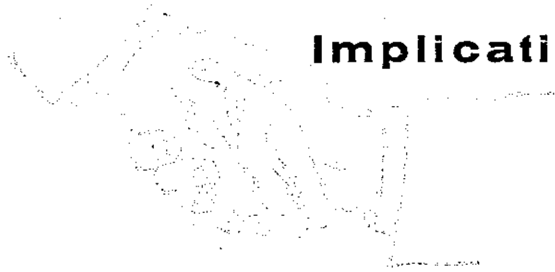
CONTRACT FARMING–

Implications to Banking



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CONTRACT FARMING —

Implications to Banking

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Vertical integration, contract farming, and coordination mean more or less the same thing. They refer to various types of closer coordination between farmers or ranchers and (a) farm suppliers and (b) farm commodity processors or marketers.

Less price and income risk, higher income, access to capital, larger farms and ranches, mechanization, technological improvements, competition, larger loans, longer but more predictable debt-repayment programs, and a moderate shift in the source of loans are associated with contract farming.

Broilers, vegetables, sugar beets, fruits, and berries are grown extensively under contract. Parts of the livestock industry have more recently been integrated. Probably no more than 5 per cent of the nation's agriculture is presently under contract farming.

Future integration of most enterprises will probably be slower than it was with broilers. Although tremendous progress and change lie ahead, there were greater opportunities to improve efficiency, fill market vacuums, or make a big profit with broiler, vegetable, and sugar beet integration a quarter century ago than appear to exist with most agricultural enterprises at the present time.

CONTRACT FARMING —
Implications to Banking

DEFINITION...

A close tie-in between farmers or ranchers and people who sell to or buy from them has several names. Some call it vertical integration; some, contract farming; and others like to think of it as closer coordination between farmers or ranchers and farm suppliers, processors, or marketers.

This publication will use integration, contract farming, and coordination as terms meaning more or less the same thing. "The key... is the extension of the effective area of control by centralized management. The arrangement involves a transfer of all or part of the management decision making to the integrator in return for a reduction of price-and-market risk..."[1]

There are many types of contract farming. The following classification reflects differences in methods of coordination and degree of centralized control:[2]

...Complete centralized control through a single firm which owns the farm supply business, the farms or ranches, and the processing and marketing facilities. A company in Missouri integrated under their ownership a 1,000,000-bird-per-year broiler operation from chick hatchery to chicken pie and other items nearly ready for the table.

...Strong centralized control or coordination, whereby farm supply, processing, or marketing firms furnish much of the credit and management along with a package contract, such as prevails in the broiler industry.

...Centralized control by cooperatives which assume strict coordinating responsibilities as with the Sunkist Growers, Incorporated, of California.

...Control through government action such as with federal milk marketing orders.

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[1] "Vertical Integration in Agriculture," Agricultural Extension Service, Purdue University, Lafayette, Indiana.

[2] Adapted from "Vertical Integration in Agriculture" and group discussions at the National Institute of Animal Agriculture, Purdue University, April 20-22, 1958.

. . . *Coordination whereby operators of efficient-sized family farms retain essential control over growing the crops or caring for the livestock, but contract in advance for a fixed price for feed, seed, or fertilizer purchased and livestock products or crops sold.* Sugar beet processors, and more recently, feed companies and meat packers initiated such programs.

. . . Improving coordination, without a formal contract, between farmers or ranchers and supply, processing, and marketing firms by greater understanding of their mutual needs. The slow processes of attaining a meat-type hog in a more nearly constant supply and of upgrading egg quality at the retail level are examples.

WHY...

Contract farming is associated with several factors which change farm credit needs. If banks are to retain their share of the desirable farm credit business, they may need to reorient their approach to fit ever-changing conditions.

. . . Farming is a high-risk business. Output is subject to sharp fluctuations beyond farmers' control. Farm products go to a market which is stubborn—it wants a specific supply. If a little too much goes on the market, prices tend to go 'way down. If the supply is a little short, prices tend to increase sharply. As a result, farm income fluctuates from year to year. Vertical integration usually places a more uniform supply on the market, and contractors absorb some of the shock of the severity of the market place by price or income guarantees to farmers. In this way, farmers assume less risk. According to about 700 bankers who responded to a survey by the Agricultural Commission of the American Bankers Association, farmers who produce under contract also tend to get a higher income than they otherwise would.

