Chapter Twelve: 
FINANCIAL ORGANIZATION

Michael Boehlje and Kenneth Foster

Introduction

The financial/organizational options currently used in pork production are much broader than the traditional debt and equity financed sole proprietorship of the past. The segments or stages of the pork industry are increasingly interdependent (as reflected in Figure 12-1), with more negotiated linkages between the stages from genetics to consumer and fewer independent firms and open market transactions. These linkages are exemplified by contracts between producers and packers, contracts between genetics and/or feed companies and producers, and the ownership integrated systems from genetics through the packing plant.

Within the traditional production sector (farrowing to finishing), various business arrangements, including farmer to farmer contract finishing, joint ownership of off-site nursery facilities, and jointly owned multiplier and breeding facilities, are becoming increasingly common. In essence, the industry is being transformed from one of independent stages linked by impersonal markets to one of a system of interdependent stages linked by negotiation. This brief discussion will focus on the increased number of financial and organizational options that are being used in the pork industry and specifically on the role of contracting and networking as alternative ways to coordinate the increasingly interdependent pork production/distribution system.81

The Options and Criteria for Choice

The options and alternatives available to finance and organize farm and agribusiness firms are much broader than traditionally have been perceived (Table 12-1). Combining various organizing and financing options into a complex structure that matches the business and personal objectives of the owner is likely preferred to the more traditional (and relatively simple) organizational/financial structure used in most pork firms (i.e., the sole proprietorship using internally generated equity and bank or other debt).

There are a number of criteria that should be considered when choosing a financial and organizational structure for a pork operation.

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Stages, Coordination, and Integration in the Pork Subsector

Figure 12-1
### Table 12-1: The Organizational/Financial Structure of the Agribusiness Firm: The Choices and Options

<table>
<thead>
<tr>
<th>Legal Organization</th>
<th>Business Arrangement</th>
<th>Leasing Options</th>
<th>Equity</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>* Sole Proprietorship</td>
<td>* Independent Producer</td>
<td>* Real Estate Lease</td>
<td>* Sources</td>
<td></td>
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<tr>
<td>* Partnership</td>
<td>* Contract Producer</td>
<td>* Cash lease</td>
<td>♦ Initial contribution</td>
<td></td>
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<tr>
<td>♦ General</td>
<td>* Subcontractor</td>
<td>* Share lease</td>
<td>♦ Retained earnings</td>
<td></td>
</tr>
<tr>
<td>♦ Limited</td>
<td>* Joint Venture</td>
<td>* Flexible cash lease</td>
<td>♦ Stock</td>
<td></td>
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<tr>
<td>* Corporation</td>
<td>* Strategic Alliance</td>
<td>* Shared appreciation lease</td>
<td>♦ Common stock</td>
<td></td>
</tr>
<tr>
<td>♦ Regular</td>
<td>* Franchise Agreement</td>
<td>* Facility/Equipment Operating Lease</td>
<td>♦ Preferred stock</td>
<td></td>
</tr>
<tr>
<td>♦ Subchapter S</td>
<td>* Licensing</td>
<td>* Capital/Financial Lease</td>
<td>♦ “External” equity</td>
<td></td>
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<tr>
<td>* Limited Liability</td>
<td></td>
<td>* Leveraged Lease</td>
<td>♦ Warrants or options</td>
<td></td>
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<tr>
<td>* Land Trust</td>
<td></td>
<td>* Leaseback</td>
<td>♦ Venture capital</td>
<td></td>
</tr>
<tr>
<td>* Cooperatives</td>
<td></td>
<td></td>
<td>* Business Practices</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td>♦ Payout policy</td>
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<td>♦ Intrafamily transfers</td>
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<td>♦ ESOPs/stock options</td>
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<td></td>
<td>* Loans</td>
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<td></td>
<td>♦ Maturity</td>
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<td></td>
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<td></td>
<td>♦ Interest rate</td>
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<td>♦ Amortization</td>
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<td>♦ Prepayment</td>
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<td>♦ Security/collateral</td>
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<td>♦ Conversion of terms</td>
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<td></td>
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<td></td>
<td>♦ Shared appreciation</td>
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<td></td>
<td>♦ Reverse mortgages</td>
<td></td>
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<td></td>
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<td></td>
<td>♦ Interest rate stripes, futures, options, swaps</td>
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<td></td>
<td></td>
<td></td>
<td>* Bonds</td>
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<td></td>
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<td></td>
<td>♦ Convertible bonds</td>
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<td></td>
<td>♦ Callable bonds</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td>♦ “Zero coupon”</td>
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</tbody>
</table>
Control

The objective of maintaining control dominates organizational and financial decisions in many pork production units. This objective is linked to the desire for independence and the focus on individual decision making. This fundamental objective may be one of the reasons for the dominance of internal equity funded sole proprietorships in the farm sector.

