Strategic Investment Alternatives for Agricultural Producers: Pathways to Wealth Accumulation

by

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Abstract

Farmers often are invested heavily in fixed assets (overhead) such as farmland and a harmonized set of equipment and buildings dedicated to the production of commodities such as corn, wheat, or milk. These commodities are the outputs from the inputs that are owned or controlled by the farm operator for the purpose of producing income.

Over a lifetime every household participates in wealth accumulation. Wealth accumulation consists of a set of activities over time aimed at producing household income or wealth. While most farmers engage in commodity production to generate current household income, the household often accumulates substantial wealth through farmland appreciation over a lifetime. There are several alternative strategies available for wealth accumulation through additional investment, either on-farm or off-farm. This article discusses these strategic alternatives and provides some evaluation of their characteristics.

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Introduction

Dynamics in the global food system have led to the latest U.S. Department of Agriculture statistics indicating that the farm gate share of the consumers' dollar in the United States is about 19 cents. That is, about 19 cents of each consumer dollar spent on food pays for the agricultural commodities produced on the farm and sold at the farm gate. The other 81 cents is the costs and margins associated with adding value through storage, processing, packaging, labor, transportation, and services built into the food products ultimately sold to the consumer.

The marketing margin captured by the gate-to-plate portion of the supply chain has consistently increased for over four decades. This has resulted in some agricultural producers seriously considering investment in businesses related to this portion of the supply chain, rather than added investment in commodity production. Recent research indicates that numerous factors account for the level of off-farm investment observed among farm households (Mishra and Morehart). These factors include: level of education, age of the operator, the amount of off-farm income, household net worth, leverage, farm size, farm diversification, management skills, and area of the country.

Farmers typically are invested heavily in fixed assets (overhead) such as farmland and a harmonized set of equipment and buildings dedicated to the production of commodities such as corn, wheat, or milk. These commodities are the outputs from the inputs that are owned or controlled by the farm operator for the purpose of producing income.

Over a lifetime every household participates in wealth accumulation. Wealth accumulation consists of a set of activities over time aimed at producing household income or wealth. Such activities are broad in scope and include everything from drawing a paycheck from an employer, to placing money in a mutual fund, to becoming an entrepreneur by starting a business. Agricultural producers engage in wealth accumulation activities to various degrees. A diagram of farm household wealth accumulation indicates the interplay among off-farm and farm pathways for wealth accumulation, Figure 1.

Many farmers engage in commodity production to produce current household income while accumulating substantial wealth through farmland appreciation over a lifetime. A recent Economic Research Service report indicates that about two-thirds of farm household wealth is from farm net worth while about one-third is from non-farm net worth (Mishra, et al). This article defines and discusses various types of strategic investments and provides some evaluation of them.

Alternative Strategic Investments

Alternative strategic investments are defined based on the investment objective or goal. To achieve continuous growth in income and wealth accumulation, new investment is critical over a lifetime. Strategic wealth accumulation investments define a portfolio of investments. Alternative investments are related to how farmers strategize and invest their marginal investment dollars to accumulate wealth over a lifetime. Strategy is often dependent on the underlying motivations for certain types of investments.

There are many investment choices. The two tables outline a choice set of seven broad classes of strategic investments, Tables 1 and 2. The choice set includes three on-farm investment strategies: classic investment, investment to produce a differentiated commodity, and investment to diversify on-farm income. Four off-farm alternative investment types are defined and discussed. These include strategies of: 1) investing in publicly-traded stocks of value added investor-owned firms, 2) investment in value added or agriculture-related small business, perhaps start-ups, 3) investing in a business to countervail downstream market power, and 4) investment in income producing businesses unrelated to agriculture. Each of these choices is explained in more detail.

Classic

The classic investment best practice is to invest in increased efficiency to lower cost and become a lower cost producer of undifferentiated commodities. There are numerous methods available to farmers to achieve this objective. They range from expanding their land base to buying larger equipment or joining a supply cooperative in an effort to reduce costs. A summary of some consequences of each strategic investment type is provided in Tables 1 and 2.

Enterprise Diversification

Enterprise diversification can be a popular means of enhancing farm income through investing in diversified activities. The motivation or goal is to enhance farm income from additional revenue-producing activities complementary with existing operations. The activities generate revenue but yet are complementary with the location and sunk cost already made in the production of commodities (for example, tractors and wagons). Entertainment farming and roadside market operations are both examples of this type investment. The new enterprise is complementary because often the bulk of the assets necessary to support the additional enterprise are already in place. A secondary motivation for this type strategic investment may be to dampen farm income variability over time through diversification.