. . . Farms and ranches are becoming larger and more highly mechanized. Total assets per worker in 1957 averaged \$29,300.[3] Machinery and equipment, figured at constant prices, increased threefold from 1940 to 1958. Higher capital

[3] Estimate based on civilian agricultural employment for 1957 as reported in "Economic Indicators," Council of Economic Advisors, United States Government Printing Office; and total assets for January 1, 1957, and 1958, as reported in balance sheets of United States agriculture, United States Department of Agriculture.

needs are closely associated with increased contract farming. Many capable farmers simply have not lived long enough to accumulate enough capital to own an efficient farm business. Contract farming provides a source of additional capital and credit and helps many farmers get a larger business. Thereby, they become more productive in their communities and obtain a fair income for their efforts.

... Technological advances challenge the imagination. Researchers seriously speak of producing experimentally one pound of broiler per pound of feed in the near future. Contract farming helps assemble the management and technical know-how needed to bring about large-breasted, plump-thighed chickens, meat-type hogs, improved sanitation, the upbreeding of herds of range cattle by artificial insemination, and greater yields per acre of higher quality crops.

... Farming is a highly competitive business. Some farmers don't make much money. Others who produce more efficiently enjoy good incomes. Many farmers who sold broilers for less than 60 per cent of parity made a reasonable profit under very competitive conditions in 1957. Contract farming helps many farmers cut production costs and meet competition.

... Historically, each farmer competed against all other farmers. Presently, farmers are more highly organized. Organizing by commodities brought about competition between groups of farmers who produce similar products. Poultry, pork, and beef compete with each other. Likewise, organizing geographically fosters competition between regions which produce the same or similar commodities. For example, competition from southern producers concerns Midwest hog feeders.

... Sellers to and buyers from farmers are competitive. Sellers constantly search for stable or increasing sales outlets, while buyers seek a reliable supply of uniform, high-quality products. Feed suppliers, hatcherymen, farm managers who get wholesale discounts for their clients, and even banks which service farm and farm-related businesses in trust are familiar examples of various types of coordination which help individual businesses meet competition.

On the distribution side of the food business, supplies are somewhat stabilized by contract farming. The seasonal broiler cycle has been moderated. This contributed to price stability which, in turn, made it easier to write contracts for future delivery. Quality and uniformity were improved. This was partly a result of contracts and, at the same time, contributed to contract farming. In any event, high quality and uniformity enabled broilermen to compete with remarkable success and capture a market which might otherwise have gone to pork, beef, or lamb producers.

These are the conditions under which contract farming is gradually spreading. No one factor can be considered the primary cause or effect. There has been a complexity of cause and effect. *Simplification would distort the picture.* Bankers will want to watch those factors mentioned for indications of changes in farm credit needs.

WHEN STARTED...

Contract farming has been practiced for a long time. Vegetables and sugar beets have been produced under contract between farmers and processors for generations. The modern broiler industry is a more recent example. In addition to processors, as was the case with many of the older forms of integration, other farm-related industries helped integrate the broiler industry. These included hatcherymen, feed manufacturers, feed dealers, poultry processors, retail food distributors, and other farm-related businessmen who saw an opportunity for profit if they provided consumers with uniform, high-quality, low-cost meats.

WHERE AND WHAT...

Where and for what commodities does contract farming exist? Bankers who responded to the survey by the Agricultural Commission of the American Bankers Association most frequently mentioned broilers or turkeys as a commodity produced under contract in their county. Contract broiler production is concentrated in the Del-Mar-Va area, Georgia, Arkansas, New England, Pacific Coast states, North Carolina, Alabama, Mississippi, and Texas. About 90 per cent of all broilers and 50 per cent of all turkeys are produced under contract.

