

Livestock Marketing/Price Risk Management

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Raising livestock has always been a challenging and risky operation. Producers deal with many different types of risk involving production, marketing/price, financial, legal, and human resource risk. Production risk is one that is usually dealt with on a daily basis. The effects of a drought reducing the availability of grazed forages and increased feeding costs. Sickness or disease may limit weight gain or be detrimental to reproductive performance. A late winter storm during calving season can result in sickness and even death for many new born calves. Producers generally have management plans in place to mitigate many of these types of production risks. For example, nutritional supplements are often fed to offset shortages in range or pasture conditions, cattle may be moved to more protected areas for calving, and animals are vaccinated to reduce incidence of sickness or disease.

Producers will often make decisions to reduce production risk and might feel that there is little they can do to impact the price they receive for their livestock. The expected price for a 500 lb. weaned calf can vary more than \$20/cwt. from the time the calf is born until it is marketed in the fall which is a difference of \$100 per head. Even at the time of sale, prices for the same weight cattle may vary as much as \$10/cwt. at a local auction which is a difference of \$50 per head. Market or price risk might not be dealt with on a daily basis as production risk, but is major source of risk that producers face that affects the productivity and longevity of an operation. It is true that individual producers have no impact on the overall market price level for calves or feeder cattle, but individual producers can have an impact on the prices they receive.

There are several different marketing and pricing strategies that a producer can implement to meet the amount of risk exposure they are comfortable with. Some of the marketing strategies that might be implemented might be local auctions, regional auctions, satellite video auctions, internet auctions, direct commodity markets, and direct niche markets. Pricing strategies might include cash sales, forward contracts, futures and options, and insurance.

Marketing

Local Auctions

Local auctions are a traditional and sometimes primary marketing method for livestock producers. When producers are ready to sell and deliver their livestock they truck them to the auction market. The auction promotes the livestock and tries to bring the best price for the producers. The price is determined by the market of the day. Once the cattle are sold, the auction subtracts their sales fees from the producer's price and then pays the producer for the livestock.

When considering this marketing strategy the obvious attraction is the overall ease for producers. No prior considerations or preparations are required to participate in the auction. However with this relative ease in participation come many drawbacks that make this option less appealing. The major costs of marketing at an auction are commission and yardage. Depending on the auction, variation can be seen in the way commission charges are assessed. Some are assessed on a per-head basis, others on a percentage of the proceeds, and still others as a combination of the two. Other deductions may be made for such things as insurance, state inspection and fees, and brand inspection.

Regional Auctions

Regional auctions are much the same as local auctions and all of the same pros and cons should be considered. Differences from the local auction to keep in mind are the possibility of greater transportation costs depending on the auction location as well as increased competition as a result of the larger auction. However these drawbacks can often be offset by the advantages gained by participating in a larger regional market.

Satellite Video Auctions

In recent years one marketing option that has continued to grow in popularity is video auctions. When producers are ready to price their livestock, but prior to when they are ready to deliver them, they contact a representative from a video sale auction and have them come to their ranch and film their livestock and help to write a description of the cattle. On a specified date, an auction takes place where buyers may be at a specific auction location or scattered across the U.S. in their own homes bidding on the cattle. A typical video auction consists of the buyers

watching the short video of the livestock as well as reading the written description as the auction company solicits bids and tries to secure the best price for the producer. The buyer usually takes delivery of the livestock at a future date (1, 2, 4 months in the future) and generally assumes the responsibility for transportation.

Video auctions are an attractive marketing option for several reasons. First, the actually handling of the livestock is reduced because livestock never have to be transported to and from auction sites eliminating transportation costs as well as loss due to shrinkage. Second, price risk can be reduced by obtaining a forward price for the livestock but unlike a forward contract negotiated between one buyer and seller, a video auction has the ability to reach multiple potential buyers. With the added security of a guaranteed forward price, producers also run the risk of missing out on price increases. Another advantage that producers might gain is the ability to determine when the buyer may take delivery. Video auctions typically have higher commission fees compared to a local auction but this cost is hopefully offset by the savings in transportation costs.

Internet Auctions

Internet auctions are a relatively new form of livestock marketing. Internet auctions typically have a written description of the livestock as well as pictures with some auctions offering the option of video as well. The bidding is opened for a set period of time when buyers may bid up until the predetermined auction end time. Internet auctions, like video auctions, can be an attractive option for producers because they are able to market their livestock to a larger number of buyers without the added costs of transportation that are associated with regional auctions. However Internet auction sites do charge sales commission fees that can often offset many of the benefits.

