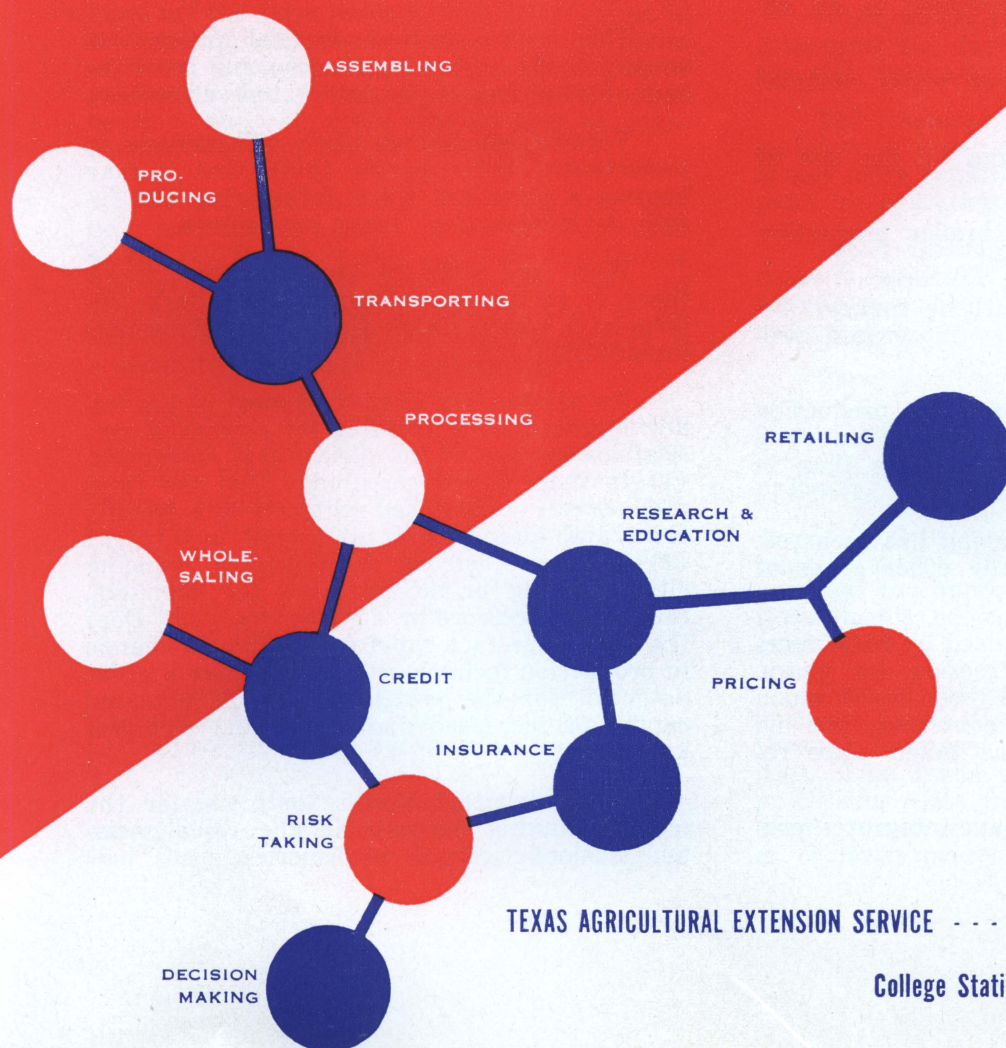


VERTICAL INTEGRATION IN TEXAS AGRICULTURE

The Setting

VERTICAL INTEGRATION means the linking together of two or more stages of production, processing or marketing activities under one management. The key feature of vertical integration is that decision-making, risk-bearing and supervision are centralized.

Instead of two or more persons, such as a farmer and a processor, making separate decisions regarding a product or a process, vertical integration consolidates decision-making into one management unit.



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How Widespread Is It?