Differentiated Commodities

Another on-farm investment strategy involves additional investment in the production of specialized commodities. Enterprise diversification is motivated by price premiums that may be realized through the successful production of such commodities. Examples include organic production, high oil corn production, GMO-free white corn production, and many others. The objective is to enhance farm income by investing in commodities that command a premium over regular undifferentiated mass marketed commodities. New investment though is required to leverage current assets to take advantage of new opportunities. For example, adding organic production may involve acquiring significant additional managerial skill to create and capture new value. A secondary motivation for this investment practice may be to reduce income variability over time through diversification.

Value Added Business

One type of strategic investment farmers is to invest in value added agriculture. This strategy is an offensive strategy, where the farmer is pursuing the capture oif margins otherwise enjoyed by businesses downstream from the farm gate. This off-farm investment often is in downstream businesses that capture margins from further processing agricultural commodities.

Value added off-farm investments have been popular among farmers in many different locations. One example is farmer investment in ethanol production. Another common example however is the value added investment in a new business. Often the new business is based on novel process or product technology. The new business adds value to agricultural commodities and the product(s) is aimed at serving a niche market.

An example of this is farmers investing in a manufacturing facility that produces soy powder. The business is based on patented process technology that provides a market niche and the start-up has a competitive advantage, at least over the first several years, from the process technology unique to the business.

It is common to observe start-ups that capture margins based upon serving a niche market that is initially protected by technology. The liquidity of these investments however is quite low.

Publicly-traded Stock

This off-farm investment practice involves buying publicly-traded stock of agribusiness companies[1]. This strategic investment is in contrast to direct investment in a post-harvest new business. The publicly-traded stock alternative is investment in a portfolio of publicly-traded stock in firms already purchasing, processing and marketing the same raw commodity being produced. The portfolio strategy of publicly-traded stock of agribusinesses provides some advantages, and has some disadvantages, compared to the start-up business investment strategy, Table 3.

Countervail

[1] This approach has been suggested by Siebert, Jones, and Sporleder and uses a simple model called VEST. If the producer were to set a vesting goal of achieving balance between the capacity of the value-added investment and the size of farm marketings, such vesting can then be quantified. The appropriate producer share of the value of total public company stock outstanding depends on farm sales in proportion to the importance of the commodities to the farming operation. See Siebert, Jones, and Sporleder for more detail.

This investment strategy is defensive in the sense that the motivation is to protect already sunk costs in a particular type of commodity production. This strategic investment is probably the most difficult to understand or even to know when it occurs. A typical situation is that a group of farmers, often through a cooperative, are motivated to invest in a downstream processing business to ease economic market power. Sometimes market power inequalities at the producer-first handler level of the supply chain lead producers to invest to gain knowledge about the processing business to countervail existing market power of buyers. Dairy farmers have invested off-farm in a significant way to operate milk marketing cooperatives. This strategic investment is an example of a countervailing strategic investment on the part of farmers.

Characteristics of this off-farm countervail investment are relatively high risk, relative illiquidity, investment in idiosyncratic assets, and extension beyond the member's core competencies. This investment may be the only alternative to reduce income variability compared to investment solely in commodity production.

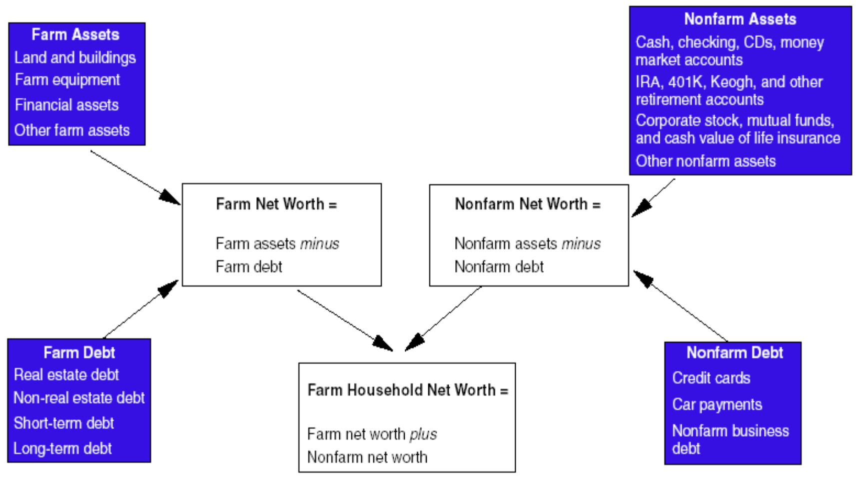
Investment Diversification

The final investment strategy also perhaps is the simplest. This investment type involves a conglomerate approach of investing off-farm in totally unrelated businesses that produce revenue streams. This alternative investment practice is motivated both by enhancing income and reducing the variability of income through diversification. An example is the purchase of an urban office building motivated solely by the potential for favorable return on equity relative to other investments.

There is a body of research which indicates that farmers generally are better off in the long-run when they diversify some of their investments away from agriculture.