Compared with broilers, laying flocks are more widely distributed and more recently integrated. It has been variably estimated that less than 5 per cent to as high as 20 per cent of all eggs come from one of several types of contract farming.

Sugar beets are extensively grown under contract in California, Michigan, Minnesota, Ohio, and most states in the northwest quarter of the country. Vegetable contracts tend to be concentrated near cities, canning centers, in the specialized California vegetable areas, and in potato-producing counties.

Contract livestock production recently captured the attention of farmers, farm-related businessmen, writers, and speech makers. Contract farming was applied to broiler, turkey, vegetable, sugar beet, fruit, and berry production without great public concern. But when it was apparently becoming imbedded in the livestock industry, this "new" type of farmer or rancher, who chose to produce under some assurance of the price to be received, became labeled by public spokesmen as a "sharecropper," "hired hand," "peasant," or member of "serfdom" as if a symbol of sin had invaded sacred chambers. Notwithstanding these labels, an increasing number of farmers and ranchers from various parts of the country are entering into some type of coordination of the various stages of meat production. An estimated 10 to 20 per cent of all fed cattle slaughtered, one-fourth of all lamb and mutton production, and something under 10 per cent of the hogs being processed have been in some type of integrated unit during one or more phases of production.[4]

It was the consensus of opinion of some 700 bankers from every major farming and ranching area that *no more than 5 per cent of all farming and ranching is under contract at any one time.*

LIMITATIONS...

Although contract farming is a common practice, certain factors keep it from spreading more rapidly. In a few cases, it takes time to develop contracts which give farmers an incentive to try as hard as they would if they were entirely on their own.

With some enterprises integrated under strong centralized control, it is difficult to attain good husbandry. Many phases of farming are still an art. Successful operations require good, on-the-spot judgment by farmers or careful, detailed supervision by qualified integrators. The latter tends to be more cumbersome. Seasonal biological production processes do not always lend

[4] Robert C. Kramer, Michigan State University, "What is Integration and Its Current Status?", National Institute of Animal Agriculture, April 21, 1958.

themselves to an eight-hour-day, factory-type operation. One or two additional pigs saved per litter by independent, interested producers at midnight farrowings can mean the difference between profit and loss.

These human factors—incentives and good husbandry—are being built into successful contracts. The tendency may be toward a type of agreement between farmers and suppliers, processors, or marketers whereby farmers retain flexibility of operation, retain incentives to practice good husbandry, strive for greater profit, and accept risks very much as if they were operating on their own. The type of coordination described in italics on page 4 most nearly fits these criteria.

Economic factors sometimes restrict contract farming. Many conditions contributed to contract broiler production. Flocks were generally small and inefficient. Production was not mechanized. There was a great potential for the application of new technologies. Little capital was being used. And there was an unsatisfied demand for uniform, high-quality, low-cost meats. These added up to an unfilled vacuum which was filled by a billion-dollar integrated broiler industry.

To the extent that credit for progressive farmers is becoming more readily available, the demand for credit through contractors is held down. Land sales contracts may provide an alternative to contract farming for meeting large capital requirements in an increasing number of cases. A land sales contract is a "long-term contract for deed frequently used as a means of low-equity financing."[5] One out of every five purchases is financed with a land sales contract. This is double the proportion of a decade ago.

Agricultural progress or change will always exist. Pork and beef production will become much more efficient. Mechanization, improved nutrition, and sanitation will greatly increase livestock output per man-hour. Capital requirements will multiply. Contract farming will be associated with some of these changes. However, conditions which might encourage contract farming appear more moderate or fewer in number than those associated with the integration of broiler, sugar beet, and vegetable production. Most commercial farm enterprises now are relatively efficient. Persons hoping to profit from contract farming are faced with greater competition with low-price, high-quality, nutritious foods. And credit is becoming more readily available.

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[5]"The Farm Real Estate Market," United States Department of Agriculture, May 1958.

BENEFICIAL OR HARMFUL...

The exact impact of contract farming is by no means clear. However, several effects can be described. Broiler producers from the lower counties of Delaware like it.[6] Bankers who responded to the A.B.A. contract farming survey generally believed contracts help farmers attain higher incomes, greater access to capital, and larger businesses at less risk. Contract crop farming has progressed gradually over the years without serious animosity by any group, even though a degree of loss of independence and lower income in a few cases may partly offset its advantages.

