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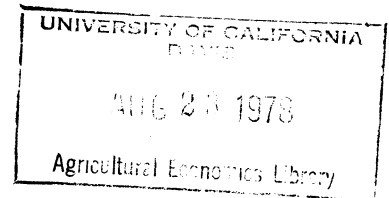
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THE COST-PRICE SQUEEZE:
SOME STRATEGIES FOR BEGINNING FARMERS

E.I. Fuller 1/

Introduction

Strategy implies an overall plan to attain a given set of objectives. By comparison, tactics imply the specifics of the step by step activities in following the plan. This paper discusses some of the issues involved in the selection of appropriate strategies to gain control of the resources necessary to operate a viable farm business. Obviously, no given set of strategies is correct for all beginning farmers. Consequently, this paper deals with choices between alternative strategies.

Premises And The Realities Of Farm Entrepreneurship

Before strategies can be defined or compared, some comments concerning the situation faced by beginning farmers are required. We can start from the proposition that management is a problem-solving activity; it is basically going from where one is to where one wants to go.

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From the beginning farmer's standpoint, the cost-price squeeze idea represents a decline in the gross margins remaining after the cash inflows from product sales are reduced by the cash outflows of the associated cash expenses directly incurred in their production. Such a reduction in net cash flow per unit necessitates sufficient production volume to provide adequate total (gross) margins to cover living expenses and the capital use payments involved.

With these basic premises in mind, we can now turn to the realities--the "what is" of the situations faced by beginning farmers.

The Need For Objectives And Goals

A first premise is the belief that it is futile to be a farm manager without a problematically operational philosophy of life. This also means that the would-be farm manager's family unit must be sufficiently harmonious in the understanding of this philosophy and its associated family life-style to be able to agree in a general way on the relative importance of the several kinds of objectives one usually has in life and in operating a farm business. There has to be some common understanding and agreement of the importance of (1) current spendable income, (2) security needs, and (3) the importance of growth--especially in net worth terms and asset holdings. In all three of the above there are monetary considerations

as well as those not easily measured in dollars. There are two more useful categories of objectives. All men express a need for (4) recognition and (5) acceptance by those around them--the groups to which they belong or want to, the community and its organizations as well as the primary and greater family groups to which they belong. Trade-offs and compromises are necessary between these kinds of objectives or goals. Effort is necessary between those within the decision group as well as within oneself to reconcile the implied conflicts.

Some Realities Of "How It Is"

There are certain economic realities which also must be faced up to. There is little reason to believe that in the near future average net farm income will be on a par with average nonfarm income, nor will the pressures of the cost-price squeeze slacken for very long. Increases in volume will typically be necessary to maintain gross margin and meet other commitments.

Further, there is little reason to believe that inflation will be quickly brought under control. So long as it is not, one should project continual escalation in farm expenses and in the acquisition price of such assets as machinery and land. A beginning farm family needs to recognize that capital accumulation occurs primarily through a willingness to forego current consumption.

There are certain physical production realities too. These have been expressed abstractly in the static production economic models. These include the universality of the law of diminishing returns and the diminishing marginal rates of substitution of factors and products. These physical realities have associated with them certain fundamental decision rules--the added costs and returns rule, the substitution rules, and the opportunity cost rule--all imply making the highest and best use of available labor and capital as one goes along.

Given the dynamics of the real world, these rules require some modification but not discarding. For instance, one observes that part of the manager's job is to take advantage of whatever economies of size are available to him and to be constantly on the lookout for any diseconomies of size which, when discovered, might possibly be overcome by the acquisition of additional units of the limiting resources which created them. The realities of stochastic variation require attention to probabilistic concepts of risk and uncertainty as well.

The realities of the modern business world require the acquisition of certain business planning skills. These include the skills long associated with farm planning; the use of budgeting techniques and all that goes with that idea to project the profitability of alternatives and to project

their expected cash flow characteristics also. But, squeezed gross margins require further skills. They require skills in evaluating the risk and/or uncertainty involved in particular production and contingency plans; and they require skills in determining the degree to which some of these risks should be accepted, while calculating when and how to transfer some of them to others through formal or informal insurance schemes (including forward pricing).

Other skills include those necessary to acquire financing. They require language skills associated with using financial terms on a par with creditors one deals with. Terms such as "leverage", "liquidity" and "solvency", not to mention "profitability", must be used with clarity in an accounting sense.

