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Forward Pricing Soybeans

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Forward Pricing Soybeans

Choosing the best time to sell your soybeans is difficult at best. In a typical year, prices to producers vary widely from month to month, depending on such things as weather conditions, new crop outlook, rumors of export opportunities and other factors which affect the supply and demand for beans and their products.

You can be certain of one thing, however—the price offered growers is almost always lowest at harvest. So if you're looking for maximum returns for your crop, you can rarely get them by selling straight from the combine.

What Forward Pricing Is

The alternative is to learn how to forward price, or to "pre-sell" your crop before you are ready to deliver it. This gives you control over the marketing process. You can think of forward pricing as a temporary substitute for a cash sale. It's a way to manage risk, or lessen the possibility that you will have to sell your crop for a price that is unsatisfactory to you.

Forward pricing, then, is a broad term that covers any technique that you might use to tie down a future price for a soybean crop that is still unplanted, still growing or in storage. Used skillfully, forward pricing is a highly flexible money management tool that can give you control over the marketing of your crop and increase your profits.

You can forward price by either *cash contracting* or *hedging* in the futures market.

Cash contracting usually means contracting or "booking" soybeans with your local elevator. Advantages to the producer include: (1) having a price established before delivery of his crop, (2) having the exact price known before sale, and (3) having a definite delivery point specified. On the other hand, the producer who cash contracts ahead of delivery gives up some flexibility in marketing his crop. He loses control of his options since he must deliver his crop exactly as specified in the contract and for the specified price. He also usually does not receive the highest price for his crop. Since the elevator operator who contracts with the producer provides a service and assumes some degree of market risk, he usually offers the producer a price under the futures price for soybeans delivered at the same time.

Hedging in the futures market also allows the producer to establish a price for his soybeans before delivery. He can't establish an exact price, as he can with a cash contract, but he can establish a price within a very narrow range. This way he can evaluate the profit potential of a soybean crop before it is ready to sell and lock in a profit that he will accept.

The futures market also offers the soybean producer maximum market flexibility. Since he can offset his contract at any time, he doesn't actually have to deliver his soybeans as specified in his contract. He simply "buys back" his futures contract on the day he sells his beans in his local market and applies the profit or loss he receives on the futures transaction to the price he receives locally. Most producers who hedge in the futures market do offset their contracts and actually sell their soybeans on their local cash market.

Futures trading has its disadvantages, too. It requires a high degree of knowledge about how the market operates. Most contracts also involve large amounts of grain—5,000 bushels per contract. And futures trading requires that you guarantee your transaction with margin money.

Common Advantages

Both cash contracting and hedging in the futures market offer soybean producers the advantages of being able to lock in a satisfactory profit for crops yet unplanted, still growing or in storage. Having a profit locked in makes it much easier for producers to make production and storage decisions and to get needed credit.

Both methods reduce marketing risk, so lenders will usually advance credit more readily and in larger amounts against growing crops or stored grains that are hedged or cash contracted. Many lenders today are requiring that their borrowers forward price.

Should You Forward Price?

Whether or not you should forward price your soybeans depends on two things:

1. *How much risk do you want to assume?*

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If you are financially independent, can take risks and survive if they go against you, you may prefer to take your chances with the cash market. You simply produce or store unpriced. If you are set up to store your soybeans and watch the market, you have some added security—but you are still holding your beans for an unknown price.

Many farmers prefer to be risk averters. They are either unable because of financial commitments or unwilling because of temperament to assume the risks of adverse price changes. So they hedge their crop by locking in a desired profit with cash or futures contracts to avoid price risks.

Young farmers just starting out especially need marketing security in order to make payments on debts, have sufficient income for family expenses and capital for expanding their business.

Some producers use cash contracts or futures contracts to cover only their direct costs of production or storage. They speculate on the remainder of their crop.

2. *Your pricing objective.* If you are after the top price during the year and you want maximum flexibility to store your grain and second-guess the market, then you probably don't want to forward price your crop. But if you want to lock in an acceptable profit, have peace of mind, be sure to meet all of your financial obligations and obtain credit easier, then you probably should consider forward contracting.