Returns

This objective focuses on which options will allow access to resources and funds at the lowest cost, and emphasizes the set of economic activities and enterprises that maximizes profits. Costs to be considered include administrative and legal costs (including taxes, licensing fees, etc.) as well as the more traditional costs of acquiring inputs and doing business. This objective focuses on organizing and financing the pork business in such a way as to meet the strategic objective of generating the highest net returns possible.

Risk

A key consideration is that of risk of financial loss. The risks involved have many dimensions.

* **Claims of various parties on income or revenues** - Because of legal structure, contract agreement, or financial arrangement, various parties have different claims on the income or revenues of the business. For example, debt holders have a different form of claim on income of the business than do equity holders. Characteristics of these claims, including amount, certainty (as contrasted with uncertain or contingent), and priority, will determine their impact on income risk.

* **Claim on assets** - Various legal and financial arrangements carry specific claims on assets of the business. These claims are frequently conditional in nature and contingent on specific financial or economic performance. For example, a debt holder may have secured a loan with a pledge of collateral – assets that can be claimed if the debt is not repaid. The amount and conditional nature of these claims will determine their impact on asset risk.

* **Bankruptcy/legal liability** - The risk of financial loss from bankruptcy and legal liability depends heavily on the financial and organizational structure. If all the assets one owns are included in one legal entity, they may all be vulnerable to bankruptcy claims. The use of multiple legal entities may help protect the assets of one entity from liability or bankruptcy claims of a separate entity. Vulnerability under liability and bankruptcy rules is the fundamental dimension of bankruptcy/liability risk.

* **Failure** - The success or failure of the business is influenced in part by the financial and organizational structure. Failure may result in losses in value or other consequences for related business ventures as well as loss of self-esteem, prestige, and respectability of the owners.
Maturity/Permanence/Liquidity

The permanence or longevity of the arrangement or option is another major criteria for choosing among financial/organizational options. In some cases an organizational structure or financing arrangement is needed for only a short period, or it may be a transition to a longer term, more permanent financial/organizational structure. Some arrangements or agreements are difficult or costly to dissolve once set up (e.g., a corporate or partnership business arrangement with no buy/sell agreements) or are long-term in nature (e.g., a 30-year mortgage with prepayment penalties), whereas other arrangements are more flexible or have a shorter maturity (e.g., a convertible bond or a short-term lease, contract, or loan). This time dimension is critical in choosing among various organizational and financial options.

If the dominant concern in the choice of the financial/organizational structure is ownership/control/autonomy, then the options available are severely limited. Many of the more flexible financing and organizing options increase the interdependence and reduce autonomy and control within the firm. Historically, autonomy and control appear to have been the dominant concern in much of Midwest agriculture.

Contracting

As noted earlier, various forms of contractual arrangements are becoming more common in pork production. These arrangements include marketing agreements, profit/loss sharing, profit/loss sharing with provided resources, and flat fee plus efficiency bonuses. Foster has described these arrangements and their applicability to the Indiana pork industry in the following fashion.82

Marketing Agreements

This method of coordination is a small, but growing part of pork production in Indiana. Marketing agreements tend to be loose agreements between a buyer and a producer to guarantee quantity, quality, frequency of marketing, or all three. The term “quality” is ambiguous and may refer to several of a list of factors. Lean yield and primal cut yield are two factors which top the list. Thus, one type of marketing agreement is represented by the carcass merit programs being instituted by many packers across the country. Another type of marketing agreement is a bonus paid for the guaranteed delivery of a certain number of hogs on a regular basis. Some buyers are also beginning to look at bonuses for hogs raised under specified conditions, for example, environmentally sound and/or humane conditions or hogs produced under the National Pork Producers Council’s Quality Assurance Program.