The basic logic is no more complicated than the old adage ‘Don’t put all your eggs in one basket!’ However, some recent evidence suggests that investment in a portfolio of food and agricultural publicly-traded stocks is preferable to investment in a well-diversified general stock portfolio for farmers (Duval and Featherstone).

Figure 1 Sources of Farm Household Wealth



Source: ERS

Table 1. On-farm Strategic Investment Alternatives: Selected Characteristics

Selected Characteristics of the Investment	On-farm Investment Alternative		
	Classic	Differentiated Commodity	Enterprise Diversification
Strategy	Enhance income through implicit strategy of being a low cost producer of commodities	Capture margin through investing to produce differentiated commodities	Enhance income by investing in diversified on-farm activities complementary with commodity production
Examples	-Purchase or rent additional farmland -Buy large farm machinery -Join a credit cooperative -Join a supply cooperative	-Organic fruit and vegetable production -Production of specialty grains such as high oil corn or popcorn -Organic food-grade soybeans	-On-farm retail sales of commodity production (e.g. roadside marketing or U-pick operations) -Agri-tourism -Aquaculture
Main Motivations	-Reduce cost -Increase efficiency	-Dampen income variability - Enhance income	--Diversify income - Enhance income -Dampen income variability
Influence on Asset Specialization or Diversification	Increased asset specialization	Little or no influence on asset diversification	Modest influence on asset diversification
Liquidity of the Investment	Moderate	Illiquid	Illiquid
Influence on Output Contracting	Modest increase from perhaps contracting some output as size of operation increases	Increases	Little or none
Influence on Primary Types of Farm Income Risk			
Production and marketing risk	Enhanced	Enhanced	Little or no dampening
Price risk	Enhanced unless hedged or contracted at a fixed price	Little or no dampening	Modest- to moderate-dampening
Financial risk	None	Little or no change	Little or no change

Table 2. Off-farm Strategic Investment Alternatives: Selected Characteristics

Selected Characteristics of the Investment	Off-farm Investment Alternative			
	Publicly-traded Stocks	Value Added or Ag-related Business	Countervail	Investment Diversification
Strategy	Buy stock in publicly-traded agribusinesses that add value to agricultural commodities	An offensive strategy resulting in Investment in new business aimed at a niche market based on process or product technology that results in adding value to agricultural commodities	A defensive strategy resulting in Investment in downstream processing to increase vertical information flow or countervail market power in downstream markets.	Speculative or unrelated investment to agriculture
Examples	-ADM -ConAgra -Bunge Limited	-A manufacturing facility that produces soy powder -Ethanol processing plant	-Invest in a tomato processing plant to make tomato paste (protect processing tomato production) -Start a denim mill (protect short-staple cotton production)	-Invest in an office building in the city -Speculative investment in gold or silver
Main Motivations	Enhance income and dampen income variability from financial participation in value added agriculture and downstream processing margins	Offensive strategy to enhance income from producing differentiated products sold into niche markets	Defensive strategy to protect an on-farm commodity enterprise	Enhance income from the expected gain from a favorable risk-reward investment profile
Influence on Asset Specialization or Diversification	Moderate to high degree of diversification	Moderate degree of diversification	May become more specialized in asset base	Potential significant diversification of the asset base
Liquidity of the Investment	High liquidity	Low liquidity	Low liquidity	Moderate liquidity
Influence on Income Variability	Dampens long-term	May magnify price risk variability; uncertain influence on income variability	May magnify price risk variability; uncertain influence on income variability	Uncertain
Influence on Output Contracting	Neutral	May increase contracting because the investment may require a commodity be contracted and delivered to a specified facility	May increase contracting because the investment may require a commodity be contracted and delivered to a specified facility	Neutral

Influence on Primary Types of Farm Income Risk				
Production and marketing risk	None	May enhance	May enhance	None
Price risk	Dampens household income variability; no influence of commodity price risk	May enhance price risk since a value added business related to commodity production will experience positive correlation between product output price and commodity price	May enhance price risk since a value added business related to commodity production will experience positive correlation between product output price and commodity price	None
Financial risk	Modest to significant increase	Modest to high increase	Modest to high increase	Modest to high increase

Table 3. Strategic Investment Comparison between Stock Portfolio and Direct Investment in a Value Added Business, Selected Characteristics

Selected Investment Characteristic	*Portfolio of Publicly-traded Stock of Value Added Businesses*	*Direct Investment in a Value Added Business*
Liquidity	More liquid	Less liquid
Amount of Management Time	Less management	More management required
Nature of Financial Risk	Less risk but potentially lower return as well	More risk and potentially higher return
Influence on Diversification	Diversifies asset base	Specializes asset base
Nature of Goal Alignment	Goal alignment nearly impossible	Goal alignment relatively easier but still difficult
Nature of Downstream Control	No downstream influence or control	Some downstream influence or control

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