Producing and Marketing Hogs under Contract
Michigan State University
Cooperative Extension Service

Authors:
John S. McDaniel, Iowa State University
Marvin Hayenga, Iowa State University
Earl Mobley, Iowa State University
V. James Rhodes, University of Missouri
Reviewers:
Bruce B. Bainbridge, Virginia Polytechic Inst./State Univ.
Robert Koehler, University of Minnesota
John C. McKissick, University of Georgia
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pork industry handbook

COOPERATIVE EXTENSION SERVICE • MICHIGAN STATE UNIVERSITY

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There has been increasing interest in hog contracting in recent years, due in part to the high cost of capital and the difficulty for many producers in obtaining adequate financing. Despite the recent interest only a small percentage of hogs are produced, fed, or marketed under contract. It is estimated that about 8 to 10% are under production contracts, and less under marketing contracts.

Forward pricing (marketing) contracts for market hogs have been available from most major meat packers for a number of years and are the most commonly used marketing contracts in the industry.

Production contracts for market hog finishing are relatively new but increasing in number in the Midwest. However, they have been used for some time in the Southeast where contract hog production is more widely accepted. Feeder pig production contracts are also relatively common in the Southeast, but are seldom found in the Midwest.

Following is an overview of the contracts which presently appear to be most common in the pork industry.

Marketing Contracts

Market Hogs. The forward sale contract is a contract between a buyer (normally a meat packer or a marketing agent) and a seller (normally a producer), where the producer agrees to sell, at a future date, a specified number of hogs to a buyer for a certain price. The buyer will normally have taken an opposite position in the futures market to offset any price fluctuations between the signing of the contract and the delivery date.

Terms typically found in a forward contract include:

- The quantity to be delivered, with the minimum amount varying anywhere from 5,000 lbs. to 30,000 lbs. (30,000 lbs. being one live hog futures contract.)
- The date and location of delivery. The delivery date may normally be changed by mutual agreement. The seller may have the option of selecting the delivery date within a specified time interval.
- Acceptable weights and grades, including provisions for premiums and discounts.
- A description of the pricing mechanism, either base price or formula price. Some contracts now price the hogs on a grade and yield basis to reward better producers, who would otherwise be less inclined to contract.
- Provisions for non-deliverable hogs and unacceptable carcasses. The buyer will normally deduct from the seller's receipts for unacceptable hogs and carcasses.
- Provisions outlining the credit requirements of the seller and inspection of the hogs by the buyer. The buyer often will request to inspect the hogs while on the seller's premises.
- A provision dealing with breach of contract. Typically, the seller is liable for all losses incurred by the buyer when the seller is in breach of contract.

The producer retains all risks of production, other than selling price, under a forward sale contract.

A producer uses a forward sale contract to reduce the risk of price fluctuations and to lock in an acceptable selling price. While the forward sale contract allows the producer to lock in a particular selling price, it also may cause him to miss out on greater profits if prices rise. Thus, the decision to contract must be based upon each producer's willingness or ability to bear the risk of price uncertainty. Some producers may be forced to contract due to a lack of diversification, indebtedness, or the request of creditors, while other more financially stable or diversified producers may be in a better position to withstand the risk of price movements.

A floor price contract is a variation of the forward sale contract, however it is not as widely used as the forward sale contract. The seller agrees to deliver a specified number of hogs to a buyer at a future date and the buyer guarantees the seller a minimum price (the floor price) for his hogs. Usually, the seller receives the higher of the floor price or market price at delivery minus a discount. The discount compensates the buyer for the costs (options premiums and other variable costs associated with the contract) of providing the guaranteed minimum price. Both the forward sale contract and floor price contract reduce only the risk of hog price fluctuations. The producer must still bear the other risks associated with hog production.

Feeder Pigs. Typically, feeder pig marketing contracts are between a marketing agency, often a cooperative, and a pig producer, where the marketing agency agrees to market the pigs for the producer in exchange for a fee.