Direct, Commodity Markets

When producers are ready to sell and deliver their livestock, a potential buyer such as a neighbor or local feedlot operator comes directly to look at the livestock for sale and makes an offer to buy them. This type of marketing is one of the more traditional forms of marketing livestock. Advantages that producers have from this type of marketing include avoiding commission and yardage fees. The buyer typically pays for transportation cost which also is an advantage for the

producer. The disadvantage to this type of marketing is that producers are typically working with a single buyer to try to negotiate a price and might not result in a price that reflects the current market price.

Direct, Niche Markets

A marketing alternative for producers to consider is to participate in niche markets. The products sold through a niche market can receive a premium on the market and can be less vulnerable to substitution because the product being sold has characteristics that make them appeal to a specific type of consumer. This premium plus the added security of fewer substitutions from consumers make niche markets appear very appealing. Often producers only consider the premium sale price of a niche product and fail to recognize any of the potential drawbacks. Some of the additional costs of production to consider might be finishing, advertising, arranging processing, and any additional time commitment.

Pricing

Regardless of the marketing method chosen by producers, there are still opportunities for a producer to reduce or increase their exposure to risk through different price options.

Cash Sales

Cash sales are not often thought of as a risk management tool but, there are opportunities with cash sales to reduce risk. One way to reduce risk in the cash market is to be in the market often. By selling livestock at multiple times of the year producers may reduce some of the effects of seasonality in cash sales. A producer may choose a variety of different production practices such as fall calving, early weaning, overwintering and summer yearling programs to market a portion of calves in different time frames. By choosing a variety of different production practices, a producer can spread out the marketing of their livestock over time and over different market classes. This form of diversification can reduce risk by not having all of your calves in one market.

Forward Contracts

Many times when it comes to price risk management, many producers choose a forward contract with a buyer. Producers contract to provide a certain number of livestock at a future date at a certain average weight. The buyer agrees to accept delivery at the predetermined date and a price is agreed upon at the time of contract. There are several forward contracts still agreed to with only a handshake between two parties. As long as the market does not move drastically higher or lower, and if the livestock meet the agreed upon specifications, there are usually no problems with a handshake agreement. However, if there are extreme changes in the market, or the livestock end up being significantly different than what was agreed to, a written contract with specifics can help in avoiding costly litigation. Most sales on satellite video auctions and many Internet sales are forward contracts. Cash forward contracts eliminate price risk as the producer's price is now fixed.

Futures and Options Markets

Sometimes you may want to forward contract your cattle, but you can't find a willing buyer or you may want to leave your livestock marketing decisions more open, but would still like to have some form of price protection. There is a Feeder Cattle Futures market that can be used to establish an expected price for your cattle which is similar to forward contracting but also different.

Producers can establish a price prior to delivery by using the Chicago Mercantile Exchange feeder cattle futures. A producer can establish a price for their calves by selling an October or November feeder cattle contract earlier in the spring or summer. Then, when the calves are sold at weaning in the local market, the producer buys back the October or November feeder cattle contract. If the market has declined from the time of the initial futures market sale, then the producer will make a positive return in the futures market which offsets the lower cash price received. However, like a forward contract, producers cannot take advantage of higher prices. If market prices increase after the initial sale of the October or November feeder cattle futures, when the producer buys the contract back, they lose money in the futures market. This offsets the higher price received in the cash market and producers are left with about the same return

regardless of whether the market moves higher or lower after the initial futures sale. Hedging is designed to minimize price risk and is not a method to consistently receive a higher price.

Put options on the feeder cattle futures is another opportunity that producers have. A Put option allows producers to establish a minimum price but still leaves the option open to take advantage of higher prices if they occur. This can be an attractive option to producers that want to minimize down side price risk but still take advantage of higher prices should they occur. The cost with this options strategy is that a premium must be paid to purchase the put option.

Insurance

You are required by law to have insurance for your truck or car and you most likely have insurance for yourself and family members against poor health, do you have insurance for your livestock against a price wreck?

In 2002 the USDA-Risk Management Agency (USDA-RMA) introduced Livestock Risk Protection (LRP) insurance for feeder cattle. This insurance product is very similar to purchasing a put option on feeder cattle futures, in that a minimum price is established. If prices fall below the established price level, then an insurance indemnity is paid out to the producer. If the market is higher than the insured price, then the producer is out the insurance premium but receives the higher market price. Unlike a put option on feeder cattle, producers can insure as few as one head if they desire.

There is no one pricing and marketing strategy that will return the highest price every year. There is also no one pricing and marketing strategy that is right for every producer. If producers know their cost of production and can evaluate the various pricing and marketing alternatives, the “best” alternative can be selected for a particular situation and year. The “best” choice depends on how much risk a producer is willing to tolerate and the overall financial position of the operation.