Establishing Your Marketing Objective

The success of any particular case of forward pricing depends entirely on the objective of the producer involved. There are three basic objectives of forward pricing:

1. *To get a higher price than the ultimate cash market.* If your objective is to get the highest price by using the futures market, your chances of success are not too great. To be successful the producer with this objective must be able to accurately forecast the cash market price that will prevail at the time of sale. In other words, he must be able to outguess the market. If you are trying to get the highest price, you may hedge, but you're thinking like a speculator.

2. *To lock in an acceptable profit and avoid large price declines.* If this is your objective, your odds for success are excellent. You figure your production costs, add your desired return to management and profit and then lock in your price when it is offered to you through a cash contract or the futures market.

3. *To base management decisions on known prices.* With this as an objective, you can use the futures market or cash contract prices to help you decide whether to plant corn, soybeans or some other crop in any particular year. You can also use it when deciding to sell beans at harvest or store for later sale. You won't

be too concerned about whether or not you get the highest price using forward pricing. You will make your money from smart management decisions rather than from trying to outguess the market.

The most frequently made mistake by a grower who forward prices is not defining his objective before he begins or trying to change his objective somewhere along the line.

Three Steps to Successful Hedging

Regardless of whether you choose to forward price by cash contracting or hedging in the futures market, you should follow three basic steps:

1. *Determine a target or asking price:* Once you determine your objectives, the first step in forward pricing is to estimate your production costs. Without an estimate of production costs there's no way to know whether you are selling at a profit or a loss. The best way to determine production costs is to work through a production budget, including both variable and fixed expenses. Variable expenses include such things as land rent, taxes, seed, fertilizer, tractor operating costs, hired labor, etc. One way to think of variable expenses is that they are those expenses you could avoid if you decide not to produce a crop.

Fixed expenses, on the other hand, are expenses which will be incurred regardless of whether or not you plant a crop. For example, a tractor will depreciate whether it is used or not.

After you have estimated production costs, you should add some return to management. One way is to figure what you could earn if you were working for someone else either as a farm manager or in off-farm employment. You should be able to make at least as much money managing your own farm as you could make working for someone else. Once you have decided how much "salary" you would like to make, you can allocate that amount of money among all of your farm enterprises. This way you can determine how much should come from your soybean crop.

Then you should add some profit. What kind of profit should you make above the cost of producing your crop and above the return to your management? This will depend on your opportunities, competition from growers in other areas, your desire to grow beans, etc. A rule of thumb might be 10 percent above your costs and return to management.

Now you can arrive at a total "asking price" for your soybeans and decide whether or not to accept prices offered to you through cash contracts or the futures market.

You would never want to hedge if your local market price did not cover your variable costs, since you in effect would be locking in a loss.

2. *Localize the futures price:* If you are forward pricing by hedging in the futures market, you must "localize" the futures price to determine the net price you will actually receive. Futures prices quoted for soybeans are prices for beans delivered to Chicago in a given month. You must adjust those prices according to your own location, anticipated time of delivery, product quality and cost of hedging. This is called "adjusting for the basis." To complete a successful hedge, you must know how to accurately figure your "basis"—or the likely difference between the futures price and the actual cash price on your local market at the time your hedge is completed.

3. *Make the hedging decision:* Once you have figured your target or asking price and determined your local market price, your only decision left in order to forward price is to decide whether or not to accept a price being offered to you. Again, this decision should be based on your own costs of production, your own desired return to management and profit, your overall marketing objective and careful study of the market.

Summary

Forward pricing by either using cash contracts or hedging in the futures market allows you to "pre-sell" your crop before it is planted, while it is growing or while it is in storage. You can think of forward pricing as a temporary substitute for a cash sale. Whether or not you should forward price depends on how much risk you want to assume and your pricing objective. The three possible objectives of forward pricing are (1) to get a higher price than the cash market will offer you, (2) to lock in an acceptable price and avoid price declines, and (3) to base management decisions on known prices.

The three steps to successful forward pricing are (1) determine a target or asking price, (2) localize the futures price if you are hedging in the futures market, and (3) make the hedging decision.

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