Modern agriculture requires substantial technical production skills derived from the several disciplines which bear upon the selected enterprises. Marketing skills, as alluded to above with the comment on forward pricing, are also required. One has nearly 24 months of time within which he can price many major farm commodities today due to the activities of the futures market. And, even if it is not true that "you can't go broke by accepting a positive gross margin", you certainly can delay it for a while!

Strategies For Acquiring Resources

Several important and often hard to make key choices are necessary to work out a strategy for resource acquisition by the beginning farmer. Some of these virtually become the horns of a dilemma because there may be no good choices, only least worst ones. Consider, for instance, the offers of sponsorship by family or friends that appear to be accepted by some 80 percent of beginning farmers today. While 80 percent take this option, some to which it is offered do not. Others, obviously, do not have the option at all. However, some who do not at first appear to have this option could consider spending some time looking around for a sponsor. Some farmers near retirement, without families of their own, do see sponsorship as a source of increased income and security during their retirement years in that it keeps their farm business going.

Sponsorship provides the control of needed assets often at reduced cash flow costs--reducing the drain on gross margins. It can permit operations at volume levels that would otherwise be un-economic given the cost-price squeeze. It provides time to build a production and business performance record for credit purposes. It often provides an opportunity to become a member/owner of a going business. Managerial and production experience can be gained without as high a failure risk as doing-it-alone might have.

Farmers who have done it alone sometimes say that the loneliness associated with not having someone to rely upon for advice and counsel can be difficult. Further, they also point out that the responsibilities associated with the freedom to make all their own decisions sometimes become more than they really want to bear. On the other hand, the independence of the unsponsored situation is very appealing to many people who would chafe under the restrictions imposed upon them by an older generation with quite different weight placed upon the importance of income, growth and security as well recognition and acceptance of objectives. Besides, the personality conflicts that can occur in a closely held farm business organization are another drawback to the sponsored approach.

Perhaps the key to appropriate overall asset control strategies is a recognition that control does not necessarily mean ownership. There is a time to commit one's equity capital to the (leveraged) purchase of assets. There are other times where it would be more appropriate to gain control with rental or lease arrangements.

Before capital is invested in anything, the question should be raised as to what one really wants to accomplish. This question has both an economic and a technical component in the answer. Part of the management job is to discover new and better alternatives. Some of these alternatives may be of lesser cost than others. Some of these alternatives

may require a commitment for a longer period of time than others. Not as frequently, the least capital cost way is also the easiest to back away from if it does not accomplish the desired end.

Further, a person can ask the question "which alternatives pay off rapidly?". Such alternatives should generally have higher priorities for the use of limited capital by the beginning farmer. Livestock feed is frequently in first place. Then comes seed and fertilizer (lime) and other cash expenses required to put in a crop. Productive livestock follows in many instances, even if machinery must be custom hired to actually take care of the crop. Otherwise, machinery would probably rank above productive livestock. Livestock buildings and facilities, and then land, tend to be the categories that show the lesser rates of return and the longer payoff periods. For want of a better approach, this paper will discuss most of these categories.

Land

In the case of land, a dilemma is apparent. Rental rates are not as demanding of cash as low equity purchase. Yet, land is not always available on a rental basis. Besides, if an operation base is required with investments in buildings and facilities, it can be difficult to control an adequate unit unless some land is owned. However, when one does purchase land at a given location, he limits his options to operating in that general area.

The opportunity sometimes exists to start a livestock operation with leased facilities and purchased feed, and with little or no investment in land. However, with inflation and the available data indicating good gross margins on crops, this beginning strategy has some drawbacks. There are problems associated with the lack of locational commitment and with continued reliance on others to provide quality feed at prices which maintain one's operating margin. Perhaps if the person is labor oriented rather than capital oriented, (9) and it is his intent to provide skilled employment for his labor, then this option might be a possibility.

Livestock And Facilities

Livestock enterprises, particularly those requiring intensive use of available skilled labor and management, should be seriously considered by any beginning farmer. Dairy and sow herds frequently make the difference in terms of a beginning farmer's ability to "get it all together". Data from a variety of sources show this. Hogs have been referred to for years as "mortgage lifters", for instance.

Breeding stock leasing costs average 3 to 7 percent more than debt costs to acquire a herd. Low equity beginning farmers may have no choice--again an increase in the cost-price squeeze occurs under conditions of low marginal income tax rates and higher leasing costs.

