Successful Farming

Hedging Margins

By: Daniel Looker
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Norm Brown, who farms about 1,500 acres near Aledo, Illinois, and finishes 40,000 hogs a year, is fine-tuning the goal of every farmer – making a profitable margin. For decades, soybean processors have locked in crush margins between the price of beans and oil. Commercial feedlots hedge cattle and corn.

Since July, Brown has been using Commodity & Ingredient Hedging, LLC, in Chicago to help him decide exactly when to make those tough decisions. He's using CIH for the half of his hogs that get purchased feed, not his own corn. (For the other half, he uses Russell Consulting Group.) CIH offers Web-based tools that allow farmers to calculate their profit margin plus a weekly hour-long consultation with its team of account executives. The website's margin model uses futures prices that are updated hourly to show each producer's margin if it's not all locked in. CIH charges a $9,000 annual fee for the service. (See an August snapshot of Brown's potential first-quarter 2011 margins on the next page.)

"You can't even get started with CIH unless you've got a good, confident handle on cost of production," Brown says. If anyone has a good handle, it should be Brown, whose other enterprise is the accounting software company, FBS Systems.

So far, Brown has found that even with help from CIH, the simple concept of maintaining a margin between his corn/soybean meal inputs and his finish hog outputs is, in fact, complex.

"One of the things that's very complicated about locking in a margin is time-frame match," Brown says. In the first quarter of 2011, he uses February and April lean hog futures and March corn futures. The Web model of margins isn't a substitute for accounting, he says. "It doesn't show you what your actual profit and loss was. This is a vehicle to help you understand what's going on and at least come up with a strategy," Brown says.

In late August, when lean hog futures were about $78 per cwt and corn futures were running around $4.50 per bushel, the CIH web based model showed Brown's operation with a potential open market margin of $7.74 per cwt in January, $9.56 per cwt in February, and $8.59 per cwt in March. That's after Brown put in his own estimates for the cost of other feed ingredients and non feed costs.

A month later, he'd locked in more of his inputs and hogs for an even higher margin. By then, he had sold 50% of his hogs, and had bought 62% of his corn and 20% of his soybean meal. The open market lean hog margin was $8.94 per cwt for the first quarter of 2011. Brown's own margin, based on his costs and futures positions, was $10.92 per cwt or about $22 per hog. CIH records show that over the past 10 years, for that time of year, Brown's margin was above the 96th percentile.

That came at a time when Brown's own corn harvest was yielding a disappointing 160 bushels an acre, and corn futures were rising past $5, as farmers across the Corn Belt found similar shortfalls. Lean hog prices also rose past $80 per cwt that month.

Norm Brown's Worksheet

Production - 1st Quarter 2011			
Hog Production	January 2011	February 2011	March 2011
Hogs Sold (Heads/Month)	2,519	3,533	1,984
Average Live Market Weight	270	270	270
Average Percent Yield	75.5	75.5	75.5
Lean Hogs Futures	Feb. 2011 100%	Feb. 2011 50% Apr. 2011 50%	Apr. 2011 100%
Lean Hogs Basis	-3.5	-2	-3.5
Feed Requirements & Costs			
Corn (Bu/Month)	17,633	24,731	13,888
Corn Futures	Mar. 2011 100%	Mar. 2011 100%	Mar. 2011 100%
Corn Basis	-0.18	-0.18	-0.18
Soybean Meal (Tons/Month)	151.14	211.98	119.04
Soybean Meal Futures	Mar. 2011 100%	Mar. 2011 100%	Mar. 2011 100%
Soybean Meal Basis	22.0	22.0	22.0
Other Feed Ingredients (Lbs/Month)	289,685	406,295	228,160
Other Feed Ingredients (Total Cost)	70,532	98,924	55,552
Feed Conversion Ratio	2.32	2.32	2.32
Non-Feed Costs			
Total Non-Feed Costs/Month	143,583	201,381	113,088
Open Market Margin	$7.74	$9.56	$8.39

Source: Commodity & Ingredient Hedging, LLC.

"You prefer buying $3.50 corn rather than $4.50," he says. "You get the confidence to do that knowing what the margins are. There are so many moving parts. This is a different paradigm than trying to pick the low and pick the high. I bought some $4.60 corn a couple days ago," he adds. "The basis was working in our favor."

CIH clients often protect 25% of expected hog production when margins reach the 70th percentile. By the end of next year, they'll be falling close to that level, $2.37 per cwt on lean hogs, a percentile of 71.67, based on late-September futures. What happens when it's below 70? "That's one of the hardest things to do," Brown says. "How big of a loss do you lock in?"

For the past three years, Rob Brenneman, who farms almost 3,000 acres near Washington, Iowa, has been using CIH to lock in margins on his 400,000 hog-finishing operation. That included two of the worst years ever for pork producers. Yet, most of the time it was possible to lock in a positive margin, he says.

"What it amounts to is that once you commit to doing that, you need to stay committed," Brenneman says. "It means you shouldn't get in and get out." Brenneman has already locked in next summer's hog margins, and he is working on the last quarter of 2011.

CIH works with more than 25% of U.S. hog production but also offers a service for crop farmers. It's not possible to hedge crop inputs in Chicago, but producers can negotiate land leases, seed costs, and at least some fertilizer by fall, says Jon Greteman, a CIH account executive in Des Moines, Iowa. "I actually have a lot of clients starting to lock in fertilizer," he says. "The ability to do that depends on competition in local markets."

CIH isn't alone with such advice. Moe Russell of the Russell Consulting Group in Panora, Iowa, urged clients to sell 10% of 2011 corn at $4.45 last summer and another 10% at $4.55. "When we did that, we encouraged them to lock in their fertilizer. That 20% should more than cover their entire fertilizer cost," he says.