In all of these cases, the producer retains ownership of the facilities and hogs and pays all of the costs of production. However, some control over minor management decisions will be implicitly shared in order to capture as much of the premium as economically feasible. If a

producer can continuously meet the needs of the buyer, this type of arrangement may actually increase returns without significantly changing risk.

**Profit/Loss Sharing**

In exchange for access to a consistent supply of quality hogs, some contractors have shown a willingness to share profits and losses. The contractor usually specifies the type of hogs raised and the feed to be purchased, but the producer retains ownership of all animals and facilities. This approach cuts income variability but also limits some potential gains when prices are high relative to costs. Limited management assistance is generally provided by the contractor under this scenario, which, if useful, may partially compensate for the sharing of profit.

By sharing in profit and loss, the contractor is not only sharing the costs of production but also in the revenues. The producer pays the expenses and markets the hogs. Profit is determined from the receipts and an agreed cost of production. Other, similar contracts have been designed which share equally in price deviations around a constant value. For example, suppose this value is $45 per cwt. If the price at which the producer marketed hogs was $50 per cwt., the net price received under this contract would be $47.50, with the remaining $2.50 per cwt. going to the contractor. In the same way, if market price were $40 per cwt., then the net price to the producer would be $42.50. The contractor may either be securing a market for his or her product (feed, genetics, etc.) or be a packer securing quantity and quality of pork.

**Profit/Loss Sharing with Provided Resources**

Another type of profit-sharing contract which is growing in use within Indiana involves more than two parties. For example, a feed company will provide feed, another firm will provide the animals (usually breeding stock), and the producer will provide the facilities, labor, other costs of production, and detailed record keeping as specified by the other two parties. The provider of the animals will usually specify much of the management and marketing.

The method of payment on this type contract is a percentage of the net sales proceeds of all offspring. The owner of the animals retains the proceeds from the sale of cull breeding stock. This aspect of the contract may deprive the producer of a significant slice of income. The animals provided in this sort of contract are expected to be of very high quality, which could translate into more pigs/sow/year, higher weaning weights, and better feed conversion.

**Flat Fee Plus Efficiency Bonuses**

This is the type of agreement typically referred to as “contracting.” The producer provides facilities, labor, some management, utilities, fuel, and repairs. The contractor provides feed, livestock, veterinary expenses, managerial assistance, and marketing. Currently, in Indiana, the level of managerial transfer to the contractor is still relatively slight. In other parts of the country, management is completely dictated by the contractor. As the expertise of the contractors in Indiana develops or contractors from other regions expand into the state, we can expect these contracts to adjust toward less producer control.
The flat fee paid to the producer can be made on any of a number of variables, including: per head marketed, per unit of weight gain, per head per day, or per unit of weight marketed. By far the most common is per head marketed. This flat payment has been observed to range from $7 to $11.00 per head. The difference reflects the relative importance that the contract places on the flat fee versus the efficiency bonuses. That is, the lower the base, the more lucrative the bonus schedules for improved efficiencies.

Table 12-2 details the bonus structure for an example finishing contract which pays $7 per head marketed plus bonuses for low mortality and good feed conversion.

<table>
<thead>
<tr>
<th>Death loss</th>
<th>Bonus/Head</th>
<th>Feed Conversion</th>
<th>Bonus/Head</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-3%</td>
<td>$.30</td>
<td>3.3-3.4</td>
<td>$.50</td>
</tr>
<tr>
<td>1.25-2%</td>
<td>$.70</td>
<td>3.2-3.3</td>
<td>$.75</td>
</tr>
<tr>
<td>1-1.25%</td>
<td>$1.00</td>
<td>3.1-3.2</td>
<td>$1.00</td>
</tr>
<tr>
<td>.75-1%</td>
<td>$1.25</td>
<td>3.0-3.1</td>
<td>$1.25</td>
</tr>
<tr>
<td>0-.75%</td>
<td>$1.50</td>
<td>2.9-3.0</td>
<td>$1.50</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2.8-2.9</td>
<td>$1.75</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Under 2.8</td>
<td>$2.00</td>
</tr>
</tbody>
</table>

In general, this type coordination reduces producer involvement in management and marketing more than any of the previous schemes. It also places the greatest limits on the magnitude and variability of producer returns.
Networking

A common theme in much of the recent discussion of producer to producer linkages in pork production is networking. Networking linkages between producers can be as informal as regular (or irregular) meetings to discuss issues of common interest or as formal as formalized business arrangements where profits and risks as well as knowledge and information are shared. No matter what the arrangement, the fundamental questions in forming or joining any alliance or network are the following.

