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Taking Advantage of a Strong Cattle Market

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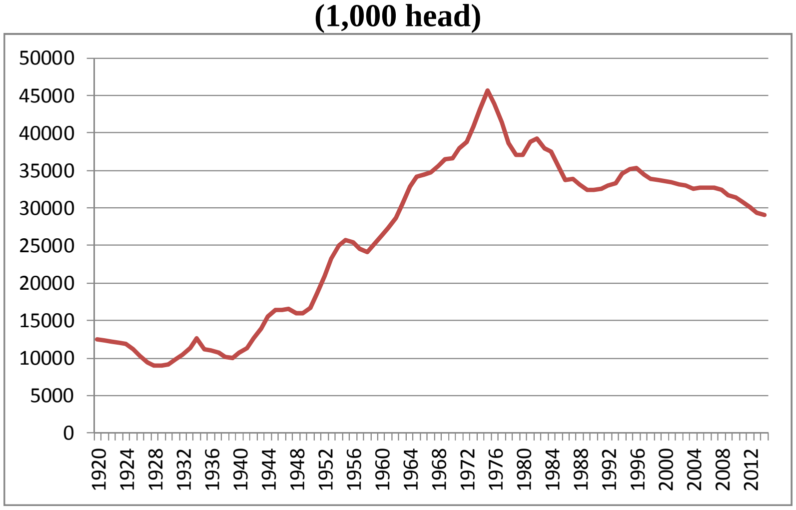
Introduction

A combination of several factors has led to extremely strong prices across beef cattle markets during recent years. Established cow-calf operators are the primary beneficiaries of these unprecedented price levels as they represent the only industry within the beef sector that is not margin oriented. While the current market environment has greatly improved profitability at the cow-calf level, it also presents challenges as producers consider long term decisions about cattle inventory, investments in equipment and facilities, and managing the financial aspects of greater cash flow in the coming years. The purpose of this publication is to (1) outline the factors behind the current strength of the cattle market and describe how producers typically respond to strong markets and (2) to help frame the economics of several key long-term investment decisions that producers are likely considering.

Current Market Background

While there are many factors behind the extremely strong feeder cattle market that cow-calf operators are currently enjoying, the primary drivers have been decreasing cow inventory and improving beef demand. Cow inventory is at a level that has not been seen since 1962. Figure 1 depicts beef cow inventory since 1920. Note the very slight increase in beef cow inventory from 2004 to 2006 followed by a decrease from 2006 to the present. An examination of Figure 1 also shows that the last few years have been associated with an especially sharp decline since 2008 as beef cow numbers decreased by more than 10% from 2008 to 2014. Cattle producers in many parts of the US have faced severe drought at some point over the last several years. The Southern Plains, which is home to a great number of cows, has been especially hard hit since 2011. As an example, beef cow inventory was Texas was down by more than 20% from 2011 to 2014.

Figure 1. Jan 1 US Beef Cow Inventory (1920-2014) (1,000 head)



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While weather has likely been the largest cause of the decreasing cattle inventory, other factors are also worth discussion. First, cull cow prices have been at extremely high levels, which has impacted the culling decision for many operations. As an example, 80-85% boning cow price averaged $75.11 per cwt during 2013, compared to $48.53 per cwt during 2008. Put simply, high cull cow prices force producers to think a bit harder about keeping cows as they approach the end of their productive lives. This has also made culling decisions much easier for producers who have been faced with weather challenges.

In addition to weather and strong cull cow markets, profitability in the grain sector has also had an impact on beef cow numbers. Rising grain prices have led to rising land rents, which has brought many new acres into row crop production over the last several years. A good number of these acres have transitioned from pasture and hay ground. Between 2007 and 2013, Kentucky added around one-half of one million acres to the state's corn and soybean acreage and a good number of those acres likely came out of pasture or hay.

These bearish supply factors have been coupled with improvements on the demand side. Retail beef demand has improved steadily since the second half of 2009. The restaurant sector, which is a major player in beef markets, has also improved considerably since the recession. Finally, the market has been further supported by strong export levels, despite rising prices. In short, a tight cattle supply combined with strength in both the domestic and international markets has been a recipe for the type of beef market that is being enjoyed by producers in 2014.