Without being fully aware of what it was all about, the public readily accepted broilers, turkeys, and crops raised under contract farming. Housewives responded to uniform, high-quality, low-cost broiler meat by buying an average of 60 per cent more for each member of their families than did housewives 40 years ago. Likewise, consumers ate more fresh green vegetables. As a consequence, diets and health improved.

MEANING TO BANKS...

Contract farming nationally may not require basic changes in the banking system beyond those needed to serve larger farms and ranches—whether integrated or independent. However, several developments appear clear—even if only of moderate magnitude:

(1) Contract farm and ranch operations tend to be larger than completely independent units. Capital requirements of the integrator are usually much larger than those of independent farmers. Thus, loan size tends to increase.

(2) Credit demands tend to shift to the bank serving the contracting institution. In some cases, this may mean the country bank will be bypassed.

(3) Loan risk to a banker tends to be reduced when a bank lends to an integrator who in turn helps finance a group of farm customers. Then, if one or more farmers runs into financial trouble, the integrator will generally be able to absorb much

[6] Frank D. Hansing, "Financing the Production of Broilers in Lower Delaware," Bulletin No. 322, University of Delaware and the United States Department of Agriculture.

of the financial problem without impairing his line of credit with his bank. From the standpoint of the bank, risk is spread over a larger base of farmers' assets and earnings plus the integrator's assets and earnings. On the other hand, if the same group of farmers borrowed directly from their bank, their individual farm financial problems would be felt directly by their banker and would be more apt to result in delinquent loan collection problems, adverse loan classifications, or write-offs.

(4) Loan risk is reduced on direct loans to farmers when integrators assure farmers of the price to be received for crops and livestock sold. This is particularly true with farmers who produce only one major commodity. It is less important on diversified farms, because a good production year or good prices for one enterprise help offset the chances of a crop failure or low prices for other commodities.

(5) Loan repayment capacity is either increased by improved management and larger units or can be more accurately predetermined because of an assured price.

To meet larger loan requirements and competition from other credit agencies that are trying to get the better farmers as customers, banks are taking one or more of several steps. Increasing capital strength, particularly in rural banks, has proved helpful. Closer loan participation relationships with correspondent banks and insurance companies are being developed. This has helped small banks handle larger lines of credit to individual farmers as well as to integrated farmers and farm-related businesses.

More and more banks are hiring agriculturally trained men. By so doing, bankers can understand the management problems of modern agriculture, including contract farming, a little better. *One or more bank officers or potential officers with a background of practical and formal training in agriculture can be the most important single factor in meeting bigger and longer credit needs of efficient farmers.* This group of farmers contributes more to our high level of living. Progressive bankers are interested in serving this group of farmers and keeping them as bank customers. In this way, banks put their communities' savings to work where they will do the most good. This is also in the best long-run interest of banks. As a community prospers, so does its bank—with more deposits and higher quality loans.

FUTURE GROWTH...

How fast will contract farming spread? Will it be used to help the livestock and poultry industries remove the stigma of greasy pork, fatty hamburger meat, and stale eggs from the housewife's mind? The extent to which contract farming is used to help remove these stigmas will depend in large part on how soon independent farmers, ranchers, processors, and marketers get large quantities of relatively fat-free pork, tender, lean beef, and fresh eggs into retail stores.

Human factors, as mentioned previously, may favor contracts whereby most of the ownership, incentive, and risk are retained in the hands of farmers. Non-economic human factors may be of such importance that vertical integration will come about more slowly than is generally reported publicly.

Contract farming may be more a result of consumers' likes and dislikes, technological progress, and larger farms and ranches than a cause. To keep abreast of changing credit needs, alert bankers will be attentive to developments in mechanization, especially of farm buildings and livestock facilities, nutrition, sanitation and disease control, and the types of contracts which give farmers the most incentive to produce efficiently the types of commodities housewives are most anxious to buy.