Section 2.8
Managing Risk

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Section Summary

- What is risk management?
- Sources of risk
- Risks for niche businesses
- Overview of risk management strategies
- Insurance options
- Exit strategies
What Is Risk Management?

• A preemptive strategy to anticipate, evaluate and manage risks in your operation

• A proactive decision-making process for:
  ▶ assessing continuously what could go wrong (risks)
  ▶ determining the probability of these events
  ▶ determining which risks are important or fatal
  ▶ choosing strategies to deal with those risks
Three Types Of Strategies To Manage Risk

1. Reduce risk within your operation:
   - diversify products you sell, change production techniques

2. Transfer risk outside your operation:
   - use insurance, contract your cattle to an alliance

3. Build your operation’s ability to bear risk:
   - maintain liquidity, plan expenses

Sources Of Risk & Uncertainty

- **Production**: variability in production process
  - weather, disease, fire, wind, theft, etc.

- **Marketing**: risk associated with purchasing inputs & selling products
  - price, quality & availability of inputs
  - relative prices of other goods, consumer preferences (changes and perceptions)

Sources Of Risk & Uncertainty

- **Technological**: risk that improvements in technology may offset current decisions

- **Financial**: for business and family
  - cost & availability of debt capital
  - meeting cash flow needs in a timely manner for ongoing farm/ranch obligations
  - maintaining and growing equity
Sources Of Risk & Uncertainty

• **Legal & social**: risk from changing social attitudes & regulations
  ▶ government price and income programs
  ▶ tax, trade, credit & environmental policies
  ▶ changing social norms (media-driven)

• **Human**: risk associated with labor & management
  ▶ health problems of key individuals, changing objectives of employees

Risks For Niche Businesses

• Production risks:
  ▶ May involve new production practices or require skills to produce unique goods
  ▶ Small producers have difficulty producing consistent quantity
  ▶ Beef products are sometimes difficult to keep uniform (consistent quality)
  ▶ Difficult & costly to change finishing program, special processing hard to find, seasonality of breeding program

Risks For Niche Businesses

- **Marketing risks:**
  - New supply participants increase competition
  - Must supply volume to meet demand
  - Need to produce consistent product & maintain uniform pricing
  - Must determine how to price different cuts
  - Seasonality affects sales
  - May sell some cuts of beef better than others
  - Market access- “getting in the door”

Risks For Niche Businesses

• Financial risks:
  ▶ Capital investment is generally higher to start up a niche business (organic certification, labeling)
  ▶ Reaching consumers in certain niche markets may require considerable capital investment
  ▶ Costs may be higher (labor, processing, promotion, transportation)
  ▶ May need to deal with bad checks or timely payment from consumers

Risks For Niche Businesses

• **Legal risks:**
  - Food safety regulations
  - Product liability
  - Regulatory compliance (USDA, HAACP, labeling claims)
  - Contracts not always economically enforceable (i.e., breach of contract by a large wholesaler, difficult for a small producer to take legal action because of limited legal & financial resources)

Risks For Niche Businesses

• Managerial (human) risks:
  ▶ Niche marketing often involves direct involvement with consumer
  ▶ More time intensive, greater labor investment
  ▶ Must be prepared to change product to fit consumer demand
  ▶ Saboteurs do exist and may cause problems
  ▶ Liability may become an issue if producer found to be source of contamination problems

Developing A Risk Management Strategy

1. Set your family & business goals
   - Understand how they relate to one another to help guide decision-making

2. Understand your attitude toward risk
   - Do you avoid, ignore, enjoy or calculate the risk inherent to your business?

Developing A Risk Management Strategy

3. Understand your ability to bear risk, given your financial position
   ▶ Analyze solvency, liquidity & cash flow requirements

4. Keep records:
   ▶ Use historical production & marketing information
   ▶ Generate financial statements & calculate performance measures (margins and turnover)
   ▶ Collect market situation and outlook data

Developing A Risk Management Strategy

5. Collect off-site information on technological, human, legal & social risks:
   - follow trends, make forecasts & projections
   - the exact data you will need depends on size, type & complexity of your operation

6. Develop a business plan that specifies goals, identifies alternatives for meeting them and monitors progress. Review it regularly.

→ See Section 2.2 of this workbook
Production Risk Management Strategies

• Diversify enterprise to reduce income variability
  ▶ increase variety of products produced and customer segments you market to
  ▶ change production practices and/or spread your operation over a larger area
  ▶ earn off-farm income

• Vertically integrate your production practices: retain more control across levels of activity
  ▶ but understand financial implications

Production Risk Management Strategies

- Use production contracts for inputs (i.e., grain), find alternatives or eliminate them.
- If adding value, have long-term service agreements and good relations with processor(s).
- Consider livestock insurance.
Financial Risk Management Strategies

• Maintain adequate liquidity to survive shortfalls (inventory, cash, other financial assets)
  ▶ reduce expenditures, use resources more efficiently, lease assets, manage pace of investments, etc.
  ▶ with growing business, however, earnings may be reinvested in business which lowers financial reserves

• Plan expenses to ensure adequate cash flow

Financial Risk Management Strategies

- Limit credit, taking into consideration your managerial ability, loan size, use of funds & loan arrangements
- Vertical integration (taking on marketing) could be viewed as a risk-managing, portfolio activity
  - Good years for retail sales may partially offset bad production years
- Insure against risks with very adverse consequences & re-examine insurance needs annually

