FINANCING AND SUPPLYING INPUTS TO THE 21ST CENTURY PRODUCER

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Staff Paper # 99-11

August 31, 1999

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Preface

The U.S. agricultural industry is in the midst of major structural change — changes in product characteristics, in worldwide production and consumption, in technology, in size of operation, in geographic location. And the pace of change seems to be increasing. Production is changing from an industry dominated by family-based, small-scale, relatively independent firms to one of larger firms that are more tightly aligned across the production and distribution chain. And the input supply and product processing sectors are becoming more consolidated, more concentrated, more integrated.

Agriculture in the 21st century is likely to be characterized by: 1) adoption of manufacturing processes in production as well as processing, 2) a systems or food supply chain approach to production and distribution, 3) negotiated coordination replacing market coordination of the system, 4) a more important role for information, knowledge and other soft assets (in contrast to hard assets of machinery, equipment, facilities) in reducing cost and increasing responsiveness, and 5) increasing consolidation at all levels raising issues of market power and control.

These profound changes in the agricultural industry present new challenges and new opportunities that require new ideas and concepts to analyze and implement. They require new learning and thinking. Some of those new ideas and concepts are presented here, not as empirically verified truths, but as "thoughts" to stimulate different and better thinking. They have been developed based on observations, analysis and discussions with numerous managers and colleagues in agribusinesses in North America and Europe. This series focuses on Financing and Supplying Inputs to the 21st Century Producer; companion series are also available on Farming in the 21st Century (Staff Paper 99-9), and Value Chains in the Food Production and Distribution Industries (Staff Paper 99-10).

Our purpose in sharing these "thoughts" is to invite discussion, dialogue, disagreement — in general to encourage others to develop better "thoughts".

Keywords: technology platforms, agricultural finance, marketing strategy, input suppliers, grower segments, financial markets

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Integration of the Financing and Product Industries in Agriculture

Traditionally, lenders have not viewed chemical, seed and fertilizer manufacturers or retailers as major competitors. And certainly livestock and grain packers and processors have been easily defined as participants in a different industry. Insurance companies have behaved predictably as participants in the risk management markets, and only in the financial markets as providers of mortgage financing. Industry boundaries were relatively well defined, and key competitors could be readily identified. But dramatic changes are occurring in the financial, risk, input and product markets in the agricultural industries. And these changes are significantly altering industry boundaries and fundamentally reshaping the competitive landscape of these industries. What are these changes and how are they impacting the competitive environment for industry participants and financial institutions in particular?

Production agriculture is increasingly being transformed from an industry that produces generic, undifferentiated products to one that manufactures specific attribute raw materials for unique consumer or end-user markets. This industry is thus becoming more interdependent and less fragmented than in the past, with an increased focus on supply or value chains characterized by tighter alliances from genetic and other input suppliers through producers, processors and food wholesalers and retailers to final consumers. This value chain approach is confounding historical definitions of and barriers between various stages or segments of the agricultural and food production and distribution industry.

One of the most logical combinations or integrations in the formation of these value chains is between the financial services industry and the risk management services industry. Insurance companies have always been significant players in both the risk and financing markets, but not as integrated providers. Instead, the investment division of life insurance companies in particular have been important providers of mortgage credit to farmers, whereas specialty crop and casualty insurance companies have been the major participants in the risk management markets. But risk is a key issue impacting the terms and rates of the financing package offered to specific customers, and it has been common-place for lenders to require various risk management strategies such as purchasing crop insurance as a condition for extending credit. More recently, new risk management instruments including price, yield and performance warranties by input supply companies and net income contracting in grain and livestock production have been introduced into the market by input suppliers and product purchasers. These new instruments and arrangements are resulting in an increasingly integrated risk management service industry and real product input supply and product processing industries.

Other examples of partial integration of previously separated industries can be cited. Some financial institutions are more formally integrating the financing and risk services industries as exemplified by the formation of Citigroup through a merger of Travelers Insurance Company and Citibank. In the last ten years, numerous input supply companies have formed their own financing subsidiary as evidenced by such organizations as Deere Credit Services, PHI Financial, Case Credit Corporation, and FS Credit Services which are specific examples of the integration of the input and financing industries. More recently, the processors and first handlers are offering financing to growers producing specialty or identity preserved crops to construct storage facilities and purchase other equipment uniquely needed for these crops as evidenced by the program offered by Cargill for storage facility investments.

The formation of more tightly aligned supply chains as noted earlier has resulted in the evolution of a new type of firm or business in the food production/distribution industries — the value chain integrator. The value chain integrator or coordinator is focused on providing an integrated package of products and services — a total systems solution that extends from end-user to input and raw materials supplier. He or she may provide only part of the products for services needed by the value chain from in-house resources, and outsource the remaining components of the integrated product service package. Thus, a firm such as Optimum Quality Grains may negotiate processor contracts for high oil corn and provide the genetic material to produce that corn, but the prescribed fertilizer and chemical inputs might come from DuPont, the financial services from PHI Financial and the risk management services from a traditional crop insurance provider. Alternatively, companies such as Koch Industries may actually provide a completely integrated package of financing, risk management, preoptimized fertilizer, genetic and chemical inputs, as well as a contract to purchase the product.

As noted in Figure 1, these value chain integrators are expected to have a significant impact on industry integration. They will dramatically change the boundaries and the competitive landscape of industries that have traditionally been definitive and separable. Lenders in particular will find that the challenges that they face in the future will not be how to compete with traditional financial service providers, but how to collaborate as well as compete with the total systems solution package of the value chain integrator or coordinator. In essence, the traditional lenders to agriculture — commercial banks and the Farm Credit System — may find that they do not define each other as their major competitors in the future, but that their most intense competition will be with firms such as ADM, Koch, and Cargill — companies that have not even shown up in the past on their radar screen.

Figure 1. Future Industry Integration

	Industries			
Providers	**Inputs/Services**	**Risk**	**Financing**	**Product**
Financial Institutions		X	X	
Input Manufacturers/ Suppliers	X		X	
Insurance Companies		X	X	
Processors			X	X
Value Chain Integrators	X	X	X	X

X = indicates a presence or a specific offering of products and services in that industry by the identified provider