Cattle Market Outlook

While outlining the factors behind the current cattle market allows one to better understand its strength, most producers are focused on assessing how long this impressive run will last. Many investments made by cow-calf operators are long term investments. Breeding stock, machinery, facilities, and other capital items require a multi-year evaluation. While predicting the future of any market is virtually impossible, it is probably worthwhile to think through some factors that could change the tone of the current market.

The most obvious factor that would affect calf markets would be an increase supply. In aggregate, cow-calf operations typically respond to increased profitability by expanding the size of the cowherd. Current calf prices are certainly at sufficient levels to trigger interest in expansion and some areas in the Northern Plains have started to do so. However, weather challenges and competition for land have delayed the expansion that many would have already expected to be underway. With grain prices moving to more moderate levels during 2013, moisture will likely be the main determinant as to whether expansion begins on a larger scale during 2014 or 2015.

However, one should also know that expansion of the beef sector takes time. In the short run, calf supply is likely to decrease as producers hold back heifers for beef cow replacement. Heifer calves born in the spring of 2014 would not be bred until spring/summer of 2015 and would not wean their first calves until the fall of 2016 in most cases. So, while cow-calf profitability is likely sufficient to encourage heifer retention, it must be accompanied by favorable weather, sufficient time for heifers to be developed, bred, and to wean their first calves. Even if weather provides good conditions for expansion, there is typically a two-year lag between heifer retention and larger calf crops being sold. So from a supply perspective, this market should remain strong for the next couple of years.

While much energy is often devoted to managing cow-calf operations through challenging times, it is also important that producers make good decision in more profitable times. Often, decisions that are made during good times have implications when profitability decreases in the future. The current status of the cow-calf industry provides an opportunity to make use of a significant increase in income. While the producer has many options, the remainder of this publication will focus on (1) significantly changing the size of the herd, (2) improvements to equipment and facilities, (3) reducing debt, and (4) expanding working capital. Each option should be carefully considered as beef producers should decide what is best for them at this time while thinking about long term.

Changes to herd size

When it comes to making changes to herd size, producers can either expand or decrease. Either comes with concerns to think about before making a decision. Two of the main topics to consider are how forage production will be affected and the long-run implications of expanding or reducing herd size. When expanding herds, forage production might be put under stress by not having enough acres or, production may not be sufficient for the increased needs. Overgrazing of pastures can reduce grazing potential and hay production for several years. Both could result in having to purchase forages or supplemental feed which will affect the cash flow, and potentially, the profitability of the beef operation. Carrying capacity should be a key consideration as one examines expanding the size of their beef operation. Another issue is how the land will be used if it is no longer being used as pasture. If the pasture is rented, the producer needs to examine the lease terms.

Strong markets can also provide incentives for producers to reduce the size of their herds as the value of breeding stock increases. Forage production should also be considered when reducing herd size. The producer needs to think about how to use the forage no longer utilized by the beef operation. Several possibilities exist including cash hay sales, renting excess pasture, and stockpiling additional forage to reduce winter hay feeding days.

The potential benefits from any of these strategies should be weighed against the lost profit from sale of breeding stock. Profits received from selling calves could be used to expand the herd, make farm improvements, reduce debt or increase working capital. Retaining profits from sales as liquid assets would improve the producer’s liquidity position. When selling cattle produces a gain in profits, producers need to be aware of how it will affect their tax obligation.

Improvements to Equipment and Facilities

Another avenue cattle producers can explore is improving equipment and facilities. Some producers will purchase equipment at the end of year to reduce taxable income; however for 2014, Federal Section 179 Expense Election is only $25,000 plus an adjustment for inflation down from $500,000 in 2013. There is still a chance that Congress could retroactively increase the Federal Section 179 amount, but producers should not count on this. Federal Section 179 Expense Election allows for farmers to deduct full purchase price of equipment/buildings/breeding livestock in one year from their gross income. When making purchases producers need to keep this in mind if they intend on expensing out the total cost of any equipment, buildings and breeding stock that are purchased. Producer should also consider the tax implications in subsequent years for any items for which the Federal Section 179 election is used as they will no longer have the ability to deduct that depreciation. Besides the tax implications, a producer should not be purchasing equipment just to have new equipment and should be careful that the Federal Section 179 election is not the only driving purchase decisions. Producers should only purchase equipment that is truly needed. When deciding on purchasing equipment, the producer needs to consider whether they are purchasing it with retained earnings or borrowed capital.