Marketing Risk Management Strategies

- Have a marketing plan
  - See Section 3.2 of this workbook
- Include an analysis of financial considerations, production costs & pricing
- Increase your marketing skills:
  - get professional assistance
  - take classes
- Monitor weather, trade, regulatory environment

Marketing Risk Management Strategies

• Look for alternatives for reducing pricing risk:
  ▶ forward pricing of production
  ▶ hedging using futures markets
  ▶ options trading (price insurance)
  ▶ spread cash sales throughout year

• Link selected strategies to costs or returns, where appropriate

Legal Risk Management Strategies

- Legal risk inherent to production, marketing, financial & human resource activities
- Choose a business structure after considering the income and property tax implications, degree of liability to third parties
- Be aware of new laws and regulations
- Understand all contractual arrangements, as well as what happens under default

Legal Risk Management Strategies

• Understand tax reporting and payment obligations; wage and safety requirements, compliance with nondiscrimination statutes, etc.
• Keep records of compliance with environmental regulations
• Have a will and other related documents & plan for unexpected illness or death
Human Risk Management Strategies

• Define how decisions will be made in your business & what everyone’s responsibilities are
  ▶ For both family & hired labor
• Make sure managers have risk management duties & the authority to act
• Train employees in safety & emergency response
• Have a back-up plan for day-to-day operations
  ▶ For a key employee or you

Insurance Options

• For most businesses:
  ▶ Liability- base coverage and umbrella (your asset protection plan)
  ▶ Multi-peril crop insurance or livestock insurance
  ▶ Health and Life insurance
  ▶ Workers Compensation

• For a separate business structure:
  ▶ Directors and officers liability (financial barrier between assets & owners)

• Other (structural insurance…)

When Planning For Risk & Uncertainty

HAVE GOOD ADVISORS

- Banker
- Lawyer
- Accountant
- Insurance agent
- Mechanic
- Cooperative Extension specialist
- Spiritual advisor
Remember...

- Use a comprehensive strategy of production, marketing and financial responses to risk, rather than separate ones.
- Structure the business to minimize exposure.
- All responses to risk have a cost.
  - I.e., insurance premiums, a higher price foregone through forward contracting.
- Make changes as the business grows.
Extreme Events

**HOW LUCKY ARE YOU?**

- What happens when these occur?
- What does the future hold for these events?
- Will national policies and laws have great impacts on the way we do business?
- Are there ways to protect your assets?
Your Exit Strategy

• In planning for change, don’t think it won’t happen to you!
• You MUST have an exit strategy as part of your business plan
• Planning allows time to consult with professionals and put your plan in place, optimizing your chances of getting the most financial and personal satisfaction from the results
• Include your family and financial advisor in the process

Your Exit Strategy

- Two exit strategies to transfer power & assets: if you don’t do it through planning it will happen in crisis
  
  1. **Internal action**: transition to preserve leadership & ownership continuity in a family business involves estate planning, also business & tax planning
  
  2. **External action**: sell your business as an ongoing concern (depending on its organization) or liquidate assets

Risk Management Resources
National Ag Risk Education Library

- Ag Risk Library contains:
  - Budget Library
  - Specialty Crop Library
  - Center for Farm Financial Management
  - Funding opportunities

- Online at www.agrisk.umn.edu
AgManager.Info

• Kansas State University website: source of information, analysis, & decision-making tools for agricultural producers, agribusinesses and others
• Livestock site contains info. on livestock and meat marketing, budgets, and policy issues to assist producers in making marketing decisions
• Other info. includes human resource management, income tax & law, current policy and agribusiness issues
• Online at www.agmanager.info
USDA Economic Research Service

• Main source of economic information and research from the U.S. Department of Agriculture
• Publications and data cover wide range of topics
• Searchable database
• Virtual briefing rooms on ERS research and associated economic issues
• Online at www.ers.usda.gov/
Western Center For Risk Management Education

- Funding opportunities: Competitive grants program
- Farm Family Support Network: assistance to farm families in developing their options for the future
- Trade Adjustment Assistance Program: technical assistance, cash payments, & education and training support for agricultural producers & fishermen
- Online at westrme.wsu.edu
Business Owners' Toolkit

- Web site includes:
  - Small business guide: planning & starting a business, financing, marketing, government contracts, human resources, taxes, protecting assets, exiting a business
  - Small business tools: model business documents, financial spreadsheet templates, checklists, official government forms
- Online at www.toolkit.cch.com
Food Safety and Inspection Service

- Pathogen Reduction/HACCP & HACCP Implementation information
- Contains generic HACCP models, general regulatory information & HACCP implementation information for small and very small plants
- Includes links to USDA/FDA Foodborne Illness Education Information Center
- Online at www.fsis.usda.gov/OA/haccp/imphaccp.htm
USDA Risk Management Agency

- Information on federal insurance options, pilot programs & regulatory information
- Offer educational program to assist producers & agribusinesses in understanding their increased risk exposure and responsibility, to understand and integrate these strategies in decision-making
- Online at www.rma.usda.gov
USDA GIPSA

• Grain Inspection, Packers and Stockyards Administration
• GIPSA's Packers and Stockyards Programs:
  ▶ maintain fair trade practices in the marketing of livestock
  ▶ audit and investigate the regulated industry for compliance in payment to livestock sellers
  ▶ assure open competitive marketing conditions for livestock & meat
• Online at www.usda.gov/gipsa