

## Five Strategies for Managing Crop Revenue Risks

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### **Strategy #1: Let cash flow needs drive post-harvest sales decisions.**

With the 2010 harvest wrapping up early, producers need to consider where they stand currently with their own financial situation. Grain sales to meet fall and winter cash flow needs should be paramount. A rule of thumb is for a farm operation to maintain working capital (current assets minus current liabilities) of \$200 to \$300 per tillable acre. While interest rates remain relatively low, a farm's ability to manage financial risk is critical. Consider generating enough from pre-harvest and post-harvest sales to meet scheduled debt service and prepaying 2011 input costs.

Granted, a rally of nearly \$2.50 per bushel for corn and over \$3 per bushel for soybeans from their 2010 summer lows will likely increase the sense of loss from earlier sales you may have made. But while the emotional loss for those bushels previously priced will be high, I encourage producers to be realistic with price expectations for the unpriced portion of your crop and allow cash flow needs rather than emotion drive additional sales.

Cost of storage and interest costs should be considered, along with futures market carry and potential for seasonal narrowing of basis as harvest selling pressure on futures subsides. Remember, these higher-than-

expected futures market prices will eventually ration a smaller-than-expected 2010 crop by reducing demand. Both the livestock and ethanol industries will face much higher operating costs and breakevens as the result of today's corn and soybean prices.

### **Strategy # 2: Maximize 2010 crop insurance decisions.**

Nearly 86% of all Iowa's insured row crop acres are covered by revenue crop insurance products, mostly Crop Revenue Coverage (CRC) policies in 2010. The high harvest futures prices for both December corn and November soybean futures contracts increases the potential indemnity payments that many farms will receive should they have a large yield loss for 2010. The October harvest prices averaged \$5.46/bushel for corn and \$11.63/bushel for soybeans.

Work with your crop insurance representative regarding collecting potential indemnity payments and keep good records on each field that can be reported for Actual Production History (APH) purposes. The reason this is critical is that government farm programs such as the Supplemental Revenue (SURE) use crop insurance losses across entire farms and will require good 2010 records.

Consider proving your APH yields on the smallest unit, likely a farm field by owner for each section of land. Regardless if you insure using enterprise units or use county-level products, you get to determine annually by March 15<sup>th</sup> the product, level of coverage and unit structure for your crop insurance decisions. In 2011 the

new Revenue Protection (RP) insurance product will replace both the Crop Revenue Coverage (CRC) and Revenue Assurance (RA) products. This should simplify the insurance decisions since producers no longer need to compare CRC to RA premiums and respective differences in coverage.

**Strategy # 3: Expect higher 2011 input costs and mitigate the expected price increases.**

Both the financial risk and market price risk of row crop farming has increased substantially since the 2008 crop year. The experience of those prices has lifted current prices beyond what most expected just a couple months ago. However, higher prices will also trigger much higher input prices; especially fertilizer, fuel and perhaps even seed. Producers will want to maintain adequate working capital (current assets minus current liabilities) to help cover operating costs and debt servicing.

Many of 2011 crop costs are already being incurred with fall tillage, fall applied fertilizer and early seed discounts. Most row crop farms have 2010 operating costs borrowed and are now making 2011 input decisions. Early discounts for the purchase of fuel, fertilizer and seed meant the need for prepaying with cash to lock-in those costs. But in turn, this also means increasing counter-party risk as you become an “unsecured creditor” to the input suppliers that you pay in advance for products to be delivered later. So keep very good records that specify the particular purchase made and start early on your 2010 income tax planning.

**Strategy # 4: Have a net profit per acre goal.**

The time-honored strategic objective to “buy low” and “sell high” still dominates farmer thinking. But for many, at this time of year, you tend to focus only on the “buy low” part by covering 2011 input costs before their prices increase significantly. Unfortunately, too little attention is paid to the risk of missing current profit

margins available in selling a portion of 2011 crops at the same time. Producers often wait for even higher futures prices without a profit goal. Instead of focusing solely on “price” risk management of inputs and output separately, try to think in terms of profit margin risk management. That’s becoming more common as producers lock in 2011-crop prices this fall and at the same time they lock in 2011 input costs.

Having a net profit per acre goal for 2011 is the first step to tying together both potential production costs and output price. Once futures prices begin to decline, emotion once again takes over and limits the ability to sell at these lower prices. Use a scale-up strategy by selling bushels incrementally as prices increase. Remember that crop insurance decisions next March can help guarantee revenue by adding coverage for yield and/or price risk that could occur in 2011.

Ironically, while crop prices and yields are both higher than five years ago, the net profit margin per acre may not have changed significantly because of rising land rents and input costs. The advantage benefits landowners who in Iowa have seen values increase by nearly 50 percent in the past five years. And in some cases, even farmers who rent most of their land have shared in the benefits if they locked in multi-year rents three to five years ago. The current high crop prices should support even higher land values and the potential for cash rental rates to follow land values higher.

**Strategy # 5: Remember the valuable lessons learned from 2008.**

Don’t forget some of the things that occurred as a result of those extremely high futures price.

- a) The 2008 futures price spike caused great stress on margin calls for both producers hedging grain and merchandisers that offered grain contracts. As a result, many grain contracts now have a small fee of a few cents per bushel associated with them. This fee is charged to help cover potential interest costs on margin money the elevator or co-op may have to put in to hedged futures positions.

- b) An unfortunate by-product of the extremely high 2008 crop prices is that they distorted many farmers' views of the potential for 2009 and 2010 crop prices. This led to poor marketing decisions the past couple of years, as farmers ignored good crop prices because they compared them to the freakishly high prices of 2008 instead of common sense comparison to prices of the past several seasons. The rare harvest-time strength in 2010 crop prices may end up with a similar result.
- c) Basis risk has increased as many merchandisers extract greater net profit from each bushel they handle. Some merchandisers have expanded their offers for various grain contracts that even commit bushels to delivery for multiple years of crops.
- d) At this same time, other merchandisers have reduced their exposure by offering primarily spot cash bids and forward contracts only. They fear the risk of making margin calls against contracted grain and even default on delivery should futures prices spike like those they witnessed in 2008. Since many merchandisers are only basis traders, they are looking for less risk with high price volatility.

## Summary

Many producers regretted not locking in more 2008 and 2009-crop prices during the spring 2008 futures price rally. Instead, the higher prices led to higher input costs and much lower net profit margins. The ability to lock in crop inputs while selling the outputs almost simultaneously is being tested on many Iowa farms today. It makes the use of crop revenue insurance products tied to forward cash and hedge-to-arrive contracts even more important as a strategy to lock-in attractive selling prices.

Today it is more important to work with an ag lender who understands the changes taking place in row crop agriculture. It will be increasingly important to 1) manage cash flow with 2) higher operating fund requirements that 3) cover multiple years' crop inputs. The uses of crop marketing plans that are successfully implemented are becoming as important as cash flow projections. Lenders know they don't get repaid with income you projected; only with what you actually generated by making those cash flow projections come true.

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