Dairy production and swine farrowing are difficult and challenging enterprises in the old and obsolete facilities frequently found on farms available for rent. Rates of return on new facilities are often not sufficient for the beginning farmer who is already committed cash flow wise with low equity in owned land; investments must be made with great care. Beginning farmers often handle these enterprises with "brute strength and ignorance". Physical and mental fatigue with long hours from available labor often narrow the gross margin and limit the volume of production that can occur with old facilities. Livestock health and associated feed to produce transformation rates at ideal levels are hard to control.

If newer facilities are to be considered, some real challenges exist there also. Obsolescence rates are rapid on such facilities. Property values do not usually increase proportionately with the investment in such facilities, and equity in the property declines. Payoff rates for dollars invested in these facilities are usually quite low and/or slow in terms of years to pay back. A commitment to a land base of often less than totally adequate production capability to feed the livestock housed in these facilities is also another major concern.

For many beginning farmers the option of going with obsolete facilities is usually the only live one. When this happens, a commitment to long hours of work and the challenges of good livestock herdsmanhip are important and difficult ones.

Machinery

Probably a mixed strategy of ownership, leasing and custom hire of machinery fits most beginning farm situations. Machinery is expensive; yet at the same time, crop losses due to a lack of timeliness in planting and harvesting are also very expensive. For established farmers, at least, the additional cost associated with the "next-larger-than-needed-size" in order to assure timeliness in operations is often not hard to justify. When external capital rationing exists for the beginning farm firm, appropriate size selection is critical. Perhaps part of the key to a solution is to ask oneself "what are the absolute machinery necessities to ensure economic levels of timeliness and to ensure that day-to-day operations can continue?". Contrast with, "what does one need in terms of machinery and equipment to get the necessary jobs done?" and with "what would be nice to have for reasons of providing sufficient system backup and to reduce the strain associated with getting through stressful times caused by breakdowns and inclement weather?". Leasing and custom hire may be the answer in the last two categories, even if gross margins are reduced. Mechanical repair skills help.

Marketing

Strategies associated with marketing decisions tend to turn into questions of how much price risk to transfer to others and/or what combination of a forward pricing strategy

and a speculative strategy should one follow when pricing commodities. Transferred risk usually means lower net returns. Yet, if transferred risk would allow financing at a higher rate of leverage and, consequently, a greater volume of production it may still be the superior alternative. Here, too, a beginning farmer's strategy might be to reduce gross margins if by doing so the managerial objectives of security of position are met and with them the lesser stress which might come from adverse price movements--then forward pricing schemes should be seriously considered when available.

Financing

From a strictly financial viewpoint, strategies also have to be developed to determine to what degree one should seek supervised credit through FmHA and similar second mortgage schemes which essentially provide risk capital for getting started. One needs to realize that a certain flexibility and/or freedom of choice is given up with such schemes. At the same time, if plans are well laid and major risks are sufficiently transferred, these kinds of schemes provide opportunities for beginning farmers to actually make a go of it. The cash flow must still be maintained to pay the necessary interest and capital repayment commitments which might go with such financial agreements.

To make financing work for beginning farmers usually requires the transfer of more than just some price risk. Production risk in the form of the purchase of managerial advice, such as hiring consultants and formal insurance schemes such as hail and lightening insurance for livestock, also needs to be part of the package. Such transfers of risk and various other formal and informal insurance schemes usually increase cash outflows and production cost. Yet at the same time, they more nearly assure the survival of the firm with its heavy debt commitments. Besides, they help creditors go along with highly leveraged, though potentially profitable, farm plans. After all, the usual debt to asset ratios specified by creditors are an attempt to insure their position against adverse cash flow conditions in the farmer's business. A beginning farmer may not go to the limit in order to assure a reserve borrowing capacity for similar reasons. To adopt such a financing strategy is an informal insurance scheme, paid for by the loss of earnings foregone by operating a smaller business.

Concluding Comment

An old Yankee axiom of "patch it up and make it do!" is not an unrealistic approach for the beginning farmer with limited capital resources. So long as such critical factors as seed can be planted properly and livestock kept healthy are

taken care of, such an approach can make a great deal of sense. In many ways this axiom is really an outgrowth of another, "use your head and save your heels!". Only then should "brute strength and ignorance" come into play by a beginning farmer. And in any event, living with a lack of expense or with one spouse having a job off the farm, with all the sacrifices that entails, are certainly important roads to becoming established in farming.

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