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The ABC's of Using Cash Contracts

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The ABC's of Using Cash Contracts

Assuming that you have decided you want to forward price your soybean crop by cash contracting, let's look at the steps you should take, one by one.

Determine Your Objective

Your success or failure with cash contracting will depend entirely on your objective going in. So the first step in cash contracting is to decide what your objective really is.

Trying for the highest possible price? If this is your objective, you have an extremely difficult job ahead of you. For one thing, the futures market will almost always offer you a higher price at any given time than you can get with a cash contract, simply because the cash contract price is based on the futures price and the cash contractor has to realize some profit in return for the services he offers you.

It may be possible for you to cash contract at a higher price than the cash market will offer you when your beans are ready for delivery, but this is a gamble. You are really speculating here on the belief that you know more about the cash market trends than the experts in the grain marketing business.

Trying to lock in an acceptable profit and protect yourself against severe price drops? If so, you have an excellent chance ot success. All you have to do is make an accurate projection of your production costs, decide how much return to your labor and management you want and then add an acceptable profit to the total. You can then decide what contract price you are willing to accept.

Trying to make better production decisions? If so, cash contracting can be an extremely helpful management tool for you. Some elevators will contract a full year ahead of your anticipated delivery date for your crop. This is ample time for you to look ahead and decide how many acres of soybeans you should plant relative to corn acreage, for example.

Combination of objectives? You might use contracting to help you make production decisions and also to lock in an acceptable profit on the production you choose.

Determine Your Production Costs and Asking Price

No single step is more important in successful cash contracting than this one. Begin by estimating your production costs and desired return to management. You are pricing the crop before it is produced, and you certainly want to establish an asking price that includes all direct cost of production plus a fair return to your labor and management. Decide how much total return to management you want from your total farming operation and how much of this you want to make from your soybeans. You can then divide this figure by the number of bushels you plan to produce and get a return to management figure per bushel.

You should then add some profit, which is essential to any business. Decide how much profit per bushel you think your soybean operation should make above your own return to management or "salary" and add this to your production costs per bushel and your return to management per bushel. This will give you your total asking or target price.

If you can't determine how much profit you want your soybeans to return, you might use 10 percent of your total per-bushel costs as a rule of thumb.

Determine What the Market Is Offering

The next step is to take a good, thorough look at the market situation and see if it is offering you a price equal to or above the asking price that you have determined you will accept. A good rule of thumb is to check with at least three elevators and see what price they are willing to contract for the month you will be ready to deliver your beans. Insist on a written contract. If possible pick up actual sample contracts from these elevators and check their terms. Have your attorney read the contract if you have any questions about the terms. Remember, a contract is a legal and binding agreement and should not be entered into lightly.

Once you have price offers from your local elevators and have checked the contracts over, you can then decide which elevator seems to be offering the best price and the best terms.

Then check the futures price to see how the cash contract prices that you have been quoted compare with

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the futures quotations for the same month of delivery. By knowing and subtracting the "basis" for your area from the futures quotation for your anticipated delivery date, you can see how the cash contract prices you have been offered compare with the futures price for the same month. This way you can tell whether or not the cash contract prices are fair. Then, if the prices seem fair and if they are equal to or above the price you have determined you will accept, you can choose the elevator you want to do business with.

Determine When to Contract and How Much

You are now ready to set a time to execute a contract, a month for delivery, and the amount of grain you want to contract.

If your objective is to try to get the highest possible price for your beans, or at least to try to get a price higher than the cash market will be offering when your beans are ready for delivery, you probably will not to be in any hurry to contract. You'll want to watch what happens for a while in the marketplace and try to pick up some clues or signals about what is likely to be the supply and demand situation when your crop is ready to deliver. Remember, if highest price is your objective, you're really speculating, and you'll need some supply and marketing information to base your decisions on. The longer you wait into the growing season, the better you should be able to tell what will be happening next harvest season. On the other hand, the longer you wait for information, the more information the buyers will also have.

In reality, growers who are after the highest price and are trying to second-guess the market probably won't be interested in cash contracting at all, since it requires a willingness to deliver beans at the agreed-upon price regardless of what happens to supply and demand after the contract is signed. Or they may contract just enough beans to cover their production costs and speculate with most of their production. Growers who are trying for top dollar will usually either speculate in the futures market or simply produce unhedged for the cash market.

One way to market to a degree is to price average by contracting part of your production at two or three different times during the season rather than contract all of your beans at one time. By contracting at several different times, you can lock in a profitable price early on part of your production and then possibly contract more of your beans later when prices look even more favorable. Remember, though, that prices also may go down. So you're really speculating again.

If your objective is to lock in an acceptable price and protect yourself against large price drops, you'll probably want to contract a large part of your production as soon as the market offers you the price that you have determined you can accept.

If your objective is to contract in order to help make production decisions—in other words, produce for the market—you should compare the prices the market is offering for the different crops you might choose to grow. You can figure your potential per-bushel returns for corn versus soybeans, for example, and logically determine how many acres of each you should grow to make the most money in any given year. By comparing your anticipated costs per bushel for corn versus soybeans, say, and then subtracting these costs from the contract prices being offered for both crops, you can easily figure which crop appears most profitable to produce in any given year.

Once you decide which crop you want to produce, you'll probably want to contract the maximum recommended percentage of your production as soon as the market offers you a price you are willing to accept. If you're making production decisions based on the cash contract prices available to you, it's logical that you'll want to lock in those prices on most of your anticipated production.

In no case do you want to contract all of your anticipated production. If you do and if you have a poor growing season, you could very easily be unable to deliver all the bushels you have contracted to deliver. A good rule of thumb is to never contract over two-thirds of your normal anticipated production.

Execute the Contract

The next step in the recommended contracting procedure is to actually execute the contract. You should be able to do this with confidence if you have throughly worked through all the previous steps.

Follow Up on the Contract

The last step before delivering your beans to the contractor is to keep him fully informed about your crop's progress. Give him periodic crop reports during the growing season. If your crop is making less than normal progress, be sure that the contractor knows this.

What Kind of Contract Do You Want?

Remember, you may be able to choose from three different kinds of contracts:

1. *The fixed price agreement*—you will simply agree to deliver a specific number of bushels and quality of soybeans to the contractor on a specific date for a specific price.

2. *The deferred price contract*—specifies how many beans you agree to deliver, the quality and the delivery date. But you can establish the price you'll get by picking the price being offered on any given day prior to the maturity date of the contract.

3. *The pooled sales contract*—used primarily by members of grower cooperatives. Gives you a cash advance at time of delivery and an additional payment when the beans are sold or processed.

Choosing a Contractor

As with all business transactions, perhaps the most important single factor in contracting soybeans is the kind of person or firm you are doing business with. Even the most detailed contract can't cover every situation that could come up in your contract dealings. So the attitude of the person you deal with, his integrity and his sense of fairness can mean the difference between a successful and enjoyable experience and one that is unsuccessful and aggravating. Factors you should consider are price, reputation of the individual or firm, your banker's or attorney's advice and your personal contact with the individuals.

Summary

The most important factor as you begin to work out a cash contract is to determine your objective going in. Are you trying for highest possible price, trying to lock in an acceptable profit and avoid large price declines, or trying to make better production or storage decisions? Once you have your objective in mind, the procedure you should follow is to: (1) determine your production costs and asking price, (2) determine what the market is offering you, (3) determine when to contract and how much, (4) execute the contract, and (5) follow up with the contractor. The three kinds of contracts are (1) the fixed price agreement, (2) the deferred price agreement, and (3) the pooled sales contract. A final very important point is the kind of people you are dealing with.

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