1) Who to partner with? What are the benefits, and what are the costs of networking with specific types of partners? What will I gain? What will I give up?

2) How to identify? Once the right type of partner has been defined, the next issue is to identify a specific individual or firm that has the desired characteristics. This may involve a systematic search and an interview/discussion/negotiation process.

3) How to negotiate? Any form of alliance or network involves negotiation concerning what are common interests, what information will be shared, what risks and rewards will be shared, etc.

4) How to govern? How will policy and strategic direction be determined: through a board, consensus of membership, etc.?

5) How to manage? If the alliance involves a business venture, the day-to-day management of that venture should be separate from governance.

6) How to finance? Who will provide capital if necessary, and how will that capital contribution be compensated?

7) How to exit? In many cases alliances or networks are not permanent; they are not needed after a time or the parties have different objectives. A procedure to exit or terminate the alliance in the least disruptive fashion is important to the long-term business success of the alliance partners.

Lawrence has identified three basic categories of networks: 1) information networks, 2) marketing networks, and 3) production networks. With respect to production networks, he provides illustrative networking models as summarized in Figure 12-2. Lawrence summarizes the benefit and limitations of joining a network as follows.

Benefits
1. Capture proven technology
2. Capture real economies
3. Improve product quality and market access
4. Utilize production, marketing, and information systems

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Limitations
1. Commitment of people
2. Joint responsibility
3. Formal business procedures
4. Loss of markets and suppliers

Production Networks

Genetic Multiplier

- Farrow to Finish - Raise Gilts
- Farrow to Finish - Buy Gilts
- Breed Gilts
- Central Breed Gest. Farrow

Decentral
- Breed Gest Farrow
- Breed Gest Farrow
- Nursery
- Finish

Marketing Cooperative

Multiple Packers, Multiple Users

Figure 12-2
Model A
* Traditional farrow-to-finish, one or multiple sites.
* Raise gilts, rotational, roto-terminal, or terminal cross.
* Market direct to packer.

Model B
* Traditional farrow-to-finish, one or multiple sites.
* Buy gilts from multiplier herd, jointly owned, terminal cross.
* Market cooperatively due to common genetics.

Model C
* Central breeding-gestation farm.
* Buy gilts from multiplier herd, jointly owned, terminal cross.
* All-in / all-out by site.
* Bred sows delivered at 110 days of gestation to fill barn.
* Pigs are early weaned to prevent disease problems.
* Weaned sows returned to central breeding-gestation farm.
* Either pigs stay in crate until 9-10 weeks old:
  * Or, early-weaned pigs moved to off-site congregate nursery.
* Pigs out of nursery finished off-site.
* Market cooperatively due to common genetics.

Model D
* Centralized breeding-gestation farrowing site, “sow corp”.
* Buy gilts from multiplier herd, jointly owned, terminal cross.
* Nursery either with farrowing, separate site, or with finishing.
* Finishing on third site or with nursery.
* Market cooperatively due to common genetics.

Model E
* Decentralized multiple sites for breeding-gestation-farrowing.
* Buy gilts from multiplier herd, jointly owned, terminal cross.
* Early weaned pigs to a congregate off-site nursery.
* Weekly farrowing on farms and harvest pigs twice or more a week.
* Group pigs in nursery into large groups for AIAO.
* Finish at third site AIAO.
* Market cooperatively due to common genetics.
A Final Comment

A more diversified financial/organizational structure will typically (but not always) increase the flexibility and reduce the financial risk of the business venture. In fact, diversified financing is an alternative and possibly more effective strategy to reduce risk in many farm firms than diversifying in production enterprises, product lines, and/or business ventures. Consideration of a broader set of options for financing and organizing the business, including contract production and various forms of networking, may provide the opportunity to increase efficiency and reduce costs, and most likely will increase the availability of funds to finance growth and expansion.