Vertical integration is common in many nonagricultural industries. For example, some oil companies are integrated from the oil well to the service station. They own wells, crude pipelines, rail tank cars, refineries, product pipelines, and own or control service stations.

In agriculture, only a small number of farmers, such as the milk producer-retailer and the roadside market operator, are fully vertically integrated. The present trend is toward "partial" vertical integration, which involves the linking together of certain specialized stages of production, processing or marketing.

Vertical integration may involve farmer-businessman arrangements that extend from the transfer of only one or two risks to complete ownership and operation of the farm by business, or vice versa.

Some agricultural commodities in which vertical integration has developed to an appreciable extent are:

- Sugar beets are grown under contract with sugar companies.
- Hatcheries obtain eggs by the use of contracts.
- Some 90 percent of broiler production is vertically integrated.
- A large proportion of the turkeys are produced in vertically integrated programs.
- Vertical integration of the production of table eggs varies widely from state to state, but it has been less than in other poultry enterprises.
- Vertical tieup in dairying has occurred, but less than in many other areas of animal agriculture.
- Contracts have been used by both vegetable canners and freezers for years. Fruit contracts have been used much less than vegetable contracts, and no apparent increase has taken place recently.
- Some meat packers have integrated programs for hogs.

- Some meat packers and retailers have contracted for feeding cattle so that a dependable supply of the desired qualities will be assured. Some retail food chains own packing plants.

Why Is It Growing?

Agricultural production and agricultural business activities usually are integrated within one management unit because of the profit derived from combining certain stages. In some cases, there may be no direct prospect of profit from one particular stage of the integrated operation. This is probable when the less profitable stage complements another stage in the production or marketing chain. For example, a large retailer of meat might feed cattle even if the feeding operation were slightly unprofitable, provided he was assured of a more dependable supply of a specific quality meat for his customers. Consequently, his ultimate profit from his combined enterprises might be increased.

The motive behind vertical integration usually is the overall profit resulting from the sum of all phases of the integrated enterprises.

Vertical integration likely will increase in importance. Some people think that it may become a dominant force influencing the future development of Texas agriculture.

What are some of the situations which favor it, or what conditions make a farm enterprise a logical choice for successful vertical integration?

An affirmative answer to most of the following questions is required for successful vertical integration of an agricultural enterprise. (1) Is there a real possibility that the farm product can be produced regularly in a specific form and quality and in desired quantities? (2) Is there a strong possibility of reducing either buying or selling risks for suppliers, farmers, processors or distributors? (3) Does the enterprise face rapid or continuous change in production technology? (4) Is there a great potential for the profitable use of increased capital or increased managerial and technical knowledge?

Vertical integration is only one of the many changing currents in the rapid social and economic growth of America.

IN TEXAS AGRICULTURE

etting

How Does It Work?

Agricultural production can be vertically integrated with processing or marketing in two ways:

(1) **By contract**—Vertical integration can occur through a legally enforceable agreement which unifies to some degree the management of agricultural production with one or more stages of processing or marketing.

(2) **By ownership**—Vertical integration can be achieved through purchasing a sufficient share of the enterprise to exercise some degree of management control.

If the farmer contracts with an outside source, it involves the shifting of on-the-farm management functions to management in the processing or marketing system. While this limits the farmer's management-decision freedom it also relieves him of certain risk-bearing. On the other hand, vertical integration can cause farmers and ranchmen to assume more off-the-farm management decisions as in the case of a farmers' cooperative enterprise or if the farmer has equity in a processing or marketing firm. This involves him in risk-bearing, but also gives him an area of management-decision beyond the farm.

In the first instance, the integrator may be a feed dealer, packer, ginner or chain store executive. In the second instance, the farmer himself may be the integrator by virtue of owning and operating a business that is associated with farming, but which generally is a separate, off-the-farm enterprise.

