



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