A marketing contract might contain the following provisions:

- The producer agrees to market all pigs through the marketing agency.
- The marketing agency prescribes specific management practices to be followed by the producer. These may relate to the weight at which the pigs are to be marketed, health of the animals, and immunization against diseases.
- Many larger marketing agencies will pool feeder pigs into homogeneous groups to increase their marketability and will provide technical assistance to the producer.

Producers are essentially hiring marketing expertise to enhance their market prices and minimize the time and effort of locating buyers for their pigs.

Production Contracts

Investors, feed dealers, farmers, and others are often interested in producing hogs, but are unwilling or unable to provide the necessary labor, facilities, and equipment. Therefore they search out producers who are willing to furnish the labor and equipment in exchange for a fixed wage or a share of the profits. The resulting contracts, between owner and producer, vary considerably in form and responsibility of each party involved. Some producers have also found contract production to be an effective method of expanding their operations, without assuming much additional risk. These contracting arrangements are attractive to young or financially strapped producers who do not have the capital to invest in a herd, and for producers with under utilized facilities.

Some of the more popular contracts are fixed payment, directed feeding, and profit-share. These contracts are most commonly used for feeder pig production and hog finishing, with hog finishing being the most popular use.

Fixed Payment. These contracts guarantee the producer a fixed payment per head as well as bonuses and discounts which are based on performance.

Under a guaranteed (fixed) payment contract for finishing hogs, the producer normally provides the building and equipment, labor, utilities, and the necessary insurance. The contractor supplies the pigs, feed, veterinary services and medication, and transportation. The contractor also would provide management assistance and would be responsible for marketing the finished hogs. The producer will often receive an in-payment which is based on the weight of the feeder pigs when they come into the producer's facilities. For example, $5 for a 30 lb. pig and $4 for a 40 lb. pig. The producer's final payment is based on the pounds of gain times the negotiated payment rate per pound of gain. Most contracts contain bonuses for keeping death losses low and feed efficiency high, as well as penalties for high death losses and unmarketable animals.

Directed Feeding. A cooperative or feed dealer will contract with a producer to finish-out hogs. The contractor's objective when entering into a directed feeding contract is to increase feed sales and secure a reliable feed outlet.

The contractor provides the feed and some management assistance and typically directs the feeding program. The contracting firm will often purchase the feeder pigs itself, in which case profits from the sale of the hogs are shared, or it will help the producer obtain financing to purchase the pigs. The producer agrees to purchase all feed and related services from the contractor and is responsible for all costs of production. The producer receives all proceeds from the sale of the hogs minus any outstanding balance owed to the contractor.

Profit-Share. The producer and contracting firm divide the profit 50-50, 60-40, etc., depending upon who provides the majority of inputs and their value. Typically, the producer provides the facilities, labor, utilities, and insurance for his portion of the profit. The contracting firm normally purchases the pigs and is responsible for all feed, veterinary, transportation, and marketing expenses. Over the duration of the contract, the contractor's cost are charged to an account. This account balance is then subtracted from the sale proceeds to determine the profit. The contracting firm will often use its own feed and provide management assistance. The producer is normally guaranteed a minimum amount per head as long as death losses are below a set percentage. For instance, the producer would receive $5/head if death losses were 3% or less and $3/head if death losses were 5%. The producer receives this regardless of whether a profit is made. The contractor's return depends upon the profit made on the sale of the hogs and the gain received from the markup on feed, pigs, and supplies provided.

Through contracting producers are able to achieve more stable returns, trading the possibility of large profits for the assurance of a more reliable return. Many producers enter into contracts because they lack the capital necessary to produce on their own or they do not wish to tie up a large amount of capital in hog production.

Feeder Pig Production Contracts

Feeder pig production programs come in several options.

Option 1: The producer provides everything but the breeding stock and bids what he is willing to produce a feeder pig for, based on production criteria such as pigs weaned per litter, etc., with docks and bonuses based on a target level. Most of the risk is still retained by the producer.

Option 2: A person with contract finishing yards will provide breeding stock, feed, and management assistance, and will pay the feeder pig producer a flat fee for each pig. This fee will vary according to pig weight, and current production costs. In this example most of the risk falls on the person providing breeding stock, feed, and management.

Option 3: The owner provides breeding stock, feed, facilities and veterinary costs. The manager provides labor, utilities, maintenance, and manure handling. A fee for each pig produced and a monthly fee for each sow and boar maintained is paid to the manager. This option fits owners who no longer want to be actively involved but have a good manager with limited cash willing to take over.

Option 4: This is a shared revenue program. One example would be where the producer supplying facilities, veterinary care, utilities, labor, and insurance would receive a negotiated percentage of gross sales in return for his share of production costs for each pig sold. The feed dealer would receive a certain percentage based on his share of the total inputs. The remaining percentage would go to the breeding stock supplier and the management firm that supplies computerized records, and consultations. Negotiated percentage shares should be based upon inputs and services provided, and risks borne by each participant.

Farrow-to-Finish Contracts

Currently most farrow-to-finish programs being offered are set up on a percentage basis to reflect the relative amount of input resources supplied by each person or firm.

Option 1: The producer supplies facilities, labor, veterinary care, utilities, and insurance for an appropriate percentage of gross sales based on input costs. The feed retailer supplies feed, standard feed medications, and receives a predetermined percentage. The capital partner and breeding stock supplier get another percentage. The management firm also receives a percentage for supplying computerized records services and management consultation.

Option 2: The current hog inventory is purchased outright by a limited partnership. They will supply sow replacements. The producer supplies facilities, labor, utilities, veterinary costs, repairs, and manure disposal. The feed retailer provides feed and standard feed medications. A management agency supplies production and marketing guidance. Each of the contract participants receives a percentage of the proceeds when hogs are marketed. A remaining percentage is split between the limited partnership and the general partner for managing the partnership.

Breeding Stock Leasing

The popularity of breeding stock leases has declined in recent years and they are presently seldom used. Many contractors were dissatisfied with the care of the breeding herd and often were unable to collect their payments from producers. Consequently, very few breeding stock leases are available today.

Characteristics of a Good Contract

The relationship of producer and contractor are generally more complex and interdependent for production contracts than for marketing agreements. Hence, production contracts need to be evaluated with special care.

Before considering the details of a contract, one should first consider the reputation of the company or individual with whom the contract is to be made. For instance: How long has the company been in business? What has been the company's financial success? How long has the company offered contracts? Do other producers in the area have contracts with the company? Does the company fulfill the terms of its contracts?

- The contract must be in written form and must be clear and concise.
- The contract should clearly define the rights and responsibilities of both parties involved.
- The contract should also contain the following: the number of pigs involved, the names of both parties, duration of the contract, the method and timing of payment, and definition of who shall supply certain inputs.
- A contract should be thoroughly read and understood before it is signed. Enlisting the advice of a lawyer, lender, or contract specialist is helpful and often necessary when evaluating contracts.

Some other possible contract provisions would include:

- The right of the owner to inspect pigs at any time.
- Designation of responsibility for purchasing and marketing.
- The basis for compensation of feed and non-feed costs.
- The method of legal procedure if failure of payment arises.
- The means and timing of communication by producer to owner when a death loss occurs.
- Who assumes the risk of death loss.
- The extent of the producer's responsibility for care of the pigs and record keeping.
- Designation of who will provide insurance and how much coverage.
- The brand of feed and supplement that is required if any, and who is responsible for ration formulation.
- How and when the contract may be terminated by either party.

The key to feeding or producing hogs under contract is finding the type of contract that will allow each individual producer to profit most from what they do best. This may be record keeping, producing with a low mortality rate, or an ability to maximize herd feed efficiency. Whatever the case producers should make certain that the contract will reward them appropriately for what they do best.

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