Vertically integrated farming has many variations in type and method of fulfillment. In broiler production, for example, a feed dealer may supply the grower with chicks, feed, medicine, fuel, litter, advice and supervision. The grower provides a broilerhouse, equipment and labor. If the operation loses money, the contractor (the feed dealer) may absorb all or part of the loss.

Cooperative arrangements have been prominent features of vertical integration in agriculture for many years.

Citrus growers in California are a notable example of a high degree of vertical integration through cooperatives. The majority of

western citrus growers belong to local cooperatives, while in turn they share in the management of a larger federated cooperative. The local cooperative furnishes growers with orchard supplies and may provide such custom services as pruning, fumigating and spraying. One of the largest federated cooperatives maintains a nation-wide sales organization, provides research and service facilities for its members and has a field staff to see that quality standards are maintained.

Is It Good or Bad?

Is vertical integration desirable? You are the final judge. It depends on your attitude toward centralized control and specialization. It also depends on the commodity you handle or produce, and the kind of business you are in. Here are some advantages and disadvantages which will be helpful in making a decision.

ADVANTAGES

When an off-the-farm businessman is the integrator the farmer is relieved of much of the risk normally involved in production.

The financial arrangements usually associated with vertical integration help the farmer get more capital, improve facilities and expand his operation.

These financing arrangements also may make it easier for young farmers to get started and for producers with limited capital to reduce risks that might be disastrous.

Vertical integration often includes provisions for technical and economic assistance which help the farmer reduce production costs, improve quality and standardize farm products.

If farm production is vertically integrated under contract, the farmer may be in better position to improve his bargaining power through his cooperatives or other farm organizations.

Vertical integration makes it possible to iron out day-to-day and seasonal fluctuations through improved handling and storage facilities. This tends to reduce procurement and processing costs for processors and merchandisers, resulting in higher prices for the farmer or lower prices to the consumer, or both.

A high degree of vertical integration also tends to eliminate some intermediate stages between the producer and retailer.

DISADVANTAGES

When an off-the-farm businessman is the integrator, the farmer has less opportunity to make decisions or manage his farm production.

Reductions in risk generally are, but not always, accompanied by limitation of opportunities for profit.

Vertical integration may speed up the problems of output expansion resulting from a more rapid adoption of new technology. This may contribute to more burdensome surpluses or make it necessary that more resources be taken out of use because of increased productivity.

Farmers may be forced to increase the scale of their operations to make the best use of labor-saving equipment and to use their resources fully.

Farmers who do not wish to vertically integrate their operation may have difficulty finding good markets for their products. They may be faced also with greater competition.

Unless farmers themselves do the integrating, any increases in return resulting from increased efficiency may not be shared by them.

One prominent, though speculative, thought regarding the disadvantages of ver-

tical integration is whether the centralization of management and the concentration of marketing and distribution in the hands of fewer handlers increases the hazard of monopolistic tendencies.

WHAT'S AHEAD

Future issues dealing with the specific commodities will point out:

(1) The nature and extent of vertical integration in the United States and in Texas agriculture.

(2) An estimate of the direction vertical integration in Texas will move in the future.

(3) Present management practices used on vertically integrated farms in Texas.

(4) Guideposts to observe in deciding whether vertical integration on your farm or ranch is worthwhile.

In developing the commodity-by-commodity analyses, staff members are reviewing studies in other states as well as in Texas. They are interviewing farm and business leaders to obtain first-hand opinions and vertical integration is under close observation wherever it is being practiced. In doing so, we hope to help you make wiser decisions about this important development.

One thing is certain: additional research and education is needed to guide the choices of farmers and ranchmen who are considering vertical integration in agriculture.

This is the first in a series of leaflets based on current knowledge and practices regarding vertical integration in Texas agriculture, prepared largely by the extension and research staffs in the Department of Agricultural Economics and Sociology.

Subsequent publications will include vertical integration analyses on specific crops and livestock important to the Texas economy.

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