Another option for upgrading equipment and being able to deduct the expense on income taxes is leasing equipment. Leasing equipment is becoming more popular as limitations are placed on Federal Section 179 Expense Elections. Since the leasing payment is being expensed each year, the equipment is not placed on the depreciation schedule. However, the lease payments are a fully deductible expense. Once the lease term is up, should the producer decide to buy the equipment, then the machinery can be added to the depreciation schedule and depreciated in normal fashion.

Reduce Debt

Producers could also use the retained earnings from the strong cattle market to pay down debt. In general, reducing debt allows a cattle producer to improve their overall financial wellbeing. Paying down debt improves a producer's debt to asset ratio, which measures solvency. Solvency determines if long-term financial commitments can be met. Reducing debt also helps their current ratio, which measures the ratio of current assets to current liabilities. The ratio shows how liquid that farming operation is its ability to meet short term obligations. Both financial ratios might be examined by lenders when making credit decisions. Reduction of debt load also is beneficial as it lowers cash overhead costs and likely puts producers in a better position when cattle prices decrease in future years.

One drawback of paying down debt is that only the interest paid on loans can be counted as an expense on income taxes. So, there is no short-term tax advantage to principal reduction. One also needs to make sure that there are no penalties for paying extra as those penalties could potentially negate the benefits. It is probably wise to discuss these strategies with a tax consultant, farm management specialist, or another professional.

Increasing Working Capital

Finally, producers may want to consider increasing their working capital during a profitable time period. Working Capital is calculated by subtracting total current farm liabilities from total current assets. Having a rather large working capital means that a producer has sufficient amount of cash or can get it fairly quickly if needed. Working capital is farm specific and there is no common amount of working capital that is recommended across the board. Since current assets include cash assets or marketable livestock and grain, those assets are the next best thing to cash. Any marketable livestock and grain increases the producers overall working capital.

Increasing working capital is like saving for a rainy day when the extra monies may be needed. Just as households should maintain some type of emergency fund, there are also benefits to farm operations for having some liquid funds available for unexpected expenses. By having working capital available, the operator may be able to avoid additional debt as these types of expenses arise. This saves potential interest expenses and makes the farm less vulnerable to financial setbacks as they have some cushion to absorb financial shocks.

There is another benefit to having significant working capital that is much harder to quantify. In addition to providing the ability to absorb unexpected expenses easily, working capital may also allow a farm operator to be opportunistic when investment opportunities arise. These opportunities may include the purchases of additional acreage, breeding stock, equipment, etc. Sometimes attractive investment opportunities present themselves and when they do, the ability to move quickly can greatly improve the likelihood of success.

Conclusion

Profitability in the cow-calf sector has historically run in 10-14 year cycles as producers expand and contract the size of their herds based on market conditions. While many have questioned the importance of cattle cycles recently and many factors beyond cattle supplies have a major impact on price and profitability, producer response to market conditions will be a major driver of cattle prices in the future. While prices are such that expansion is very likely in the near future, supply conditions should remain positive for several more years. Given that, the next few years should provide many opportunities for cow-calf operators to invest in their cow herds, or capitalize on the strong market in other ways.

Cash-flow should always be on any cattle producers' mind whether they are trying to take advantage of the market or manage their operations as usual. Changes in herd size, investment in equipment and facilities, debt reduction, and expansion of working capital will affect cash-flow to some extent. Expanding and/or improving equipment/facilities will require more cash than simply maintaining the current status of the herd; however these decisions may provide long term benefits for the operation. The opposite can be said if the producer decides to capitalize on the strong market by liquidating, but may also provide opportunity to invest elsewhere in the farming operation. Cash flow should also be examined if the producer decides to reduce debt as there will likely be both short term and long term impacts on cash flow. Impacts on income taxes should be analyzed before deciding if a cow-calf producer wants to capitalize on the current market conditions. These decisions will be unique to each operation, which makes careful consideration especially important. For more information, or to discuss existing opportunities, producers can contact their County Extension Office or Kentucky Farm Business Management Area Specialist.