue to maintain production volume and achieve an adequate price.

A marketing plan for each crop is essential to overall farm financial planning. Having a plan could mean the difference between profit and loss for the farm, and it often means the difference between survival and bankruptcy.

Charting a course through the marketing year, well before the farming season begins, is a good management practice for several reasons. First, it is easier to make thoughtful plans in the calm of winter than during the hectic activity later in the growing season when economic conditions may be changing rapidly. If decisions need to be made fast, a basic plan in place will be useful. Second, a marketing plan can be helpful even if failure occurs. The farmer will know at least he failed only after having accounted for all possible variables, and not because he was unprepared and lost control in a stressful moment and/or made an uninformed and disastrous marketing move. Finally, a marketing plan is essential to overall farm planning. The first planning step is to calculate crop production costs, the second to create a marketing plan. Once production costs and market returns have been estimated, a farmer can estimate the farm's cash flow and whether production will be profitable. If cash flow or profit problems appear, adjustments need to be made.

How to Create a Marketing Plan

Professor George Flaskerud, Crops Economist at North Dakota State University, recommends one relatively simple way of putting together a personalized marketing plan. Creating this simple plan only requires seasonal crop price patterns for the state and USDA crop price projections. In drawing up the marketing plan that Flaskerud recommends, the goal is for the farmer to sell the total crop for more than whatever the average seasonal U.S. crop price turns out to be. That is, he wants the farmer with the plan to

be one of the farmers selling for above-average price, not one of the large group that inevitably must sell below the average.

The structure of his plan is simple. He selects five target prices and matches them with five target dates. Then he determines to sell a particular percentage of crop when either the first price or first date is reached, and another percentage of crop when either the second price or second date is reached, and so on. Each chunk of crop is linked to two signals that can trip its sales; a price and a date. If the price doesn't do it, the date will. Success depends on selecting the right dates, the right prices and then making sensible adjustments as the season advances and economic winds shift.

Here's how Flaskerud recommends doing it. He bases his selling dates on seasonal price patterns, his selling prices on USDA price predictions and he concentrates his sales at the middle of the price range – meaning he sells a little at the beginning, a lot in the middle and a little at the end.

In deciding on deadlines for selling, Flaskerud picks dates near the high points in the historical annual pattern of prices in North Dakota. These North Dakota seasonal price patterns for various crops may be found in an NDSU Extension Service circular called "Seasonal Price Patterns." To determine price targets, Flaskerud looks at USDA price predictions for the year's seasonal average farm price. These predictions, revised monthly, are available to North Dakota farmers in publications such as *Agweek*. Similar publications that provide this information in other states and regions are available. Contact your local extension educator or state Extension Marketing Economist if you are unsure.

Deciding what prices to shoot for requires a bit of intuition but mostly just simple arithmetic. The average price for the entire U.S. is given as a range of prices. Flaskerud selects a price at the middle of this range and converts it to a North Dakota seasonal average price. He makes this conversion by adding or subtracting the usual difference between North Dakota and U.S. prices. He links this average price to the first of his five dates and he specifies a much higher price to the last of the five selling dates based on fundamental and technical analysis. In the current market environment, a high that is 20 percent greater than the average may be appropriate. This leaves three dates in the middle. To these he assigns prices that more or less split the difference between the low price matched with the first target date and the high price matched with the last.

Since he has planned to sell only the first portion of his crop at USDA's predicted average, his crop should sell, overall, at more than the average. The first two portions he will sell through a cash forward contract. Prior to harvest, he will handle the other three by buying put options that guarantee the prices he's specified in his marketing plan but that will not lock him into those prices if the market should go higher. Put options are a form of insurance, and like insurance, cost money to purchase. Cash forward

contracts cost nothing but they lock in price and require delivery.

What combination of put options, cash forward contracts or other marketing methods a farmer chooses and what price objectives he specifies will depend on the crop, time of year he prepares the plan, the moisture situation and other quality factors, personal attitude toward risk, financial situation and beliefs about the direction of the market.

Once the initial marketing plan is made, says Flaskerud, a farmer will need to update it as the year goes by. For updating, most farmers will use revised USDA forecasts as basic information. They will also want to follow news reports of crop calamities throughout the world, information on changing local weather conditions and changing economic and market conditions by whatever reliable information sources they care to put faith in.

A marketing plan won't guarantee top prices, but it will increase the odds that a farmer will sell for above average price and will turn a profit. Understanding marketing plans and how they are constructed will enable insurance agents to market insurance coverage consistent with helping the plan to succeed.

SIMPLE MARKETING PLAN EXAMPLE

(Assigned percent of crop will be sold at a date or price, whichever comes first.)

% Of Crop To Be Sold	DATE Selling Deadline	PRICE Selling Objective
15	4/25/99	$3.80
20	5/25/98	$4.00
30	11/20/98	$4.20
20	4/25/99	$4.40
15	5/25/98	$4.60

***This example is for illustration purposes only and NOT intended to be used as a marketing plan for any specific crop or producer.**

Where to go from here:
