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Texas Agricultural Extension Service

Retained Ownership Strategies for Cattlemen

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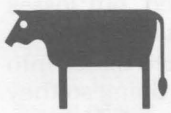
How many times have cattlemen heard, "You can only expect to cover all costs of a cow-calf operation 1 or 2 years out of 10"? Too often cattlemen accept this belief as fact, making it too easy for them to blame their lack of profits on "the market." In nearly every marketing survey conducted, producers point to low prices as their major marketing problem.

Today's business oriented cow-calf operators must have reasonable projections of their production costs if they are going to take advantage of pricing opportunities as they become available. When the production costs are known, a reasonable profit margin can be added to determine a price that would achieve the business objective. When that price occurs during the production period, the producer takes it and is happy. If he does not find the target price, either on the cash market, forward contract market, futures market or ag options market, he either sells and takes a loss or he does not sell.

More and more, business oriented cow-calf and stocker operators are refusing to accept a loss early in the production process. When possible, they are retaining ownership of their cattle, carrying them either into a stocker grazing period, or to a custom feedlot or both. The following discussion deals with opportunities, conditions and decisions facing a cattleman considering retaining ownership of cattle.

Extension economist-livestock marketing, Extension economist-management, Extension beef cattle specialist and Associate professor-animal science, respectively.



Market Integration

Market integration, or retained ownership, involves carrying production activity into the next phase of preparation for the market place. There are certain advantages associated with this production and marketing strategy. Retained ownership eliminates some trading points which can lower procurement, transportation and selling costs. Cattle or calves may still be moved, but without the stress of being cycled through regular market channels. Such cattle can be shipped directly to where they will be grazed or finished in a feedlot.

Retained ownership allows the cattleman to spread risk from one production activity to another and from one period of time to another. A cattleman should seriously investigate the possibilities of retained ownership and then elect the alternative that most closely meets his profit objective. Research and history have shown that somewhere during the production process someone will profit from cattle before they reach the packer.

During certain periods and conditions, retaining ownership can be and has been more profitable than selling calves at weaning. The rancher must carefully evaluate each decision period, because by retaining ownership he is assuming more production and marketing risks. If the cattle are not properly contracted, or if the producer is misinformed about

future market conditions, retaining ownership could cause an accumulation of losses rather than profits.

There are other important conditions to consider in deciding whether to retain ownership. First, the producer will be increasing the requirements on his management and decision-making processes. More capital will be required for the additional production expenses. The cattleman will be changing his cash flow situation because retained ownership delays income and adds production costs.

The First Decision Point

The most important piece of information for making marketing decisions comes from the producer himself. That piece of information is his production costs for each stage of production. Too frequently cattlemen pass up profits because they do not know their own production costs. If, at weaning time, a profit has not been locked in or is not available on the cash market, the logical strategy is to maximize returns (or minimize losses) from that point on. A profit may not be realized, but losses possibly can be reduced through retained ownership. Many producers have transformed losses into profits by retaining ownership, but in doing so they had to be willing to do their homework because conditions can change so frequently.

Buy-Sell Price Relationships

One reason cattlemen have not utilized retained ownership strategies more often is to avoid the adverse buy-sell price situations associated with buying lighter calves and selling heavier cattle. Generally, as cattle gain more weight their price per pound drops, or as a term commonly used in the industry implies, the price "rolls-back." Also, the longer cattle are carried the greater the effect of seasonal price changes, which may or may not benefit the cattleman.

The information contained in Table 1 illustrates both of these effects on cattle prices. The table depicts a typical Texas operation: weaning calves and selling them in the fall (October), grazing stockers until they are pulled off the pasture to allow wheat maturity (March), and feeding cattle to finish for at least 120 days (July).

During the 10-year period depicted in Table 1, price roll-backs occurred in 6 years from October to March. Positive price differences or price margins, however, occurred four times during the October to March time periods. Price roll-backs that resulted in severe margin differences were experienced during three periods. These price roll-backs were -$18.12, -$13.49 and -$11.17 per hundredweight during the years 1979-80, 1980-81 and 1985-86, respectively. Over the 10-year period, price differences were positive two out of ten times from October through July. Such situations usually spell profits for cattlemen. There

Table 1. Seasonal price changes of 400- to 500-pound and 1100- to 1300-pound steers, dollars per hundredweight, 1977-87.

	AMARILLO 4- to 5-cwt. STEERS	AMARILLO 7- to 8-cwt. STEERS	PRICE CHANGE	AMARILLO 11- to 13-cwt. FED STEERS	PRICE CHANGE	PRICE CHANGE
YEARS	OCTOBER	MARCH	OCT.-MAR.	JULY	OCT.-JUL.	MAR.-JUL.
1977-78	$42.73	$51.84	+ $9.11	$54.48	+ $11.75	+ $2.64
1978-79	74.21	84.38	+ 10.17	69.25	- 4.96	- 15.13
1979-80	91.34	73.22	- 18.12	72.05	- 19.29	- 1.17
1980-81	81.44	67.95	- 13.49	68.53	- 12.91	+ .58
1981-82	68.40	64.61	- 4.24	66.66	- 1.74	+ 2.50
1982-83	65.31	69.25	+ 3.94	63.77	- 1.54	- 5.48
1983-84	64.09	67.94	+ 3.85	66.22	+ 2.13	- 1.72
1984-85	69.55	66.24	- 3.31	55.44	- 14.11	- 10.80
1985-86	69.26	58.50	- 11.17	59.28	- 9.98	+ 0.78
1986-87	68.69	67.85	- 0.85	66.19	- 2.50	- 1.66
10-YEAR AVERAGE	69.50	67.13	- 2.41	64.19	- 5.32	- 2.95

Source: Commodity Price and Basis Information for Selected Texas Markets.

Table 2. Break-even prices for a 500-pound calf grazed to different endpoint weights at different costs, dollars per hundredweight[1]

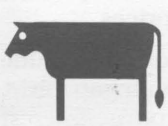
Pounds gained	Costs of gain, $/cwt. 35	40	45	50	55
	Breakeven prices, $/cwt.				
100	68.33	69.17	70.00	70.84	71.67
150	65.77	66.93	68.07	69.23	70.38
200	63.57	65.00	66.43	67.86	69.29
250	61.67	63.34	65.00	66.67	68.33
300	60.00	61.90	63.75	65.63	67.50

[1]500-pound calf at $75.00 per cwt.; costs of gain include all production, management, marketing, finance and transportation costs.

were, however, large price discounts or roll-backs of -$9.98 per hundredweight or more in 4 of the 10 years over the October to July period. A cattleman must be careful to evaluate his situation during such periods. Unfortunately, all three periods were at the very beginning or at the end of a cattle cycle—periods when price expectations run highest.

The amount of price decrease that can be endured before the break-even level is reached is a function of the total cost of gain. For example, during the October to March period of 1981-82, the price roll-back was -$4.24 per hundredweight. However, the difference in the total value of a 450-pound steer calf at $68.40 per hundredweight and a 750-pound feeder steer at $64.16 per hundredweight was $173.40. That means the additional 300 pounds gained on wheat pasture would have had to cost less than 57.8 cents per pound in order to break even.

Following the example through the feedlot for the same period (1981-82), shows fed cattle prices at $66.66 per hundredweight. From October 1981 to July 1982 the price margin decreased only $1.74 per hundredweight. Anyone retaining ownership through this period had a good chance to make a profit, if combined costs of the stocker operation and the feedlot were less than 65.6 cents per pound gained.



Costs Considerations

Even with price discounts or roll-backs, cattlemen can still make profits by using good management. An important consideration in determining whether or not to go forward with the calves is the relationship between calf prices and cost of gain. Knowing this enables the cattleman to determine the required price relationships between the start-up and completion of the production period. If the expected costs of gain exceed weaned calf prices, for example, a higher feeder cattle price will be required at the completion of the stocker phase in order to break even or make a profit. If the costs of gain are less than weaned calf prices, some roll-back in prices of feeder cattle can be endured without suffering a loss. If the costs of gain are expected to be lower than existing cattle prices, the decision to retain ownership is made easier. Table 2 illustrates the effects of costs of gains and gain efficiency of cattle on break-even prices. The table assumes grazing or backgrounding a 500-pound stocker calf with an "in" price of $75 per hundredweight. Costs of gain are given in units of $5 per hundredweight, beginning at $35 and increasing to $55. If, for example, the stocker gained 200 pounds during this period at a cost of $40 per hundredweight the break-even position would be $65 per hundredweight. As one would expect, the break-even position is lower than the "in" price because of the lower cost of gain. Also, as the stocker weight gains improve, break-even prices become lower.

Table 3 provides break-even prices for 700-pound feeders entering the feedlot at a price of $68 per hundredweight. Once again, costs of gain and weights gained are varied. Since all the costs of gain figures are less than $68 per hundredweight, all of the break-even prices are below $68 per hundredweight.

The data in Tables 1 through 3 can be used to estimate chances of profitability under various circumstances. For example, in March 1987, 700-pound steers were selling for $67.85 per hundredweight at the Amarillo market (Table 1). If the feeder were fed to 1,100 pounds, at a cost of $50 per hundredweight for the added 400 pounds, the break-even price would be just below $61.45 per hundredweight (Table 3). This break-even price is just below $61.45 per hundredweight because of the

Table 3. Break-even prices for a 700-pound feeder fed to different endpoint weights at different costs, dollars per hundredweight[1]

Pounds gained	Cost of gain, $/cwt.				
	45	50	55	60	65
	Breakeven prices, $/cwt				
200	62.89	64.00	65.11	66.22	67.33
300	61.10	62.60	64.10	65.60	67.10
400	59.64	61.45	63.27	65.09	66.91
500	58.42	60.50	62.58	64.67	66.75

[1]700-pound calf at $68.00 per cwt.; costs of gain include all production, managment, marketing, finance and transportation costs.

difference between the actual "in" cost of $67.85 per hundedweight and the assumed cost of $68.00 used in Table 3. The cattleman could have had a $6.40 per hundredweight roll-back and still broken even. The average roll-back between March and July over the 10-year period was -$2.95 per hundredweight (Table 1).

Information Sources

It is essential that cattlemen have good information on current conditions and trends in the livestock, grain and meat sectors as they become involved with retained ownership strategies. They must also be current on consumer eating trends, as well as the general conditions of the U.S. and world economies.

It may at first appear to be a difficult task to access such information, but it is not. Much of the information is available at little or no cost through the U.S. Department of Agriculture, the Extension Service or cattlemen's associations. The next step is to determine what factors are having the most impact on the current market and to watch those trends carefully.

Weekly or monthly newsletters with analyses of current trends and factors most prominently affecting the markets are available through the Extension Service or commercial consulting firms. These resources may help the cattleman to fine-tune his market awareness and decision-making skills.

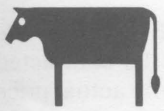
Conditions and Trends to Monitor

Trends in domestic cattle numbers should be considered before deciding whether or not to retain ownership. The cattleman should know the size of the U.S. cow herd, the calf crop and the number of feeder cattle available for placement into feedlots. He should know if these numbers have been increasing or decreasing and for how many years it has been the trend. This will provide some indication of future beef supplies relative to consumer demands.

Knowing the number of cattle on feed relative to previous months and years provides some idea of future fed marketings and cattle prices. Likewise, estimates of the number of stocker cattle being grazed on pasture, heifers being retained for breeding herds, and the recent calf crop provides some indication of future supplies of feeder cattle.

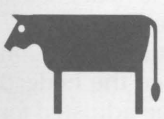
Grain supplies, expected domestic grain production and grain export possibilities are important in estimating the cost of feeding. Also, the cattleman needs to be familiar with any government policies that could affect grain supplies and prices.

Other factors that are just as important include supplies of competing meats (pork, poultry and fish), meat and live animal imports or exports, interest rates, cold storage supplies of meat, recent price trends relative to supply conditions, distant futures market prices, current market psychology, etc. These are just examples of factors that should be considered when estimating possibilities of increasing profits or reducing current losses.



Financial Considerations

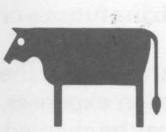
Retained ownership increases capital requirements and delays income. This must be considered and some adjustment to cash-flow expectations must be made if the cattleman is to be successful. The cattleman may need to prepare a balance sheet, projected cash flow and a marketing plan before his lender will provide the additional capital required for increased production costs and delayed income. Some lenders may require that a portion of the cattle be hedged before lending additional capital. Cattlemen can sell some cattle and retain ownership in others to refinance their integrated activity. There are many strategies in obtaining the required additional capital, and increasingly lenders will require better information.



Feeding Requirements

In today's cattle industry, leased grazing and custom feeding are options available to most cattlemen. In both options there are various arrangements for assessing charges. The two most common methods are: a fixed charge based on cost of gain; and the sale of feed and services. The fixed cost of gain generally favors the cattle owner. With this arrangement, the cattle owner shares in the risks of death loss and assumes all the risks of falling cattle prices. With fixed cost of gain the grazer or feeder shares in the death risks and assumes all the risks of poor cattle performance, bad weather, poor facilities, sickness, rising feed costs, weight shrink and management.

When feed and services are sold, the grazer or feeder only shares in some of the death risk. The cattle owner, on the other hand, is at risk on all the factors listed above. In either case, it is important to have written agreements on how costs are charged and who is responsible for what.



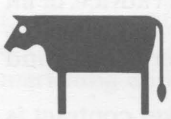
Types of Cattle

Cattlemen may desire to retain ownership either because they feel they are receiving price discounts that are too large or because they are not receiving high enough price premiums for superior cattle and calves. There are times, for example, when the market discounts prices for heifers more than would be considered normal. The cattleman may realize a higher return for these cattle by retaining ownership. The same might hold true for the producer raising genetically superior cattle who is not receiving adequate price premiums.

Cattle frame-size may also be a factor in helping the cattleman determine if the next step in retained ownership should be grazing versus taking animals straight to the feedlot. Packers, especially those boxing beef, prefer carcasses weighing 600 to 800 pounds. They avoid smaller and larger carcasses. This carcass weight requirement translates generally to a live weight range of 1,000 to 1,300 pounds.

If large-framed cattle are put on an extensive grazing program before being finished at the feedlot, they will probably exceed the 1,300-pound upper limit before acquiring the desired finish. On the other hand, if small-framed calves are placed directly on feed, they will become over finished before reaching 1,000 pounds. Large-framed calves could be placed directly in the feedlot and not given the additional time for excessive skeletal growth, possibly achieving the desired finish before 1,300 pounds. By grazing or backgrounding the small-framed animal, additional skeletal size could possibly be attained to enable it to reach 1,000 pounds before becoming over finished.

This helps to emphasize the advantage of sorting cattle by age, frame-size and weight prior to the next phase of production. Younger, older, lighter, heavier or poorer quality cattle should be sorted out of groups to be retained. Poorly sorted cattle usually have higher production costs and bring lower prices because the production process can not be maximized toward production of a particular type of cattle.

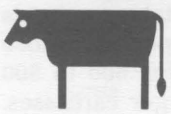


Producer Size

Many cattlemen do not have enough calves of similar kind at one time to use the retained ownership strategy. Usually 100 head are required for a pen at most feedyards. But this should not deter cattlemen from using this strategy when trying to make a profit. Cattlemen with fewer head can form marketing associations, cooperatives or partnerships to put together the necessary cattle or required resources. They may sort and commingle their calves into lots large enough to achieve economies of size, thus making retained ownership a feasible alternative.

Usually, cattlemen operating on a small scale find it difficult to put together sufficient numbers of

homogeneous cattle, even if they are willing to commingle. If so, it may be necessary for them to sell the cattle they have raised, refinance and buy lots of more homogeneous cattle. This way there should be no arguments on quality variability.



Pricing Strategies

Cattlemen interested in the retained ownership market strategy need not assume the risks of large market swings by accepting whatever the market offers on market day. There are flexible pricing instruments available to lock in a desired price prior to market day, should the target price present itself. These forward pricing instruments include forward contracts, commodity futures market contracts and ag options market contracts. Each of these contracts offers specific advantages and disadvantages to the cattleman.

Forward contracts are flexible in that they can be written to fit the description of the cattle, with a specific date of delivery and a specific price. Once signed, the cattleman is committed to the terms of the contract. If cattle prices go up $20 per hundredweight, the cattleman just missed an opportunity to make more money. But, if he based his target price on the cost of production plus a profit objective, he still made a profit and that's good business judgement.

The futures market offers some flexibility of placing and lifting hedges. If cattle prices begin a strong upward trend after the cattleman is already hedged, he has two choices. He can stay with the original hedge, which is usually the best advice, or lift the hedge, and benefit from the price rise. If prices fall, however, the cattleman is no longer hedged and is exposed to the declining market.

The inflexibility of the futures market contract is that contract quantity (size), quality and cattle weights are standardized. Cattlemen must be careful not to overhedge and must adjust the price for differences in quality, if such differences exist. Another disadvantage of the futures market is that an initial margin deposit is required. Should the market rise, the hedger would likely be required to make additional margin deposits (margin calls).

Cattlemen utilizing the futures market must remember that they may have to adjust the price they have hedged. They must adjust the hedged futures price if the futures price is different from the price received from the cash market on sale day. This is called "basis," and is a simple calculation of the sale day cash price minus the sale day futures price. If the futures price is higher than the cash price on sale day, a discount basis exists. It must be subtracted from the hedged price to determine the actual price netted. This usually is a slight adjustment of $1.00 per hundredweight or less for steers (more for heifers), but it can be more and should be taken into consideration. A larger than usual basis could nullify the desired profit objective. Should the cash market be higher than the futures price on sale day, a premium basis exists and is added to the hedged price.

Ag options contracts offer a third forward pricing alternative. The options contract provides the option buyer or hedger with the right, but not the obligation, to take a position on the futures market at a specified price for a specified contract month. The option buyer pays a premium for the option right. The advantage of using options is in knowing your costs up-front, i.e., the premium. If the price of cattle goes up, the hedger is under no obligation to exercise the option. He is only out the premium and receives the benefits of the price rise. Options trading can be viewed as buying price insurance. If it is needed, use it; otherwise, be pleased it wasn't needed.

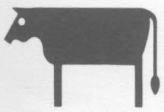
Options contracts are contracts to take a position on the futures market. Therefore, since the hedged price is a futures price, it also must be adjusted for quality differences and local basis.

By using the forward pricing tools, cattlemen are able to avoid much of the price risk they usually face. It makes the retained ownership strategy an even more feasible solution. Use of these price risk tools may also help cattlemen attain the additional capital required when retaining ownership for prolonged periods.

Tax Advantages

Retained ownership also offers cattlemen some flexibility in managing their annual income tax liabilities. By retaining ownership, a cattleman may transfer income from one year to the next. This may be especially useful in years when sales have been high. It is possible that some sales can be carried over to the next year at reduced risk by utilizing futures or options contracts.

If cattle are being fed in one year and sold in the next, prepayment of feed and production expenses, not to exceed 50 percent of the total, may be charged against income received during the year the cattle were placed on feed. This allows catlemen some flexibility in planning their cash flow and tax liabilities from one year to the next.



Choosing A Feedlot

Most cattlemen desiring to retain ownership through the feeding stage are going to custom feed, primarily because they want the flexibility of deciding to feed or not to feed during any given period. Also, the large investment in facilities required to establish an efficient, low-cost feedlot would make it necessary to have a continuous feeding operation. Given that a cattleman would prefer to custom feed, he must choose the best feedlot. Following is a list of criteria a cattleman should consider in choosing a feedlot.

Integrity: The first thing a cattleman needs and wants to know is "Can I trust them?" Much of the cattleman's business is done with a handshake, and he expects to be treated honestly. Knowing the reputation of the feedlot and its management personnel is important.

Experience: How long has the feedlot been in business? How experienced is the management?

Attitude: Does the feedlot managment appear to be genuinely interested in and concerned about helping you attain a profit? If so, the cattleman will feel more confidence in them.

Expertise: Does the feedyard have employees or advisors competent in handling health, nutrition and marketing matters?

Cost Calculations: How does the lot calculate close-outs? Do they charge on a cost of gain basis or on feed cost plus some mark up? Are they cost competitive with other feedlots? Do they change yardage?

Feed Cost: Are the feed costs competitive with other feedlots? If not, why? Is the quality of feed lower or higher? Do they use aggressive and sound marketing strategies in purchasing their feed? Answers to these questions may also indicate to the customer how well the feedlot will assist him in marketing his cattle.

Financing Arrangements: Many feedlots will form partnerships with cattlemen, or will assist them in obtaining the necessary capital for the feeding period. Some feedlots will even assist with the financing of the stocker grazing operation.

Market Assistance: What assistance in marketing the cattle does the feedlot offer? Do they assist with hedging strategies or do they turn you over to a broker? What percentage of their business is custom business? Is the feedlot owned by or affiliated with a packer and is this information volunteered?

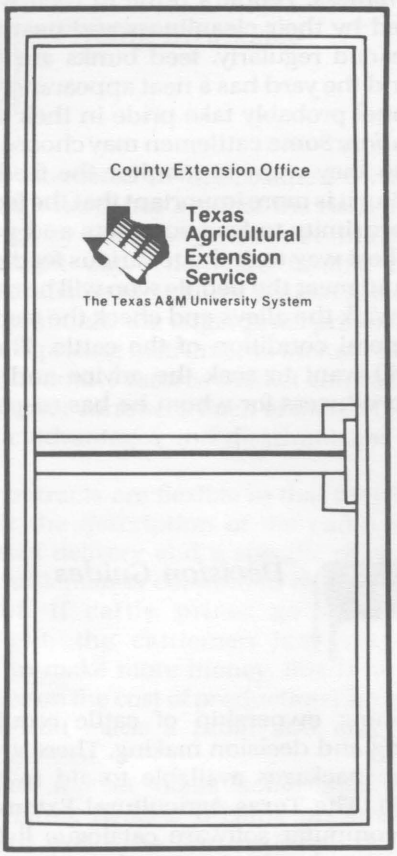
Cleanliness: People's pride in their work is often reflected by their cleanliness and neatness. If pens are cleaned regularly, feed bunks are free of stale feed, and the yard has a neat appearance, the feedlot personnel probably take pride in their work.

Location: Some cattlemen may choose a nearby lot because they want to monitor the feeding of their cattle. But it is more important that the feedyard be in close proximity to feed suppliers and packers.

The best way to evaluate various feedlots is to visit some and meet the people who will be managing the cattle. Walk the alleys and check the feed bunks and the general condition of the cattle. The cattleman also will want to seek the advice and opinions of other producers for whom he has respect.

Decision Guides

Retaining ownership of cattle requires careful planning and decision making. There are computer software packages available to aid in making this decision. The Texas Agricultural Extension Service has a computer software catalogue listing helpful decision guides, budgets and production records. These can be obtained through the local county Extension office, the area farm management economists or the state Extension livestock marketing and management economists.



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